Royal London Diversified Asset-Backed Securities Fund

Quarterly Report 30 June 2022

Asset split

	Fund (%)
Conventional credit bonds[2]	93.5
Index linked credit bonds	0.1
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.3
Foreign index linked sovereign	0.0
Derivatives	6.1
Other	0.0

Fund data

	Fund
Duration[3]	0.5 years
Gross redemption yield[4]	4.15%
No. of stocks	244
Fund size	£209.7m

Source: RLAM, based on the Z share class. Launch date: 24.09.2012.
[1]Benchmark: SONIA.
[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[3]Excluding cash
[4]The gross redemption yield is calculated on a weighted average basis

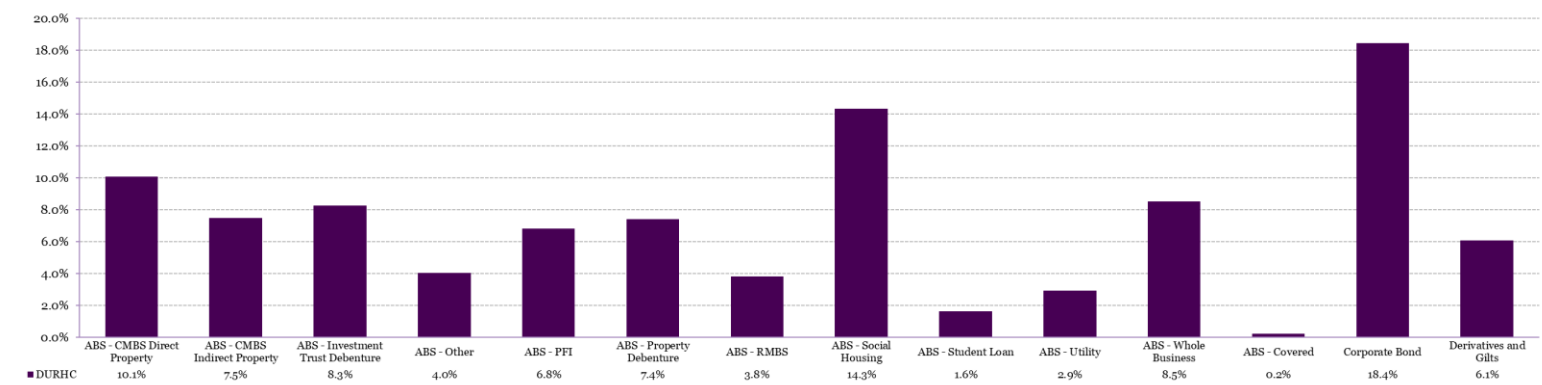
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q2 2022	**-1.19**	**0.22**	**-1.41**
Year-to-date	-1.06	0.31	-1.37
Rolling 12 months	1.24	0.34	0.90
3 years p.a.	3.07	0.31	2.76
5 years p.a.	2.90	0.45	2.45
Since inception p.a. 24.09.2012	3.86	0.48	3.38

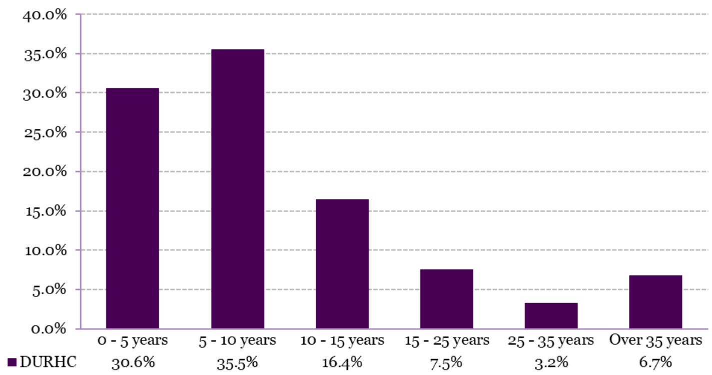
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.
Source: RLAM, based on the Z share class.
Please note that fund name was changed from RL Duration Hedged Credit Fund on 21 December 2020, and the objective amended, while the benchmark of that fund changed from 3-month LIBOR to SONIA, effective 8 August 2019. Both changes are reflected in the returns shown above.
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Sector breakdown

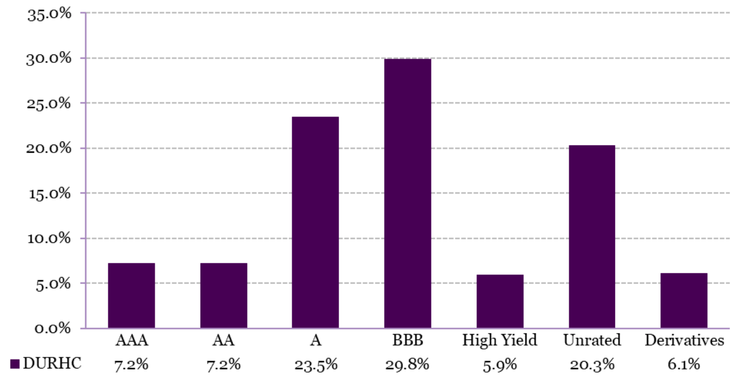


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Scottish Mortgage 6.875% 2023	1.8
British Land Co 5.264% 2035	1.7
Telereal Securitisation FRN 2033	1.6
Edinburgh Investment Trust 7.75% 2022	1.5
Trafford Centre 2038	1.4
Grosvenor UK Finance 6.5% 2026	1.1
Mercantile Investment Trust 6.125% 2030	1.1
Finance for Residential Social Housing 8.368% 2058	1.1
Annes Gate Property 5.661% 2031	1.0
Law Debenture 6.125% 2034	1.0
Total	**13.3**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

Fund activity and market commentary

- Inflation has been the headline macroeconomic market influence over the quarter. Increasing energy and commodity prices have added to the natural increase seen as the global economy continued to emerge from its Covid-induced slowdown of 2020 and 2021. Geopolitical events continued to weigh on sentiment as well, as Ukrainian resistance to the Russian invasion continued.
- Central banks have responded to rising inflation by tightening monetary policy and indicating that there is more to come. The US Federal Reserve (Fed) has led the way, increasing rates by 1.25% over the quarter – its clear threat to do more has led markets to price in a further 2% of hikes in 2022. The European Central Bank (ECB) was less aggressive – partly due to a more fragmented backdrop with the gap between German and 'peripheral' bonds widening in recent months – but confirmed that it will end its bond buying programme in July and signalled that a 25bps hike in July and even another 50bps in September will both be possible. The Bank of England (BoE) has increased rates by 25bps at every meeting since December 2021 and this continued through the quarter, with the fifth consecutive increase in June taking the UK base rate to 1.25%.
- In the UK, economic data generally indicated that growth was slowing, while inflation rose each month – CPI inflation for May hit 9.1% and the BoE has suggested it could reach 11% by the autumn. Growth indicators were weak, with composite PMI indicators deteriorating, consumer confidence still below pre-pandemic levels, and GDP underwhelming. A government £15bn fiscal package was designed to alleviate some concerns for consumers.
- Bond markets returns were hit hard in the period, as rising interest rates drove government bond yields higher globally (prices move inversely to yields): the UK's benchmark 10-year gilt yield rose by 62bps to 2.23%; the 10-year US treasury yield rose by 67bps to 3.01%; and the 10-year German bund yield rose by 78bps to 1.34%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, for example, gilt markets returned -7.42% on an all-maturities basis (FTSE Actuaries), whereas gilts with 5 years to maturity or less provided negative returns of just -0.76%.
- Total returns for the sterling investment grade credit market of -6.79% were less negative than gilts in the second quarter, but this was still the worst calendar quarter for sterling credit market this century. However, the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 45bps to 1.74%. This means that, on average, corporate bonds underperformed gilts of an equal maturity.
- In credit markets, defensive sectors continued to outperform on a relative basis, albeit still providing negative returns – supranational, covered and asset backed sectors outperformed, while financials (banks and insurance) were laggards, particularly subordinated bonds. Real estate was particularly weak in the period given the significant rise in base interest rates and future interest rate expectations. Credit quality benefitted relative returns in the period, with bonds in the AAA ratings band outperforming on a relative basis, followed by AA, A and BBB rated bonds – the high yield market underperformed investment grade credit.
- The second quarter was the weakest quarter for sterling credit markets this century, and although investors might typically expect bond markets to move inversely to equities, both equity and fixed income markets experienced significant losses globally in the period. The combination of rising inflation and falling growth has struck valuations down from the all-time highs, a result of ultra-loose monetary policy not just since the onset of Covid-19 but extending back to the Global Financial Crisis.
- The fund's hedging of duration risk prevented strong negative returns seen in the broader sterling credit market, while secured bonds, of which the fund holds a strong preference, performed well relative to the market. The major driver of negative returns in the period was the significant widening of credit spreads across sectors, and especially the financial sector where the fund has material exposure. When looking at excess returns (returns with the impact of duration/interest rate risk stripped out), the financial sector was one of the weakest in the second quarter. Security selection was a material benefit to fund performance, especially in the structured sector, helping to confine returns to only a small negative relative to the broader credit market for the quarter. There were positive contributions from a broad range of holdings, including **ICSL** (Student Loans), **Telereal**, and **ERF** (Equity Release Funding).
- Issuance was extremely limited in the second quarter, as rising rates deterred potential borrowers. However, given that first quarter issuance was relatively strong as companies sought to refinance while interest rates remained low, it is little surprise to see a pause at a time when cost of issuance is increasing.
- While higher yields and spreads damaged absolute returns, market weakness has given us opportunities to add high quality cashflows at attractive spread levels. The social housing sector remained a key area of interest, with an attractive combination of strong ESG credentials, high quality cashflows, security and zero historic defaults. During the quarter we bought a new issue from **Jigsaw** and **bLEND** – an aggregator

which helps smaller housing associations access capital markets. We also added a new issue from **Hexagon**, a smaller association but one that is highly rated and offered an attractive spread compared to the sector.

- Given the fund's preference for secured bonds, we also took the opportunity presented by volatile markets to purchase attractively priced securities across the wider secured space. In primary, we added new issues from breakdown recovery company the **AA**, and the UK private rental sector (PRS) business, **Folio Residential Finance.** Both of these bonds offer a senior secured claim on the underlying assets and cash flows of the issuers, supplemented by supportive triggers to help dampen ongoing credit risks. In secondary markets, we added to attractively priced ABS across both FRNs and fixed rate bonds. This included AAA RMBS and CMBS, such as **Together** 2018-1 A and **Taurus** 2018-UK2 A, as well as secured corporate bonds exhibiting longer spread duration such as **Connect** m77/GSO, an infrastructure bond that was issued to fund the refurbishment of motorways in Scotland and **Gwynt Y Mor**, the Offshore Transmission operator, which brings electricity back from an offshore windfarm in Wales on to the national grid.
- Helping to illustrate the risk and return benefits of secured bonds, a major positive contributor to performance in the quarter was a bond issue from **Telereal Securitisation Plc**. Telereal is a key infrastructure asset for the UK, leasing telephone exchanges to BT (British Telecoms) and enabling BT to provide its fixed line telecommunication network. Telereal undertook a liability management exercise in the quarter, which we participated in – as part of this exercise, the company redeemed two bonds at a significant premium. The company then issued two new bonds at above-market spreads, and given the secured nature of the bonds, the key importance of the underlying assets for the UK and their strong credit ratings, we were happy to buy the new bonds.
- Financials, notably banks, remain a material part of the sterling credit market but a less significant part of the fund allocation. Financials had lagged in March and April, and new issue pricing was therefore attractive. Given fund diversification we were able to take advantage of these opportunities selectively, adding senior bonds from US names **Goldman Sachs, Wells Fargo** and **Bank of America** at elevated spread levels. We also added new issues from Deutsche Bank and OP Corporate Bank.
- Secondary market disposals were mainly undertaken to manage liquidity in the fund, but also to raise cash for the purchase of new issues. In the period we sold bonds across sectors, including financial services (specifically banks), real estate, social housing utilities, and structured bonds. Sales included bonds from **BNP Paribas**, **British Land**, **Scottish Power** and a structured bond from **Lunar Funding**.
- There were no defaults in the portfolio during the quarter and across the corporate sector failures remain at low levels. While defaults are likely to increase from the current very low levels as we transition back to more normal economic conditions, we believe that the fund is well positioned for this. The fund has a material exposure to BBB bonds where compensation for default risk remains elevated and losses are further dampened by security, strong covenants and, in the majority of cases, a senior claim on issuers' assets and cashflows. Credit risk is not something that should be taken unthinkingly but it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.
- Our credit philosophy is based on the sustainability of our lending position over the long term. Environmental, social and governance (ESG) integration has to be a part of this consideration: these factors can play a part in determining the financial future of a company and are therefore integral for any effective assessment of credit risk. We continue to believe that lending on a senior secured basis, with strong covenants, can have a dampening effect on rising governance-related risks for a large part of the fund. From an environmental perspective, we continue to carry out bespoke engagement with issuers, with further detail available in our ESG integration report.

Key views within the portfolio

- A bias towards senior asset backed securities, an area that we believe still offers the best risk/return characteristics.
- Very limited exposure to junior tranches of securitisations, where downgrade, loss and extension risks are heightened.
- Selective exposure to unsecured debt (less than 20% of the corporate bond element), targeted at well-regulated financial debt and undervalued corporate debt.
- Zero exposure to supranational bonds, as we expect secured debt and corporate debt to outperform over the medium term.
- An exposure to credit risk with minimal exposure to interest rate risk (hedged with interest rate swaps).

Outlook

- Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, central bank interest rate increases are already showing signs of slowing down activity and we believe that inflation will peak in major economies during the second half of 2022. Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see a move higher in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors, and other factors.

- Despite the worsening economic outlook, we believe that the widening in credit spreads has taken valuations to attractive levels, relative to government bonds. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the long end of markets where all-in yields still look challenging.
- The BoE announced in May that it will begin the sale of its holdings of corporate bonds from the week commencing 19 September, via a regular multi-stock auction. While its buy programme had a significant (if only temporary) impact on sterling credit markets, we do not expect the same for the sale. Although the holding is material in size, it is not a structurally significant portion of the market, and with the proposed sale's timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.

Find out more

- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars, and other mediums. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.com, including regular *JP Journal* updates from Head of Fixed Income Jonathan Platt.

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