Royal London Investment Grade Short Dated Credit

Quarterly Report 30 June 2022

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	97.9	99.7
Index linked credit bonds	0.2	0.0
Sterling conventional gilts	1.9	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.3
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	3.3 years	2.9 years
Gross redemption yield[4]	4.24%	3.35%
No. of stocks	272	497
Fund size	£1,582.3m	-

Source: RLAM, based on the Z share class. Launch date: 07.12.2015.
[1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index
[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

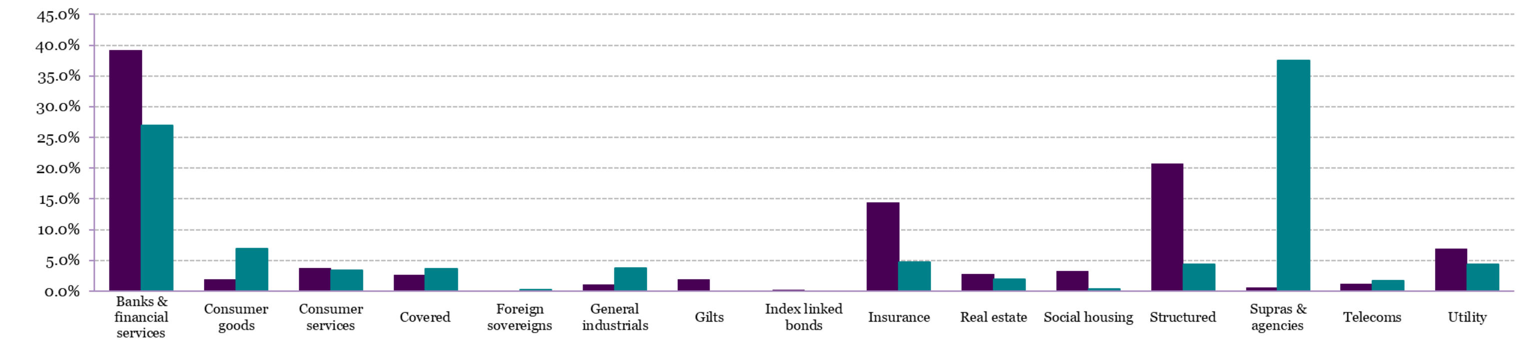
	Fund (%)	Benchmark[1] (%)	Relative (%)
Q2 2022	**-3.31**	**-2.19**	**-1.13**
Year-to-date	-5.77	-4.88	-0.90
Rolling 12 months	-6.22	-5.80	-0.43
3 years p.a.	-0.21	-0.56	0.35
5 years p.a.	0.73	0.33	0.40
Since inception p.a. 07.12.2015	1.41	1.00	0.40

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. 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. [1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index. Performance for the Royal London Investment Grade Short Dated Credit fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over longer measurement periods.As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Top 10 Country of issue

	Fund (%)	Benchmark (%)
United Kingdom	61.6	28.5
France	7.1	7.2
United States	6.8	8.2
Netherlands	3.5	6.9
Germany	3.4	13.9
Jersey	3.0	2.1
Australia	2.6	1.9
Canada	2.1	4.4
Spain	2.0	2.1
Switzerland	1.5	0.9
Other	6.5	23.8
Total	**100.0**	**100.0**

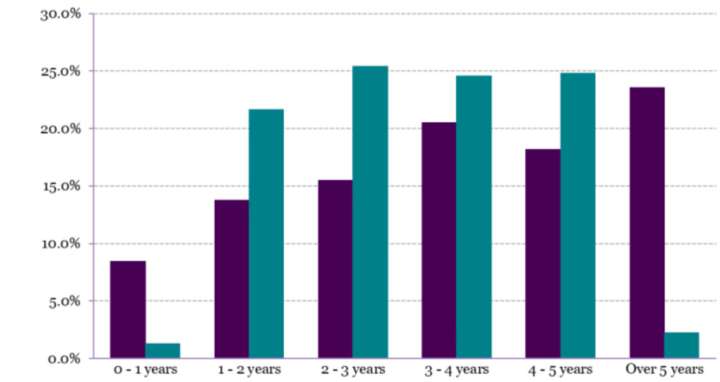
Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Gilts	Index linked bonds	Insurance	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
INVSD	39.1%	1.9%	3.7%	2.6%	0.0%	1.0%	1.9%	0.2%	14.3%	2.7%	3.2%	20.7%	0.6%	1.2%	6.9%
Benchmark	26.9%	6.9%	3.4%	3.6%	0.3%	3.8%	0.0%	0.0%	4.8%	1.9%	0.4%	4.4%	37.5%	1.7%	4.4%

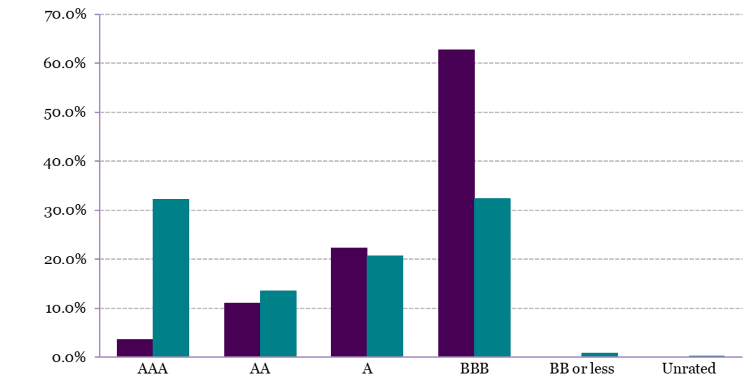
Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



	0 - 1 years	1 - 2 years	2 - 3 years	3 - 4 years	4 - 5 years	Over 5 years
INVSD	8.5%	13.8%	15.5%	20.5%	18.2%	23.6%
Benchmark	1.3%	21.6%	25.4%	24.6%	24.8%	2.3%

Credit breakdown



	AAA	AA	A	BBB	BB or less	Unrated
INVSD	3.7%	11.1%	22.4%	62.8%	0.0%	0.0%
Benchmark	32.3%	13.5%	20.6%	32.4%	0.9%	0.3%

Ten Largest Holdings

	Weighting (%)
UK Treasury 0.75% 2023	1.9
Land Securities Capital Markets Plc 1.974% 2026	1.2
Delamare Finance 5.5457% 2029	1.1
BNP Paribas 2% 2031	1.1
Places For People Homes 5.09% 2043	1.1
Credit Suisse Group 2.125% 2025	1.0
Western Power Distribution Holding 3.875% 2024	1.0
Zurich Finance 6.625% VRN Perpetual	1.0
AXA 6.6862% VRN Perpetual	1.0
Heathrow Funding Ltd 6.75% 2028	0.9
Total	**11.4**

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

Market overview

- 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.

Portfolio commentary

- 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 underperformed the market during the quarter. Credit sector allocation was the most significant performance detractor, specifically our preference for subordinated financials (particularly in insurance), which underperformed the market, and our substantial underweight in supranational bonds, which outperformed. On the other hand, stock selection was positive in the period, particularly in the structured bonds sector, as well as in social housing and real estate. This performance was underpinned by our proven investment philosophy, favouring secured bonds with strong covenants, and focusing on bottom-up research to identify borrowers with resilient cashflows and robust balance sheets.
- Within subordinated insurance, key detractors included bonds from the likes of **Aviva** and **M&G** – as these have substantial assets on their balance sheets they tend to be marked down in difficult markets, but these are businesses we believe will remain resilient in the long term. As a high beta sector (a sector which typically underperforms during a negative market environment but outperforms in a positive environment) we were not surprised or deterred by the impact of our preference to subordinated financials on performance in the short term, and we remain highly confident of the long-term value offered by the bonds held in our funds. Although the underweight in supranationals hurt performance, we are comfortable with our stance given the sector offers a very low yield premium that can be materially improved elsewhere in the market without taking excessive risk.

- Issuance was extremely weak 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.
- Financials, notably banks, remain a material part of the sterling credit market and source of new issues. Financials had lagged in March and April, and new issue pricing was therefore attractive, adding senior bonds from **Deutsche Bank**, **Royal Bank of Canada** and **OP**. We also added a **Yorkshire Building Society** senior non-preferred new issue at a yield premium of over 200bps. These bonds are senior within the capital structure, but can be 'bailed in' in event of bank failure and so came to market at significant spread premium. In effect these sit between traditional senior and subordinated bonds, and offer an attractive premium to more usual senior bonds. Within subordinated bank bonds, we added a new perpetual bond from **Virgin Money** at a very attractive yield levels.
- In the secondary market we used weakness to add to preferred names, notably in the structured sector with an attractively priced asset backed bond from **Broadgate Property Holdings**, a AA rated bond from **Octagon Healthcare** and a real estate bond from **MPT Operating Partnership.**
- The focus on ESG factors was accelerated by the pandemic and then again by the invasion of Ukraine, the latter focusing attention on the transition away from fossil fuels both from a geopolitical and climate change perspective. An easy way to do this is sell exposure to utilities and focus portfolios on the likes of green bonds. But as with credit ratings, we believe that such 'simple' solutions will not produce desired outcomes for investors or wider society. Our ESG integration retains engagement and in-house research at its core. As long-term lenders of our investors' money, we are naturally suspicious of 'easy' ways to 'green' a portfolio, and ensure we integrate ESG factors into our investment decision because we feel it is irresponsible not to. Please see our quarterly Sterling Credit ESG report for details of recent activity.

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 focused on identify 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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