Royal London Short Duration Global High Yield Bond Fund

Quarterly Report 30 June 2022

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q2 2022	**-6.46**	**0.22**	**-6.68**
Year-to-date	-7.50	0.31	-7.81
Rolling 12 months	-6.13	0.34	-6.47
3 years p.a.	-0.77	0.36	-1.12
5 years p.a.	0.67	0.48	0.19
Since inception p.a. 15.02.2013	2.53	0.49	2.03

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 Inc share class. Performance for the fund is calculated on a mid basis with income re-invested.

[1]Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 15 December 2020, and is reflected in the returns shown above.

Fund price and yields

	Distribution yield
Fund	5.35%

Source: RLAM and State Street. Based on the Z Inc share class.

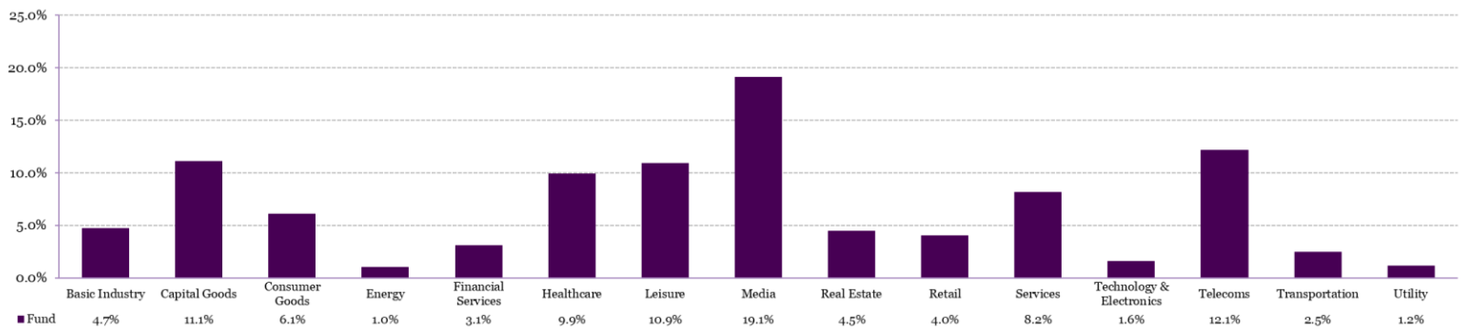
[2]Excluding cash

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.

Fund data

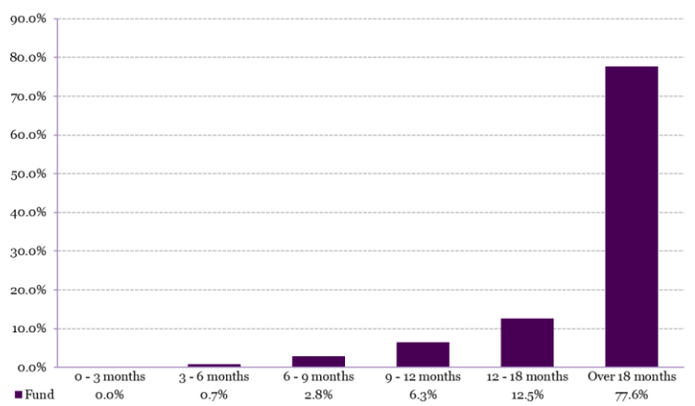
	Fund
Duration[2]	1.9 years
No. of stocks	114
Fund size	£1,140.9m
Launch date	15.02.2013

Sector breakdown

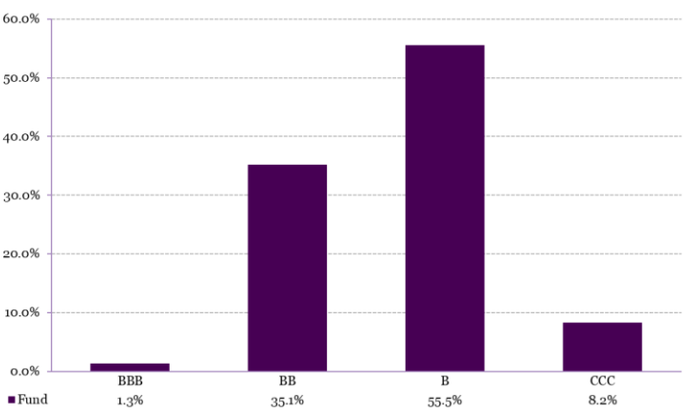


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Transdigm Inc 6.25% 2026	2.0
AMC Networks Inc 4.75% 2025	1.8
Grifols 3.2% 2025	1.8
CCO Holdings Llc 5.125% 2027	1.8
Silgan Holdings Inc 3.25% 2025	1.8
Mauser Packaging Solutions Holding 5.5% 2024	1.7
Wesco Distribution Inc 7.25% 2028	1.7
Gray Escrow Inc 7% 2027	1.6
Virgin Media 5.0% 2027	1.6
Uber Technologies Inc 7.5% 2027	1.6
Total	**17.4**

Source: RLAM. Percent of fund is based on Security's fund Base Value over Total fund Base Value less Cash and FX Hedging, subject to rounding.

Market overview

- Inflation was the headline macroeconomic influence over the quarter, although this crystallised into fears of recession in June. Higher energy and commodity prices added to the supply chain-related increases seen as the global economy emerged from the Covid-induced shutdown of 2020 and 2021. Geopolitics continued to weigh on commodity prices and sentiment, as Ukrainian resistance to the Russian invasion continued.
- Central banks responded to this rising inflation by tightening monetary policy and indicating that there is more to come. The Federal Reserve led the way, increasing rates by 1.25% over the quarter – its clear commitment to do more has led markets to price in a further 2% of hikes in 2022. The European Central Bank 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 25 basis points (bps) hike in July and another 50bps in September are both possible. The Bank of England has increased rates 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%.
- Bond markets returns were hit hard in the quarter, as rising interest rates drove government bond yields higher globally (prices move inversely to yields): the benchmark 10-year US treasury yield rose by 67bps to 3.01%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk).
- Meanwhile, the high yield spread widened by another 182bps to 614bps, taking the yield on the broad high yield index (including CCC rated bonds) to 8.9% – the quarter saw three consecutive months of higher yields and wider spreads, although most of these shifts occurred in June. This was the third worst month for our benchmark (the ICE BofAML (BB-B) Global Non-Financial High Yield Index) since it launched in 1997, as the market started to discount a recession rather than a slowdown. The benchmark delivered returns of -10.30%, making this one of the most difficult quarters for some years. The combined impact of the first and second quarters was particularly painful, with the market down over 15% since the start of the year. After a record year for new issues in 2021 with c. $500bn of high yield issuance, the adverse market conditions caused new issuance to remain minimal in the second quarter having more-or-less dried up in January.
- The outlook for the next six months isn't overly negative for the asset class. While it seems likely that there will be a recession (there will almost certainly be a technical recession of two consecutive quarters of negative growth), this would be manageable if it were reasonably shallow. Beyond this, however, it is less clear whether central banks will have to raise rates further to bring inflation under control and this lack of visibility beyond year end is what is weighing on markets at present. For anything other than a deep and sustained recession, however, the current spread and yield offer some protection to investors.

Portfolio commentary

- The fund performed strongly over the quarter relative to its all-maturities peer group, but underperformed its Sterling Overnight Index Average Rate (SONIA) benchmark due to the weakness in global bond markets. However, it has significantly outperformed the benchmark over the rolling 12-month period.
- We took a cautious approach for the quarter, in keeping with this defensive strategy, recognising that the closure of high yield primary markets is a signal for additional uncertainty. Thus our focus is on keeping duration short by not reinvesting proceeds from redemptions, thus building up cash balances through this period of volatility.
- We still find the global high yield curve technically very interesting and the front end very cheap. Over the course of the second quarter, we lost some names to redemptions (including **Sinclair Television Group**, **TerraForm Power**, **Cogent Communications**), reduced position sizing (**Casino**) and exited names (**TK Elevator**, **VTR**). These positions were replaced with some new holdings (**Stonegate**, **Ardagh**, **Puregym**).

Outlook

- As we said in our report for the first quarter, we turned more defensive in March to navigate the remainder of 2022 – derisking our funds by reducing duration and increasing security. While the near term is relatively unthreatening, the outlook for interest rates and economic growth is very unclear heading into 2023 and we will retain a defensive mindset until the prognosis for inflation is clearer.
- Columbia University academic Adam Tooze says the current combination of economic phenomena is truly unprecedented. He cites the Bank of International Settlements (BIS), which takes much the same view in its latest annual economic report: "*As the BIS remarks, the combination of inflationary and recessionary forces that we are currently facing, along with financial stability risks is "historically unprecedented". It is worth saying that when the BIS says this, it is not merely an impressionistic remark intended to convey the drama of the moment, or an*

overused journalistic cliché. It is a precise statement based on the comparison of the current conjuncture with all relevant data in its database, stretching back to 1945. It is all the more attention-grabbing for that.

"To repeat: In the last 18 months we have seen the fastest global growth in 50 years, followed by the most rapid slowdown, creating what is in the BIS's view, a global economic configuration unprecedented in history. Specifically, we have never seen such a combination of already rapid inflation and rapidly slowing growth with elevated financial vulnerabilities, notably high indebtedness against a backdrop of surging house prices… In the current conjuncture, if you aren't puzzled you don't get it. This isn't your common or garden slowdown. Admitting to disorientation is a sign of honesty and realism" (as quoted by John Authers – Bloomberg Opinion, 28/6/22).

- Other than caution due to the very unclear macroeconomic outlook, the high yield market is pricing in a severe recession and we feel it now offers some value. With spreads at over 640bps at the end of June, the implied five-year cumulative default rate is 33%. This compares to cumulative default rates of 25% during the Global Financial Crisis and 30%+ in the 1990s and early 2000s.The all-time high was 41% in the long and deep depression of the 1930s. So, while defaults are currently at record lows, the high yield market is discounting a major recession and commensurate level of defaults.
- Yet this implied default rate takes no account of the much higher quality and more robust nature of the high yield market today, compared to 2008/9; nor of the current financial state of issuers as we head towards the downturn. The future default cycle is unlikely to be as negative as prior cycles because the market composition has improved: the highest risk CCC rating band now only represents 9% of the market, compared to 17% in 2007; meanwhile, the BB rated band now accounts for 60% of the market. In addition, following the bumper issuance of 2020 and 2021 (and the strength of the energy sector in 2021 and the first half of 2022), most issuers are in a stronger position than normal at this stage of a cycle and default and recovery expectations remain extremely benign.
- Unlike equities, given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment, however, so we will maintain our defensive positioning until there is more clarity about the outlook. We will be paid sufficiently for adopting a lower-risk position and expect this to continue for the next two quarters at least. The way through difficult markets is to focus on those risks that you can control and know what you own. We will keep duration low and focus on the quality of issuers' financials, rather than relying on third-party ratings: at a sectoral level, cashflows are the key factor, so we need to know about on- and off-balance sheet leverage. We prefer not to wait for defaults as the recovery process can take time: however, should they occur, the key is to have an adequate solvency cushion.

Find out more

- Royal London Asset Management (RLAM) recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March.
- There are regular updates on our investment thinking in the *Our views* section of www.rlam.com , including a blog each Monday from Head of Fixed Income Jonathan Platt on key issues in sterling credit and other fixed income markets. We also deliver regular webinars – please visit the RLAM Digital Insight Hub.

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