Royal London Sterling Extra Yield Bond Fund

Quarterly Report 30 June 2022

Executive summary

- The fund recorded a return, gross of tax and management fees, of -3.65% for the quarter, giving a total return of -3.03% for the rolling 12-month period. Performance in the quarter reflects weakness in government bond markets, the widening of investment grade and high yield credit spreads, and the sensitivity of some of the fund's holdings to higher interest rates; these factors were partly offset by strong performance from some areas of its broad range of investments and by robust income generation.
- In economic terms, the second quarter was largely a continuation of the first. Inflation was again the headline influence, although this crystallised into fears of recession in June. UK economic data generally indicated that growth was slowing, while inflation rose each month – annual CPI inflation for May hit 9.1% and the Bank of England (BoE) has suggested it could reach 11% by the autumn. The BoE has increased rates at every meeting since December 2021 and this continued through the quarter, with the fifth consecutive increase in June taking the base rate to 1.25%. Having started later, the US Federal Reserve is now leading the charge against inflation, increasing rates by 1.25% over the quarter – markets are pricing in around 2% of further US hikes in 2022.
- Rising interest rates drove government bond yields higher globally. The benchmark 10-year gilt yield rose by 62bps to 2.23%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, the gilt market returned -7.42% on an all-maturities basis (FTSE Actuaries), whereas gilts with five years or less to maturity posted a negative return 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 the 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. Meanwhile, global high yield markets returned -10.30% (ICE BofAML (BB-B) Global Non-Financial High Yield Index). The high yield market was down over 15% in the first half of the year.
- Distributions in respect of the second quarter, payable at the end of August, are 1.62p, 1.45p, 1.53p and 1.51p, respectively, for the A, B, Y and Z class income shares, moderately lower than the 1.68p, 1.51p, 1.58p and 1.57p distributed for first quarter of 2022, but above the 1.55p, 1.38p, 1.47p and 1.45p distributed for the fourth quarter of 2021.

Performance

	Fund (Class A) (%)	Fund (Class Z) (%)
Q2 2022	**-3.65**	**-3.65**
Year-to-date	-4.98	-4.98
Rolling 12 months	-3.03	-3.04
3 years p.a.	2.63	2.63
5 years p.a.	4.36	4.36
10 years p.a.	8.10	-
Since inception p.a. 13.12.2013	-	6.35
Since inception p.a. 14.04.2003	7.69	-

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. *Source: RLAM. Based on the A and Z Income share classes. Performance for the fund is calculated on a mid basis with income re-invested. The fund returns in the table above are gross of fees. 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.*

Fund commentary

- The quarter proved challenging with higher interest rate expectations impacting some of the individual holdings in the fund. However, while it delivered negative returns for the quarter, the fund significantly outperformed the sterling investment grade credit and global high yield markets, reflecting the resilience of many of its holdings, its relatively short duration, a weighting of over 10% in floating rate assets (where income rises on higher interest rates) and the benefit of robust income generation. In addition, the increase in energy prices – Brent crude oil rose another 6.4% to nearly $112 a barrel – supported the performance of bonds of energy businesses **Harbour Energy** and **Waldorf Production**; shipping group **SD Standard**; and offshore services businesses **BW Offshore**, **DOF Subsea**, **Floatel** and **REM Saltire**. Short-dated bonds generally held up relatively well, while secured bonds in the property sector also proved to be resilient.

- Despite these factors, however, the fund wasn't immune to the adverse environment. Holdings in the banking and insurance sectors were the areas of most evident weakness, with bonds of **Aviva**, **BUPA**, **M&G**, **NatWest Bank** and **Scottish Widows** all significantly down in price. Holdings in the hybrid bonds of utility **EDF,** where the issuer has the option to extend the maturity of the bonds beyond their first call date but at increasingly penal cost, were also down sharply – the hybrid sector, like financials, tending to be particularly sensitive to market sentiment. Some longer-dated structured bonds were also impacted, including **Progress Heathcare**, **Punch Taverns**, **Tesco Property** and **Unique Pub Finance**, as these were more sensitive to the rise in gilt yields; while bonds in the retail sector, including **Co-op Group** and **John Lewis**, were also down on deteriorating sentiment with the squeeze on consumer spending.

- New issues were limited by the volatile conditions throughout the quarter. Purchases included UK energy business **Enquest**, which offered 9% income for up to five years unless repaid earlier at a premium, and BBB rated bonds of commercial property business **Blackstone Property**, offering a near 5% yield for their 10-year term. We also bought new issues of **Bayport**, the microloans company operating in developing countries, which was refinancing the maturity of an existing bond held in the fund, and Scandinavian transport fuel provider **Greenbit**, orientated towards increasing provision of renewable products. The fund also participated in new issues of **Barclays**, sterling-denominated and offering 8⅞% income to first call in 2027, and dollar-denominated bonds of finance group **Julius Baer**.

- **Virgin Money** announced a new issue of subordinated bonds, offering a yield of 8¼% until the first call date in 2027, while also tendering at a price of 101¾ for their 8% bonds callable in December this year. The fund participated in both the new issue and also the tender for its holding of the 8% bonds. Similarly, **Lime Petroleum**, the Norwegian continental shelf oil and gas production company, announced a new issue of 2025 bonds, paying 9¼% over short-term Norwegian Krone interest rates, as part of acquisition financing of a stake in the established Brage field – the new bonds repay in instalments over their three-year term reflecting its strong cash flow generation. The company also announced the exercise of its repayment option of its 2024 bonds, issued in June last year, having paid interest at a rate around 10% and repaid at a price above 108. Again, the fund participated in the new issue and benefitted from the bond repayment.

- Weakness in the secondary market allowed us to add to positions at attractive levels. Holdings in financials **Bupa**, **Allianz**, **Generali**, **Virgin Money** and **Ing Group** were increased at the prevailing lower prices and correspondingly higher yields. Similarly, we also added to the holdings of utilities **EDF** and **Thames Water,** together with materials business **Monaco Resources** and BBB rated bonds of **Medical Properties Trust**, the US healthcare property group. In June, funds to support these purchases were realised by the repayment of secured bonds of **GLH Hotels**, of resources group **MetalCorp bonds**, and early repayment of energy business **Pandion** bonds at a price moderately above their par value, and by partial repayment of the **Opus** structure, where underlying assets are loans issued under the government backed and guaranteed Covid Business Interruption Loan Scheme, which is now effectively in run off. The holding of shorter-dated bonds in property group **Peel Holdings** was reduced as the opportunity arose to purchase longer dated bonds in the company at more attractive pricing. We reduced the holding of **Norwegian Energy** shares. These had been received as part of a bond restructuring almost 10 years ago, together with a tranche of bonds since repaid. Liquidity in the company's shares has typically been low, but strong operational performance in early April, together with clear progress on the redevelopment of the Danish offshore gas field Tyra, triggered a sharp uptick in both share price and liquidity. The fund's holding was progressively reduced, the shares having more than doubled in price since the end of 2021. Finally, activity in short-dated **UK gilts** reflected short term liquidity management in the fund.

Investment 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 harsher financial environment. We will maintain the focus on investing in 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 more challenging 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 we believe investors are being paid well to take credit over government bond risk.
- 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. While the fund holds no bonds in the BoE programme, the effects seem likely to ripple into the wider market, at least in the shorter term.

Fund price and yields

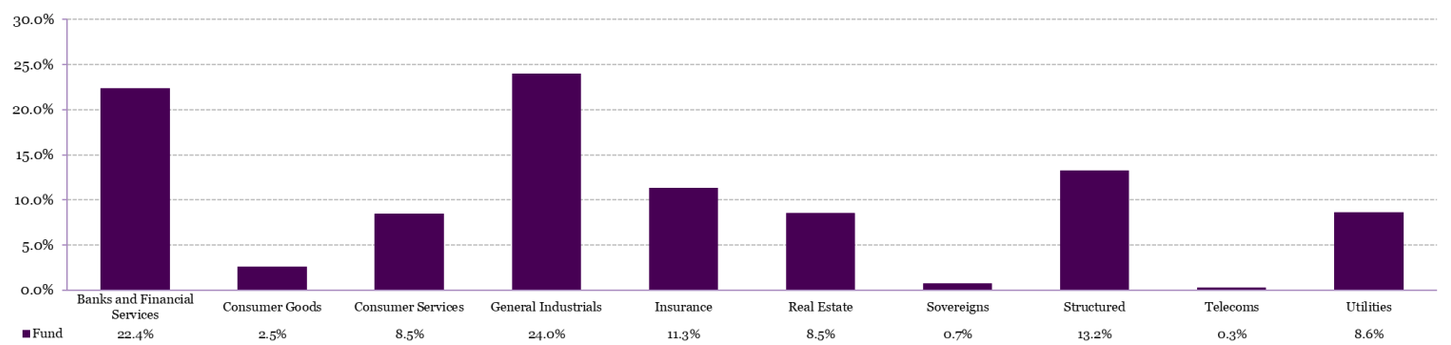
	Fund (Class A)	Fund (Class Z)
Gross redemption yield	6.60%	6.86%
Gross income yield	5.86%	6.13%

Source: RLAM and State Street. Based on the A and Z 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

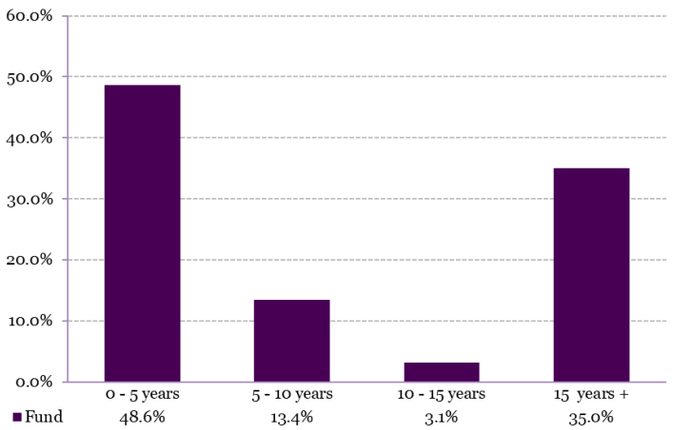
	Fund
Duration[2]	4.2 years
No. of stocks	215
Fund size	£1,621.3m
Launch date	11.04.2003

Sector breakdown



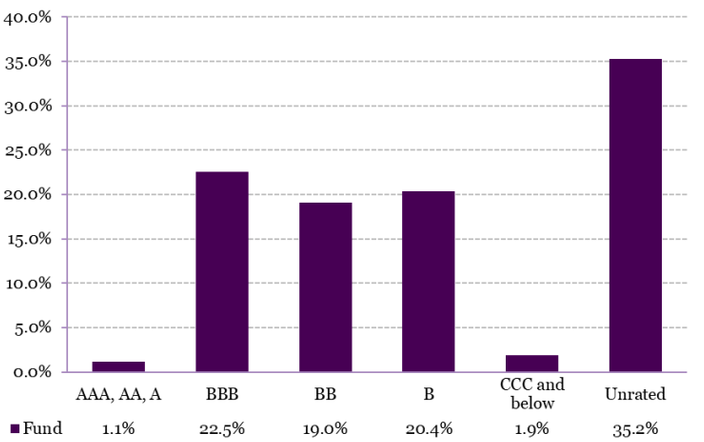
Source: RLAM. Figures include the impact of cash held.

Maturity profile



Source: RLAM. Figures include the impact of cash held.

Credit breakdown



Source: RLAM. Figures include the impact of cash held.

Ten Largest Holdings

	Weighting (%)
Santander UK 10.0625%	2.5
Co-op Group 6.25% 2026	2.3
Centrica 5.25% 2025/75	2.2
Électricité De France 5.875% 2029	2.1
Thames Water 4.625% 2026	2.0
Santander UK 10.375%	2.0
M&G 6.34% 2043/63	1.8
Metrocentre Finance 8.75% 2023	1.8
Phoenix Group 5.75% 2028	1.6
Heathrow Finance 4.375% 2027	1.5
Total	**19.6**

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

Currency breakdown

	Fund (%)
Sterling	75.1
US Dollar (hedged 11.5%)	15.2
Euro (hedged 4.6%)	5.8
Norwegian Krone	3.6
Swedish Krona	0.2
Canadian Dollar	0.0
Total	**100.0**

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

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