Royal London Multi Asset Credit Fund

Quarterly Report 31 March 2022

Asset split

	Fund (%)
Loans	35.3
Secured high yield	17.5
Short duration high yield	14.7
Conventional high yield	14.5
Asset backed securities	2.1
Investment grade corporate bonds	0.0
ROW	1.4
CLOs	14.6

Fund data

	Fund
Duration[1]	2.2 years
Yield to Expected	5.7%
Fund size	£925.3m

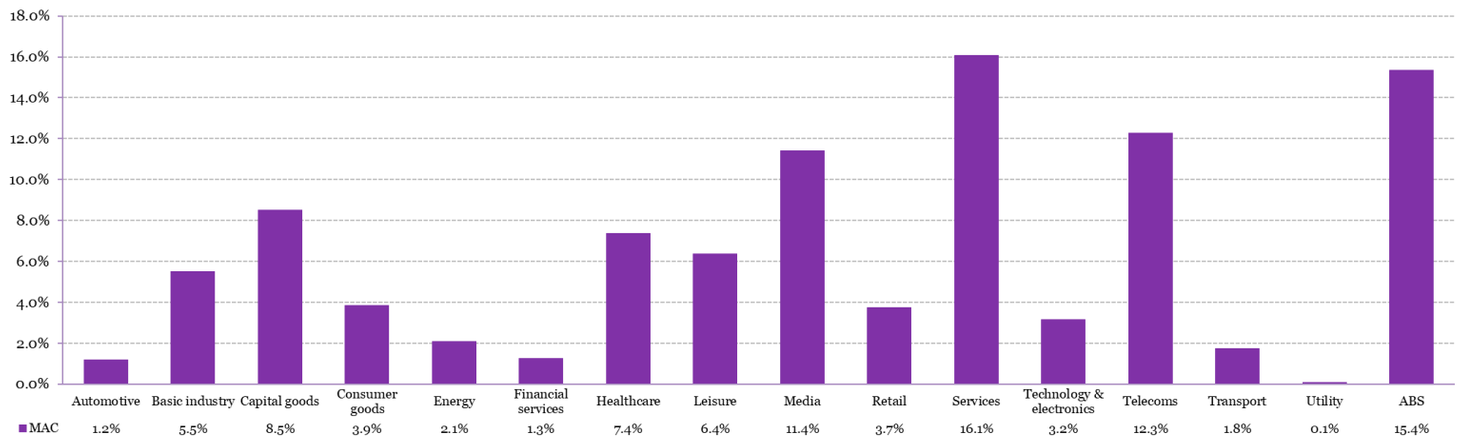
Source: RLAM and State Street. Based on the Z Inc share class.
Launch date of the share class: 09 October 2017.
Figures in relation to the asset spilt table exclude the impact of cash where held.
[1]Excluding cash
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q1 2022	**-1.39**	**0.10**	**-1.49**
Year-to-date	-1.39	0.10	-1.49
Rolling 12 months	2.38	0.14	2.24
3 years p.a.	4.46	0.35	4.11
Since inception p.a. 09.10.2017	3.84	0.47	3.37

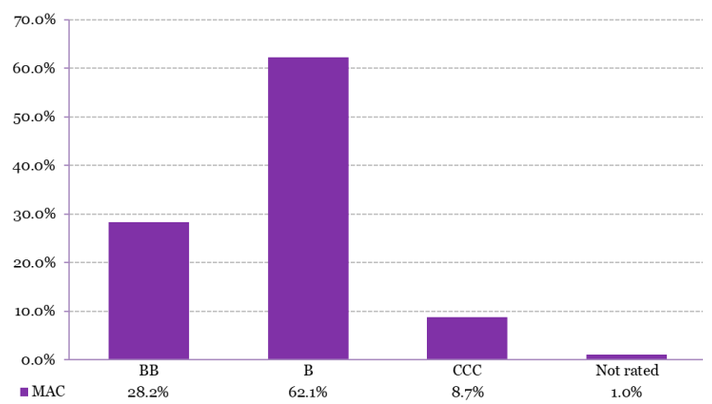
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.
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.

Sector breakdown

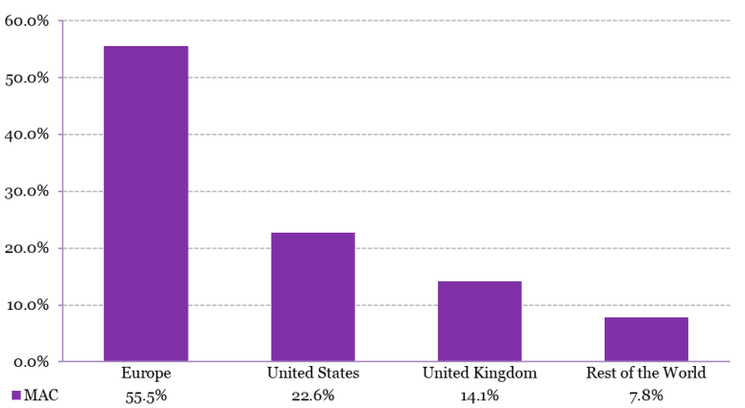


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Rating breakdown



Regional breakdown



Market overview

- The combined impact of geopolitical events and the changing outlook for growth and inflation made the first quarter particularly challenging for high yield investors. In all three months of the period markets ended with higher yields, with the first two months of the year delivering a 'double whammy' of higher government yields and wider high yield credit spreads. The benchmark 10-year treasury yield increased sharply over the quarter from 1.51% to 2.34%, having reached a highpoint of 2.47% in late March. As a result, US treasuries delivered a quarterly return of -4.90%; UK gilts were weaker still, returning -7.17%. Meanwhile, the high yield spread widened by c. 125 basis points (bps). Our broad benchmark (the ICE BofAML (BB-B) Global Non-Financial High Yield Index) delivered returns of -5.62%, making this one of the most difficult quarters for some years. Nonetheless, while delivering negative absolute returns, our funds performed well relative to their peers.
- High yield markets had started the year in rude health with an ultra-low default rate and a spread of c. +350bps giving a yield of 4.2%. However, with hindsight last August was a significant turning point as the interest rate risk environment started to deteriorate, albeit without impacting spreads. However, it was only the publication in early January of the minutes of the December FOMC meeting that it became clear that the Federal Reserve was prepared to increase interest rates significantly faster and further than expected just a few months before. The Bank of

England also signalled that it is tightening monetary policy sharply, raising interest rates again and reversing its quantitative easing programme, while the European Central Bank accelerated the end of its net asset purchases programme.

- High yield investors initially saw inflation as an interest rates story that would mainly play out through government bond markets and, without the Russian invasion of Ukraine, this might have remained the case. In January, government bond yields rose 40bps at the four-year point of the curve (the average duration of the high yield market). While spreads also widened 40bps, the dispersion of returns was fairly tight: although BB rated credits were impacted more than their B rated peers (-2.8% vs. -2.3%), resulting in a degree of compression, the difference was manageable and Covid-recovery sectors performed relatively strongly – as an example, the leisure sector was down only 1.7%. Perhaps surprisingly, given the Russian invasion of Ukraine, the story for February was similar: government bond yields continued to rise (although they narrowed into month end as investors weighed the likely impact of the invasion and the sanctions imposed on Russia by many governments, reducing the increase in the reference yield to just 15bps). Spreads widened further (41bps to +433bps), mainly after the invasion started on 24 February: while B rated bonds again outperformed BBs, dispersion still remained fairly limited.
- The main impact of the invasion was felt in March – intra month, spreads widened another 40bps to +470bps (making the quarterly shift +125bps) before rebounding to end the month at 391bps (+40bps from the start of the year), while government bond yields rose another 58bps. While the period as a whole delivered negative absolute returns, it was the change in sentiment in March that will have an enduring impact. While there was already a fear that central banks could tip economies into recession by overreacting to inflation (particularly in the UK and Europe), the invasion of Ukraine and strong response from many governments greatly increases this risk
- After a record year for new issues with c. $500bn of high yield issuance in 2021, the adverse market conditions caused new issuance to more-or-less dry up in the first quarter. Indeed, the market actually shrank in March, by c. $85bn, as Russian names were ejected from the index and Kraft Heinz regained its investment grade status. The resulting technical factors as funds built up cash reserves by an additional c. 1% through the receipt of coupons led some managers to seek value in the secondary market as the quarter came to a close – simply to manage cash levels. While the elevated uncertainty may continue to impact issuance, investment grade new issuance resumed from mid-March and we expect high yield issuance to follow suit in the second quarter, particularly as there is still significant leveraged buy-out (LBO) activity in the pipelines.
- Following the bumper issuance of 2020 and 2021 (and the strength of the energy sector in 2021 and into this year), most issuers are in a stronger position than normal at this stage of a cycle and default and recovery expectations remain extremely benign. However, while these market fundamentals remain positive and high yield markets are unquestionably higher quality and more robust than in previous recessionary environments (such as the early 2000s or heading into the Global Financial Crisis), it would be negligent not to see the quarter as a turning point. The shift in balance between 'greed and fear' means that high yield investors are now more risk-averse and will seek to be compensated by higher spreads.
- 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. To illustrate this, even though energy prices soared throughout 2021 and rose further still with the disruption from the sanctions that followed the invasion of Ukraine, the high yield energy sector still delivered negative returns in the first quarter. It is mainly a low coupon BB sector with a low spread and the operators tend to be hedged – as a result, the strength in energy prices was more than offset by the rise in reference government bond yields.
- While we were strongly bullish from the end of the first quarter in 2020 through to the start of 2022, we are now more defensively positioned. Given the rise in the reference yield and wider spreads, we believe we will be paid sufficiently for adopting a lower-risk position and expect this to continue for at least the next three quarters until the economic outlook becomes clearer.

Portfolio commentary

- Across our high yield and multi asset credit fund, we remained structurally short of duration. With less cushioning than other parts of the high yield market, the BB rated band is most sensitive to duration, so we were underweight here and favoured B rated credits. As the quarter unfolded, this proved prescient as fears about recession increased, putting pressure on the CCC rated band.
- While at very low levels (particularly compared to expectations), there was still some new issuance in the period. However, we continued to be very selective, passing on companies with weak business models or poor fundamentals, and preferred to build up a cash buffer in the expectation of better quality new issues in the quarter ahead.

- The fund performed strongly over the quarter relative to its 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; over both periods, returns relative to its peer group have been top quartile, with the 12-month performance ranked third percentile relative to its peers.
- We feel that the fund was positioned particularly well for a difficult quarter. We had reduced duration in the previous quarters with the market being driven more by macroeconomic factors and increased concerns about inflation (which we had anticipated directionally, albeit not necessarily in absolute scale). Performance came from higher short duration exposure and (as with RL Global High Yield) from having rotated from BB into B rated credits last summer as absolute yields were very low and we expected more rate volatility.
- Performance also benefitted from owning higher-quality credits (e.g. secured), which were more resilient in the challenging market conditions that prevailed for most of the quarter. Likewise, the performance of the fund benefitted from its exposure to loans, which we had increased over the previous quarter. This included leveraged loans and syndicated loan tranches (such as CLOs), which are attractive became of their floating rate nature and very short duration relative to the wider market, thereby offering protection against higher interest rates. CLOs also offer exposure to broad default rates, where our expectation is that these will remain relatively subdued given the current rates and refinancing activity.
- Over the quarter we increased our short duration bucket by adding **Darling, Dufry, Drax, Edgewell Personal Care** and **Intrum** among others. We also actively increased the secured high yield bucket (**Morton Salt, Inter Media, Voyage Care**) and added names from the leveraged loan primary market (**Cheplapharm, Scientific Games**).
- We reduced the regular high yield bucket over the quarter in keeping with our more defensive posture (selling names such as **Frontier**, **Carnival**, **Cinemark** and **Nielsen**).

Outlook

- Anyone who has read our recent quarterly reports or *2022 Outlook* article may be surprised that we have moved decisively away from the strongly bullish position that we had taken since March 2020 (when central banks stepped in with unprecedented speed to support financial markets from the full effects of the Covid-19 lockdown). After all, the fundamentals of the high yield market remain very positive with the record new issuance over 2020-21 and very low default levels. However, the key lies in the following excerpt from the outlook in our report for the fourth quarter of 2021: "While the average yield may still be low by historical standards, the improved economic prospects… continue to bode well for the asset class for the next few quarters at least. Arguably, the biggest concern for high yield markets is the tail risk of recession. However, the Fed remains acutely aware of the risks of premature tightening and choking off the nascent recovery, so this seems more of a risk for the end of 2023 at the earliest."
- Had the travails of the first quarter been confined to higher and more persistent inflation than expected and the risks of monetary policy over-tightening, we may have remained relatively bullish as the market fundamentals remain positive and high yield markets are unquestionably higher quality and more robust than in previous recessionary environments (such as the early 2000s or heading into the Global Financial Crisis). However, the combination of this risk factor with the uncertainty and disruption caused by the invasion of Ukraine and retaliatory sanctions means that the change in sentiment in March is likely to endure and it would be negligent not to see the quarter as a turning point.
- Unlike equities, the risks in high yield investing are asymmetric and it rarely pays to take excessive risks when heading into periods of more negative sentiment. High yield investors are feeling more risk-averse and will seek to be compensated by higher spreads, so we are now positioned more in favour of defensive sectors and short duration. Given the rise in the reference yield and sharply wider spreads, we believe we will be paid sufficiently for adopting a lower-risk position and expect this to continue for at least the next three quarters until the outlook becomes clearer – perhaps surprisingly, given the volatility we have been able to do this without paying a premium for exposure to safer havens.

Find out more

- 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.co.uk, 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 – there is a fixed income quarterly update on 27 April 2022, in which Azhar Hussein (Head of Global Credit) is one of the panellists. Please visit the RLAM Digital Insight Hub.

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