Royal London Short Duration Credit Bond Fund

Quarterly Report 31 March 2022

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.6	99.7
Index linked credit bonds	0.4	0.0
Sterling conventional gilts	0.0	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]	2.9 years	3.0 years
Gross redemption yield[4]	3.52%	2.36%
No. of stocks	306	479
Fund size	£1,056.6m	-

Source: RLAM, based on the Z share class. Launch date: 08.11.2013.
[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

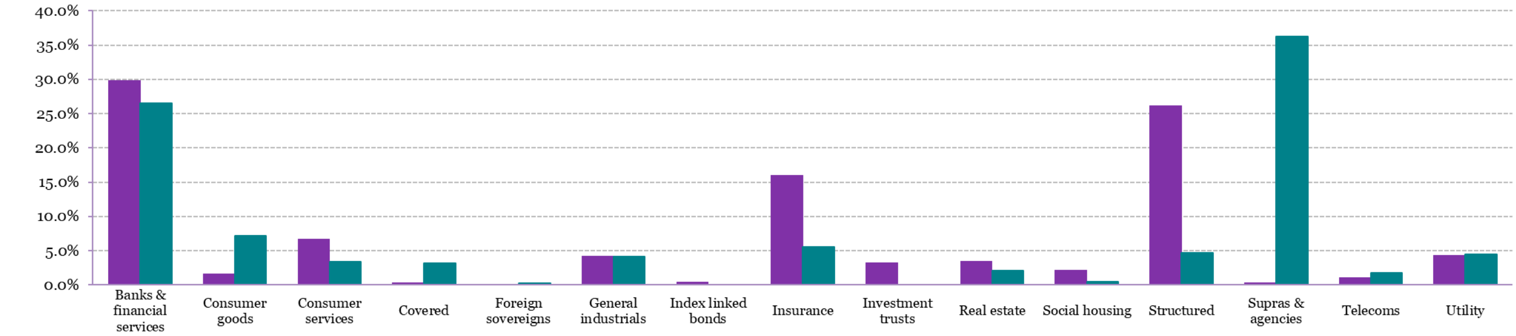
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q1 2022	**-2.36**	**-2.75**	**0.39**
Year-to-date	-2.36	-2.75	0.39
Rolling 12 months	-1.18	-3.23	2.05
3 years p.a.	2.38	0.49	1.89
5 years p.a.	2.61	0.82	1.79
Since inception p.a. 08.11.2013	3.46	1.68	1.78

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 share class.
[1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index.
Performance for the Royal London Short Duration Credit Bond 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.

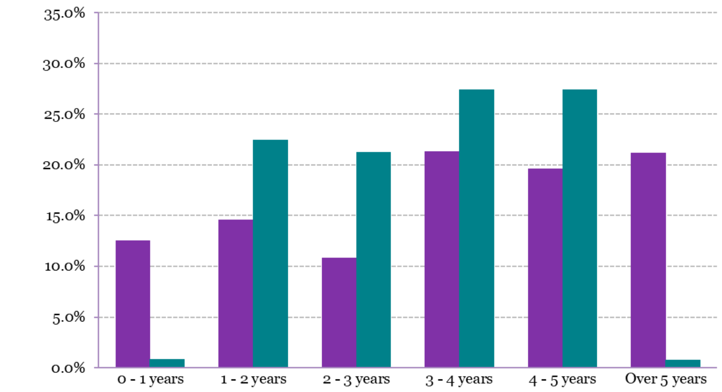
Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Index linked bonds	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
SDUR2	29.9%	1.7%	6.7%	0.4%	0.0%	4.3%	0.4%	16.0%	3.2%	3.4%	2.1%	26.1%	0.3%	1.1%	4.3%
Benchmark	26.5%	7.2%	3.3%	3.2%	0.3%	4.1%	0.0%	5.6%	0.0%	2.1%	0.4%	4.7%	36.3%	1.7%	4.5%

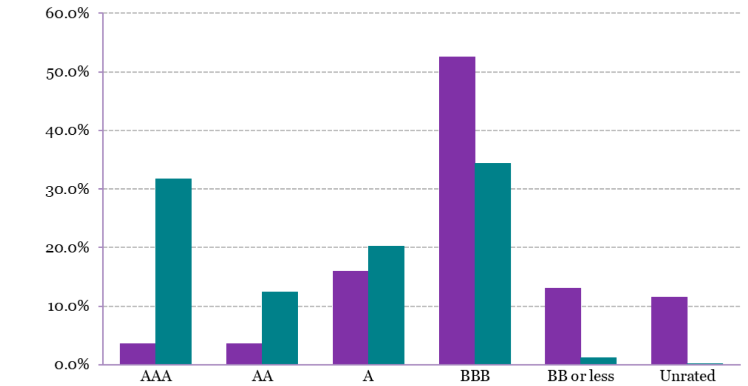
Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

Maturity profile



	0 - 1 years	1 - 2 years	2 - 3 years	3 - 4 years	4 - 5 years	Over 5 years
SDUR2	12.5%	14.5%	10.8%	21.3%	19.6%	21.2%
Benchmark	0.8%	22.4%	21.2%	27.4%	27.4%	0.8%

Credit breakdown



	AAA	AA	A	BBB	BB or less	Unrated
SDUR2	3.5%	3.6%	15.9%	52.5%	13.0%	11.5%
Benchmark	31.7%	12.4%	20.2%	34.4%	1.1%	0.1%

Ten Largest Holdings

	Weighting (%)
Lloyds Bank Plc 7.625% 2025	1.2
Rothschild Continuation Finance 9% VRN Perpetual	1.2
Électricité de France 6% VRN Perpetual	1.1
M&G Plc 3.875% 2049	1.1
Delamare Finance 5.5457% 2029	1.0
AXA 6.6862% VRN Perpetual	1.0
Edinburgh Investment Trust Plc 7.75 2022	1.0
BNP Paribas 2% 2031	1.0
Eversholt Funding Plc 6.697% 2035	1.0
HSBC Bank 5.375% 2030	0.9
Total	**10.5**

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

Market overview

- Russia's invasion of Ukraine in late February was met by a unified response from Western powers, enforcing far reaching economic sanctions. Although a sense of calm has returned to markets, the unpredictability of war means that this may not continue.
- After the relatively benign impact of the Omicron variant of Covid-19, central banks globally maintained the hawkish pivot taken into the turn of the year, as they focused on tackling higher than expected inflation rates. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and the increase to sterling investment grade yields in the period was driven mainly by underlying gilts yields, although spreads have also widened.
- War in Ukraine has exacerbated inflationary pressures. Rising commodity prices are driving up the cost of energy, food, and materials, leading to a further squeeze on real disposable incomes. This is being compounded by higher interest rates, giving rise to concern about future economic growth. Bank of England (BoE) Governor Bailey cited such concerns during the March Monetary Policy Committee (MPC) meeting but increased the interest rate nonetheless; the UK base rate stood at 0.75% at the end of the reporting period, after consecutive 25bps hikes in February and March.
- The UK's Spring Budget Statement saw some measures to limit the impact of forthcoming tax rises, mitigating around one third of impact of rising costs on consumers. Markets are still pricing in seven rate hikes in the UK over the next twelve months, taking the base rate towards 2.5%. In the US, where the economy is better insulated from rising commodity prices (it is a net energy exporter) the Federal Reserve (the Fed) doubled down on its hawkish stance on inflation, highlighting the potential for a diversion in monetary policy between central banks going forward. The Fed ended its quantitative easing (QE) programme at the end of March, as planned, and markets are now pricing eight rate hikes in 2022, which would see the target rate reach around 2.5% by year end.
- In the UK, the benchmark 10-year gilt yield rose from 0.97% to 1.61% in the quarter, a rise of 64bps. There was a respite in the upwards trend following the Russian invasion of Ukraine but concern about inflation and more hawkish central bank rhetoric meant that the fall in yields proved to be temporary. The same pattern was visible in the US and Germany, where yields rose throughout the period but temporarily dipped around the onset of war in Ukraine: in the US, the benchmark 10-year US treasury yield rose from 1.51% to 2.34% in the quarter, while the German 10-year bund yield rose from -0.14% to 0.55%.
- The first quarter of 2022 was the worst performing quarter for sterling credit markets (-6.2%) since the Global Financial Crisis. Although broad sterling credit indices outperformed government bonds this reflected their lower duration, as investment grade spreads widened by 22bps (iBoxx Sterling Non-Gilt index). Defensive sectors such as supranational, covered and asset backed outperformed, whilst financials (banks and insurance) were laggards, particularly subordinated bonds when looking at excess returns (adjusted for the impact of duration). Some energy bonds were weak despite the rise in oil and gas prices, reflecting exposures to Russia. By credit rating, AAA rated debt outperformed other investment grade ratings bands; BBB rated debt outperformed A rated debt; and sub-investment grade debt outperformed investment grade markets, albeit still delivering negative absolute returns.

Portfolio commentary

- Sterling credit markets provided negative absolute returns in what was the worse quarter since the Global Financial Crisis. Markets were driven by the significant rise in yields of the underlying gilt market, with nominal gilt yields rising by around 60-70bps across all maturities in the first quarter. Royal London's sterling credit strategies provided negative returns to investors, but outperformed their respective market benchmark.
- Short-dated credit strategies outperformed all-maturities strategies during the quarter, albeit still providing negative absolute returns. This is because long-dated bonds are more sensitive to changes in the interest rate and suffer greater capital losses when interest rates rise. This is reflected in the performance of the UK gilt market, where gilts of less than five years in maturity returned -1.4% to investors in the quarter, versus -7.2% for all maturities gilts (FTSE Actuaries).
- The main contributor to performance across the fund was security selection. Specifically, the funds benefitted significantly as a result of having no direct exposure to Russian companies **Gazprom** which fell out of the benchmark in the period following the onset of war and subsequent Western sanctions – the credits represented a small yet material portion of the benchmark. Our indirect exposure to Russian companies was also very limited, as companies in the highest risk sector, financials, had already curtailed exposure to Russia due to requirements around money laundering. We also saw positive contributions from **General Electric** bonds and biomass and low carbon heat specialist **Aggregated Micropower**.

- At a sector level, the biggest drag on performance was the large underweight in supranationals, which outperformed the broader market. This strength pushed the performance of the sector above that of the broader market on a rolling 12-month basis, although the sector has underperformed over the medium term, to the benefit of our portfolios. Conversely, our allocation to asset backed and secured bonds helped relative performance.
- In the first two weeks of the quarter sterling credit issuance was extremely strong, helping the market to meet forecast expectations for January even though the latter half of the month proved to be extremely quiet. February was similarly quiet, with the £3.1 billion of issuance in primary sterling markets nearly 50% below estimates. Issuance picked up again in March, as £6.6bn of new debt was brought to market, only a touch below forecasts. Issuance was, however, skewed heavily in favour of financials, particularly non-domestic banks.
- We participated in a number of new issues across sectors in the first quarter of the year, with a focus on short-dated senior bank bonds, picking up a number of new issues at good value. We added new issues from **Santander**, **Lloyds Bank**, **BNP Paribas**, **NatWest**, **Toronto Dominion**, and Norwegian bank **DNB**. We also bought a sterling issue from US real estate investment trust **Realty Income.**
- While the quarter saw further issuance of labelled bonds, such as 'green' bonds, some of which we participated in, we remain cautious of labelled bonds, which do not automatically offer value, and sometimes lack clarity of objective. We will continue to focus on integrating ESG risk, making sure that we assess each individual credit on its particular merits, remaining focussed on adding value in underserved or inefficient areas of the market.

Outlook

- There is considerable uncertainty about the year ahead. The war in Ukraine has worsened existing trends and has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal.
- In the UK, investors are pricing in a move to a 2.5% base rate over twelve months and in the eurozone there has been a significant shift, with tightening now expected in the second half of the year. Although we expect a slowdown in the medium term, we believe that market pricing may be too aggressive at present. However, we must highlight the uncertainty of any market forecasts at present, given the unpredictability of war in Ukraine.
- The widening in credit spreads has taken valuations to attractive levels, relative to government bonds. However, if tensions in Ukraine intensify, we would expect further modest widening in investment grade and high yield credit spreads. Nevertheless, at current levels, investment grade spreads over-compensate for default risk, and we expect that credit will outperform government debt over the medium term. Our portfolios have a material exposure to BBB bonds but we believe that compensation for default risk remains most attractive for the bonds that we hold in this rating band.
- The Bank of England announced in the quarter that it will sell its holdings of corporate bonds. While the BoE's 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 sales timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.
- We will maintain our long-standing focus on risk management by seeking to 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. In addition, we expect to maintain an overweight position in subordinated financial bonds where credit spreads remain attractive.

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.
- 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.co.uk for further information.

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