Royal London Sterling Extra Yield Bond Fund

Quarterly Report 31 March 2022

Executive summary

- The fund recorded a return, gross of tax and management fees, of -1.38% for the quarter, giving a total return of 4.38% for the rolling 12-month period. Performance in the quarter reflects weakness in government bond markets and the sensitivity of some of the fund's holdings to higher interest rates, offset by strong performance from some areas of its broad range of investments and by robust income generation.
- Following the relatively benign impact of the Omicron variant of Covid-19, leading central banks maintained the hawkish pivot taken into the turn of the year, as they focused on tackling higher-than-expected inflation rates. The invasion of Ukraine exacerbated these inflationary pressures, driving up the cost of energy, food, and materials and leading to a further squeeze on disposable incomes. This is being compounded by higher interest rates, giving rise to concern about future economic growth. The UK base rate stood at 0.75% at the end of March, after consecutive 25bps increases in February and March.
- Government bonds were badly impacted by the rise in interest rate expectations. Over the first quarter, the benchmark 10-year gilt yield rose from 0.97% to 1.61%, leading gilts to return -7.17% on an all-maturities basis (FTSE Actuaries). Yields began moving upwards towards the end of December as the Bank of England (BoE) ended its quantitative easing programme, increased interest rates and signalled further rises in 2022. The invasion of Ukraine drove a significant if temporary dip in yields: 10-year gilt yields reached around 1.55% in February, but fell to around 1.20% following the Russian aggression. The flight to safety was temporary, however, as yields again trended higher in March. The first quarter of 2022 was the worst 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). Meanwhile, global high yield markets returned -5.62% (ICE BofAML (BB-B) Global Non-Financial High Yield Index).
- Distributions in respect of the first quarter, payable at the end of May, are 1.68p, 1.51p, 1.58p and 1.57p, respectively, for the A, B, Y and Z class income shares, compared to amounts of 1.56p, 1.39p, 1.48p and 1.46p distributed for the fourth quarter of 2021 and of 1.61p, 1.44p, 1.52p and 1.50p distributed for the first quarter of 2021, respectively.

Performance

	Fund (Class A) (%)	Fund (Class Z) (%)
Q1 2022	**-1.38**	**-1.38**
Year-to-date	-1.38	-1.38
Rolling 12 months	4.38	4.37
3 years p.a.	4.87	4.88
5 years p.a.	5.75	5.75
10 years p.a.	8.60	-
Since inception p.a. 13.12.2013	-	7.03
Since inception p.a. 14.04.2003	8.00	-

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.

Fund price and yields

	Fund (Class A)	Fund (Class Z)
Gross redemption yield	5.14%	5.41%
Gross income yield	5.26%	5.52%

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]	4.5 years
No. of stocks	208
Fund size	£1,678.5m
Launch date	11.04.2003

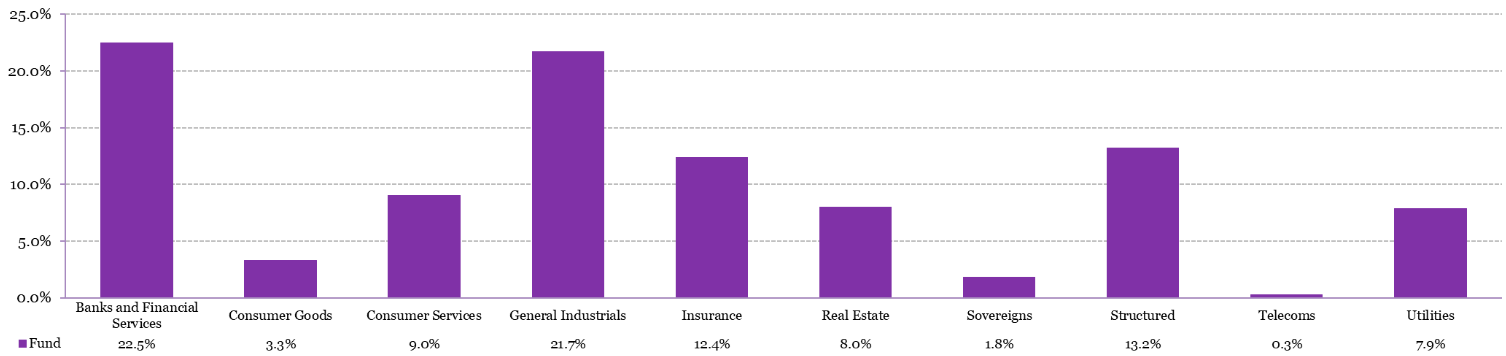
Fund commentary

- 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 holdings and the benefit of robust income generation. In addition, the increase in energy prices – Brent crude oil soared 39% to nearly $105 a barrel – supported the performance of holdings in this sector, with holdings including **Enquest**, **Okea**, **Pandion Energy** and **Talos Production** performing strongly. Secured bonds in the shipping sector and bonds of commodity businesses also generally performed well. Bonds of **Cabonline**, the Scandinavian transport logistics business, performed well as the company announced a new issue – in which the fund did not participate, but benefitted from the uplift in market price as the company exercised its option to repay the existing bonds at a level above the prevailing market price and their face value. **Citigroup** also announced the repayment at par of a subordinated bond which had not been repaid in 2017 and had then moved to a floating rate coupon – the bonds were bought in early 2020 at a price of 93. Otherwise, almost 10% of the fund is invested in FRNs (floating rate notes) which have virtually no exposure to government yields and where income generation increases as short-term reference interest rates increase. Finally, the fund had no exposure to Russian companies **Gazprom** and **Russian Railways** which both fell out of the sterling investment grade benchmark following the onset of war and subsequent Western sanctions – the credits represented a small, yet material portion of that benchmark.
- Primary issues were limited by the volatile conditions through much of the quarter. Purchases included **Fibo**, the Scandinavian construction materials business, whose Norwegian krone five-year bonds offered income 6% above short-term rates, and **Utmost**, the UK financial business, whose bonds offered income of 6⅛% until first call in 2028. We also participated in the issuance of dollar-denominated bonds of **Standard Chartered Bank** and **Rabobank**, where coupons reflected the higher government yields prevailing in the US.
- Secondary market activity included purchasing bonds of retailer **Co-operative Group** and of UK specialist secured lending business **Together Group**. The holding of short-dated sterling bonds of **Jupiter Fund Management** was increased by market purchases, while the holdings of **Santander** and **Allianz** were increased at the lower levels prevailing at the time. Against these purchases, short-dated bonds of **Investec Bank** were sold after holding up well, surrendering a yield of under 3% to their call date in 2023. Having proved very resilient to market conditions, the holding of IT infrastructure group **Bulk Infrastructure** was reduced into a buoyant market bid for stock, while the takeover of Irish property group **Yew Grove** was completed, with the fund exiting its investment with a modest capital profit in addition to strong income generation of around 5% p.a. since the initial investment in mid-2018. The small holding of shares in Canadian energy business **Petrotal**, received alongside capital repayment in the restructuring of Sterling Resources, was sold down into strength at a price over 60% higher than its end-2021 level, reflecting sensitivity to the price of oil. The holding of Dutch energy company **Tulip Oil** was sold, crystallising a capital gain of over 5% in addition to the 8¾% income generation since purchase at issue in April last year. Finally, activity in short-dated UK gilts reflected short-term liquidity management in the fund. At the end of the quarter short-dated UK gilts comprised some 2% of total fund assets, supressing overall fund yield somewhat in the very short term, but providing capacity to take advantage of attractive opportunities as they arise.

Investment outlook

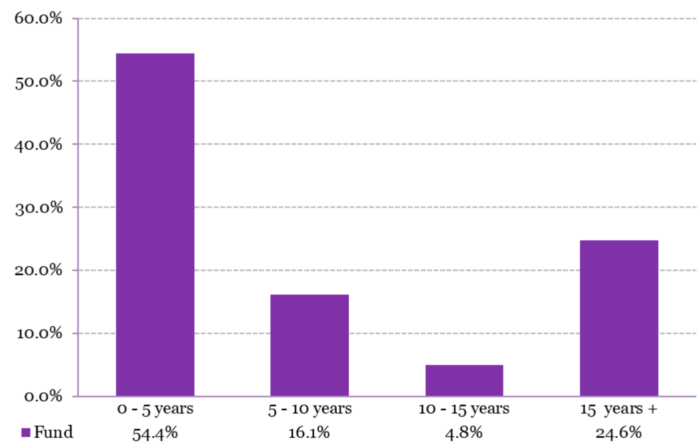
- There is considerable uncertainty about the year ahead which has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident? The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as signal of impending recession.
- In the UK, investors are pricing in a move to a 2.5% base rate over 12 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 the situation 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.
- The BoE announced in the quarter that it will sell its holdings of corporate bonds. 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 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.

Sector breakdown



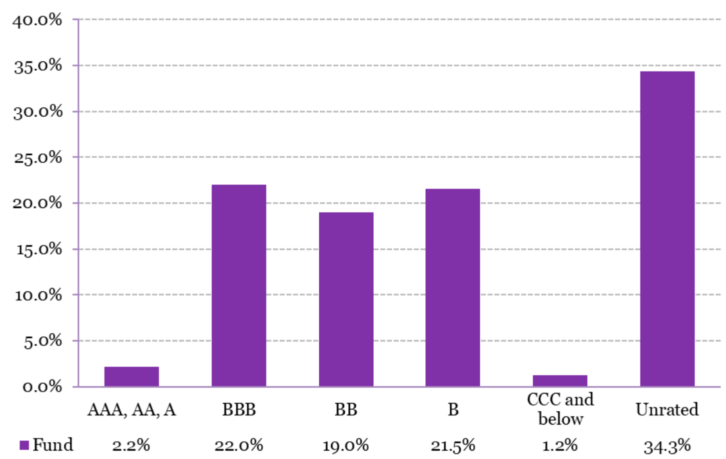
Source: RLAM. Figures include the impact of cash held.

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 (%)
Co-op Group 6.25% 2026	2.6
Santander UK 10.0625%	2.4
Centrica 5.25% 2025/75	2.3
Électricité De France 5.875% 2029	2.2
M&G 6.34% 2043/63	2.2
Santander UK 10.375%	2.1
Phoenix Group 5.75% 2028	1.8
Metrocentre Finance 8.75% 2023	1.7
Heathrow Finance 4.375% 2027	1.6
Impact Healthcare Reit Plc	1.6
Total	**20.4**

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

Currency breakdown

	Fund (%)
Sterling	76.6
US Dollar (hedged 10.2%)	13.8
Euro (hedged 4.5%)	5.9
Norwegian Krone	3.1
Swedish Krona	0.6
Canadian Dollar	0.0
Total	**100.0**

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

IMPORTANT INFORMATION