Royal London Corporate Bond Fund

Quarterly Report 30 September 2022

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.2	99.3
Index linked credit bonds	0.6	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.1	0.7
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]	6.1 years	5.9 years
Gross redemption yield[4]	7.50%	6.13%
No. of stocks	310	1,218
Fund size	£971.5m	-

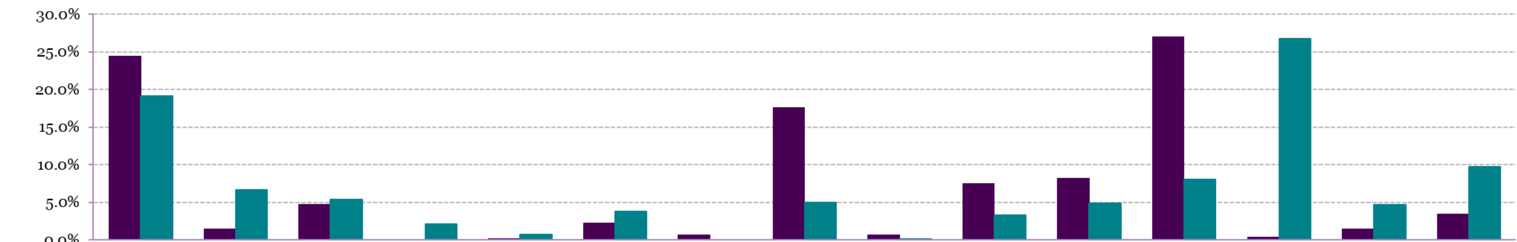
Source: RLAM, based on the Z share class. Launch date: 01.03.1999.
[1]Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.
[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[3]Excluding cash
[4]The gross redemption yield is calculated on a weighted average basis

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2022	**-9.44**	**-11.01**	**1.57**
Year-to-date	-20.62	-22.18	1.56
Rolling 12 months	-20.00	-21.92	1.91
3 years p.a.	-4.25	-6.89	2.64
5 years p.a.	-0.39	-2.29	1.90
10 years p.a.	3.62	1.60	2.02
Since inception p.a. 01.03.1999	4.72	3.33	1.39

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. 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 share class.
[1]Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.
On 1 May 2012, the Royal London Corporate Bond Fund (Class B) was renamed the Royal London Corporate Bond Fund (Class Z). The Z share class was launched on 30 April 2010. All performance after this date is for the Z share class. All performance for periods prior to 30 April 2010 is for the Royal London Corporate Bond Fund (Class A). Therefore the performance shown in this table is a merged return which includes the historical 'A' share return for the periods to 30 April 2010, before the Z share existed. If you were invested in the fund prior to this, your investment was in the A shares. If you require separate performance solely for the Z shares since 30 April 2010, please contact your Client Services Manager.
Performance for the Royal London Corporate 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.

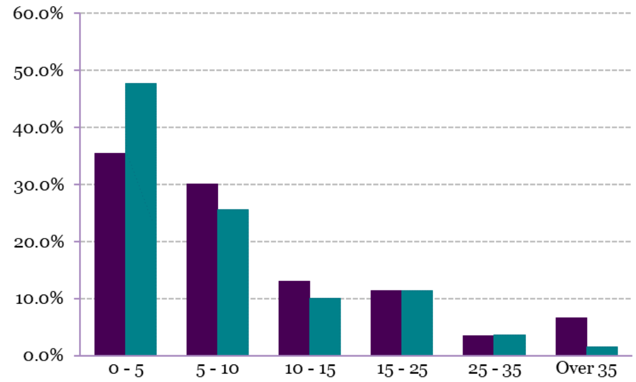
Sector breakdown



	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
RLIT	24.4%	1.4%	4.7%	0.0%	0.1%	2.2%	0.6%	17.6%	0.7%	7.5%	8.2%	27.0%	0.4%	1.5%	3.5%
Benchmark	19.1%	6.7%	5.3%	2.1%	0.7%	3.8%	0.0%	4.9%	0.0%	3.3%	4.9%	8.0%	26.8%	4.6%	9.7%

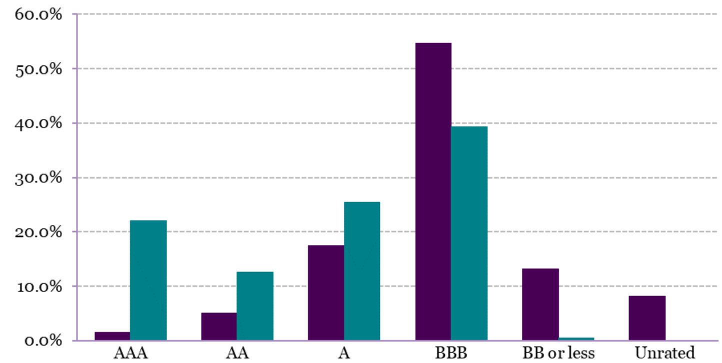
Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
RLIT	35.4%	30.1%	13.0%	11.4%	3.5%	6.6%
Benchmark	47.7%	25.6%	10.1%	11.4%	3.7%	1.5%

Credit breakdown



	AAA	AA	A	BBB	BB or less	Unrated
RLIT	1.6%	5.0%	17.4%	54.7%	13.2%	8.2%
Benchmark	22.1%	12.6%	25.5%	39.3%	0.5%	0.0%

Ten Largest Holdings

	Weighting (%)
Aviva 6.875% 2058	1.9
HSBC Bank plc 4.75% 2046	1.4
HSBC Bank plc 5.375% 2030	1.2
HSBC Bank plc 5.375% 2033	1.1
Barclays Bank 5.75% 2026	1.1
Investec Plc 1.875% 2028	1.1
M&G Plc 5.7% 2063	1.0
AXA SA 6.6862% VRN Perpetual	1.0
Électricité de France 5.875% VRN Perpetual	1.0
Thames Water Utilities Cayman Finance 7.738% 2058	0.9
Total	**11.6**

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

Market overview

- The macroeconomic factors that disrupted financial markets in the first half of 2022 continued to dominate in the third quarter – higher-than-expected inflation and interest rate increases were the key macroeconomic influences, along with growing fears of recession in the UK, Europe and the US. Inflation first surfaced in the aftermath of the Covid-19 pandemic, but was exacerbated by the Russian invasion of Ukraine in February and retaliatory sanctions which sharply increased the prices of oil & gas and other commodities. Although they have fallen back slightly, energy prices remain high and geopolitical events continue to affect sentiment as winter approaches. The apparent sabotage of the Nordstream gas pipelines from Russia to Germany suggests that energy will remain a key pawn in relations between NATO countries and Russia.
- Central banks have responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The US Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. Since March, the Fed has raised rates five times by an aggregate of 3% - its 0.75% increases in June, July and September were the biggest increases for nearly 30 years. Its commitment to do more has led markets to price in further hikes in 2022. The European Central Bank (ECB) has so far been slower to react, partly due to a more fragmented backdrop with a gap between Germany and 'peripheral' economies. However, ended its bond buying programme in July and increased rates by 0.75% (it's first increase in 11 years and a bigger increase than the 0.50% expected by economists). A further increase of 0.75% followed in September with a clear commitment of further increases to follow. The Bank of England (BoE) increased rates by 1.00% over the quarter to 2.25%, taking its tally to six increases so far in 2022 and seven in this cycle.
- The level of activity in the UK economy is still only slightly above where it was pre-pandemic. Although GDP growth was robust in the first quarter, the second quarter saw a small contraction in activity. The composite PMI business survey indicator of activity in the economy deteriorated between March and August 2022 and by August signalled only relatively weak rates of activity growth in the economy and, as with the eurozone, it continues to deteriorate as does consumer confidence.
- UK economic policy is in a state of flux following the new Chancellor's 'mini Budget' in late September. As expected, he outlined details of programmes to limit domestic and corporate energy bills as well as the reversal of his predecessor's increases in corporation tax and National Insurance. However, other measures such as scrapping the top rate of income tax (since abandoned) and the cap on bankers' bonuses came as a surprise, leading to further weakness in gilts and sterling. In the last week of the quarter, after comments to support the currency, the BoE was forced to intervene in the gilt market as problems with levels of collateral in the 'liquidity-driven investing' (LDI) part of the pensions industry pushed down the prices of long-dated gilts in a vicious spiral. Having said the previous week that it would reduce its holdings of gilts and corporate bonds, the BoE announced that it would potentially buy £65bn of long-dated gilts over the following two weeks.
- The UK gilt market was the worst performing major government bond market over the quarter, delivering a return of -12.85% as the benchmark 10-year gilt yield rose by 186 basis points (bps) from 2.23% to 4.09%. However, all major government bond markets were impacted as the ongoing interest rate rises and hawkish commentary from central banks drove bond yields higher globally (prices move inversely to yields): the 10-year US treasury yield rose by 82bps to 3.83%; and the 10-year German bund yield rose by 77bps to 2.11%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, for example, gilts with five years to maturity or less provided negative returns of just -4.93%, whereas the 15 years or more to maturity segment returned -18.77%.
- These gilt market returns took a heavy toll on the sterling investment grade credit market, which returned -11.01%. Although it appeared to outperform the gilts market, at around six years the duration of the sterling credit is lower than for the gilt market: corporate bonds underperformed gilts of an equal maturity as 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 25bps to 1.99% (iBoxx).
- In credit markets, defensive sectors continued to outperform on a relative basis, albeit still providing negative returns – supranational, covered and senior banks bonds outperformed, while the real estate, utilities and asset-backed securities sectors underperformed the wider market. Credit quality had a mixed impact on relative returns in the period – although bonds in the AAA ratings band outperformed their investment grade peers, the high yield market outperformed investment grade credit and BBB rated bonds outperformed AA and A rated bands.
- After two notably weak quarters, new issuance recovered in the third quarter, but was still weaker than normal. Much of the issuance was from banks and insurers, led by significant cross-border issuance from US and European banks and insurers.

Portfolio commentary

- After a difficult first half of 2022, the third quarter was again extraordinarily volatile and delivered the worst absolute returns for sterling credit in living memory. The main driver of returns was further weakness in government bond markets, particularly the UK gilt market. 'Unprecedented' has become a cliché in describing the challenging conditions in financial markets, yet it is the only way to describe the events of the quarter as inflation continued to rise, and central banks raised interest rates and reiterated their hawkish messages to take whatever action is needed to quell rising prices.

- Despite being negatively impacted by the significant underweight to supranational bonds (the sector offers a very low yield premium that we believe can be materially improved elsewhere in the market without taking excessive risk), the fund outperformed the broader market over the quarter. Despite the negative absolute returns, our emphasis on sector and issuer diversification and the bias towards secured debt generally counteracted the low exposure to supranational bonds.
- Credit sector allocation was the most significant performance detractor, reflecting the underweight allocation to supranational bonds, while our main overweights, such insurance, social housing and real estate sectors also impacted returns. Conversely, duration generally contributed positively to performance as the average duration of our strategies was slightly shorter than the market. Security selection was broadly neutral, with positive contributions, in particular, from the structured, real estate and social housing sectors.
- Stock selection in the structured sector was positive with notable contributions to performance from **Income Contingent Student Loans** (ICSL), **Center Parcs**, **Peterborough Progress** and **Greene King**. As well as the benefit of security, this sector offers well-diversified bonds that are exposed to different areas of the economy, while in the industrials sector **General Electric** outperformed. Despite market volatility, the perpetual bonds of **Santander**, **HSBC**, **BNP Paribas** and **Lloyds Banking Group** performed relatively well.
- While new issuance remained subdued for periods in the quarter, there were still opportunities to participate. Overall, financial bond issuance continued to be the dominant theme in sterling credit markets. New issue credit spread premiums tended to be relatively large and we participated in a range of new financial issues, including senior banks bonds of **Barclays** (holdco) and **Credit Suisse**, and senior insurance bonds of **MetLife**. We also bought subordinated banks bonds of **Sainsbury's Bank**, **BNP Paribas** and **Lloyds Banking Group**, and a subordinated insurance issue from **Zurich Finance (Ireland)**. On the non-financial front activity was relatively light, although we did participate in a new issue from **Apple** of a 40-year bond and a shorter dated issue from **PepsiCo**. These issues came at attractive spreads and represented good price concessions relative to existing bonds. The social housing sector remained keen to issue bonds, reflecting its ongoing requirement for long-term finance. We increased exposure to **Sanctuary** – an issuer which offers robust cashflows and strong ESG credentials. Elsewhere in the secured sectors, we added to **Annington**, an owner of a large portfolio of residential housing, with the new bond coming at a significant spread premium relative to comparable secondary market bonds.
- Secondary market activity was relatively subdued in the quarter, reflecting market illiquidity and the higher transaction costs associated with wider bid-offer spreads.
- There were no defaults in our funds in the quarter and we remain happy with the shape of our sterling credit portfolios. While deteriorating economic and market conditions demand extra vigilance, we are comfortable that our proven investment philosophy and process will help us to navigate the challenging environment by favouring secured bonds with strong covenants and focusing on bottom-up research to identify borrowers with attractive risk and return characteristics.
- Our portfolios are widely diversified across sectors, individual issuers and economic exposures. We believe that the lower credit rated segments of our portfolios have yields that more than compensate us for the increased risks. We continue to run overweight positions in subordinated financial debt despite the worsening economic outlook. This reflects our view that capital ratios are robust, while yields are at multi-year highs. Where we have exposure to sub-investment grade bonds and unrated debt, we consider that the diversification and yield benefits are appropriate.
- The focus on ESG factors was accelerated by the pandemic and then by the invasion of Ukraine, the latter focusing attention on the transition away from fossil fuels both from a geopolitical and climate change perspective. An easy way to do this is to sell exposure to utilities and focus portfolios on labelled bonds (such as green or sustainable bonds). But as with credit ratings, we believe that such apparently 'simple' solutions will not produce desired outcomes for investors or wider society. Our ESG integration retains engagement and in-house research at its core. As long-term lenders of our investors' money, we are suspicious of easy ways to 'green' a portfolio, and ensure we integrate ESG factors into our investment decision because we feel it is irresponsible not to.

Outlook

- Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, interest rate increases are already showing signs of slowing down activity and, despite more aggressive market expectations, 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 some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.

- Despite this outlook, we believe that the widening in credit spreads this year has taken valuations to attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With gilts yielding over 4% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is arguably at the most compelling level for nearly 10 years, particularly if inflation starts to fall: furthermore, many of our investment grade strategies deliver a yield premium to the market. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the long end of markets where all-in yields still look challenging. Most strategies have a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.
- It is too early to say whether the UK government will be forced into further U-turns in economic policy, either by its backbenchers or financial markets, but its reputation has undoubtedly been affected by recent events. The goal of boosting UK economic growth is laudable, but would require a wider programme of measures over a sustained period of five to 10 years. Also, despite the ambitious scope of the mini-Budget, it would have been more effective had the Chancellor also detailed a fiscal framework and package of supply-side reforms. Furthermore, having sacked key advisers on assuming office, the new Prime Minister and Chancellor didn't communicate their plans well: even if events subsequently play out in their favour, they cannot afford to take the gilt market for granted at a time of such economic strain.
- The BoE announced in May that it would begin the sale of its holdings of corporate bonds in mid-September, via a regular multi-stock auction. However, the sale was delayed by the adverse market conditions in the gilts market and it isn't yet clear if and when the sale will start. However, although 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 previously 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.

Find out more

- We are experiencing unprecedented times in markets. Inflation is at multi-decade highs, energy prices are rising and the latest Bank of England announcement created further uncertainty. Following on from the unsettling fixed income and currency markets of late September, RLAM hosted a webinar for RLAM's Head of Fixed Income Jonathan Platt, and Craig Inches, Head of Rates and Cash to discuss the situation and how central banks and policymakers might react. Investors can listen again via the Our Views section of www.rlam.com, which also contains regular updates from Head of Fixed Income Jonathan Platt, Head of equities Peter Rutter, and Head of Sustainable Mike Fox.

Additional information

- As we highlighted in our Annual Report, RLAM has ambitious targets for the next few years, notably in international growth as well as investment in infrastructure and people. This investment is to make sure that we continue to provide clients with the service they need and positioning us to for future regulation changes and market development.
- As part of that ambition, we are pleased to announce that we are moving to a new investment platform and have selected the industry leading 'Aladdin' platform. This decision has followed months of analysis and pre-implementation planning with the vendor BlackRock. Aladdin will help us improve our service offerings to our clients, as well as delivering operational efficiencies.
- As you would expect, implementation is an extended task, and the project is expected to complete in 2024, but we believe it is important to be transparent about such projects with our clients. Throughout the implementation, the project and management of your client portfolios will be closely monitored by our Board and Risk functions to ensure that this transition is achieved smoothly, and we will keep you updated on our progress. This is an important part of our long-term strategic goal to ensure that we continue to meet your needs today and into the future.

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