Royal London Diversified Asset-Backed Securities Fund

Quarterly Report 30 September 2022

ROYAL LONDON
ASSET MANAGEMENT

Asset split

	Fund (%)
Conventional credit bonds[2]	92.6
Index linked credit bonds	0.1
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.2
Foreign index linked sovereign	0.0
Derivatives	7.0
Other	0.0

Fund data

	Fund
Duration[3]	0.9 years
Yield to worst[4]	6.01%
No. of stocks	264
Fund size	£206.2m

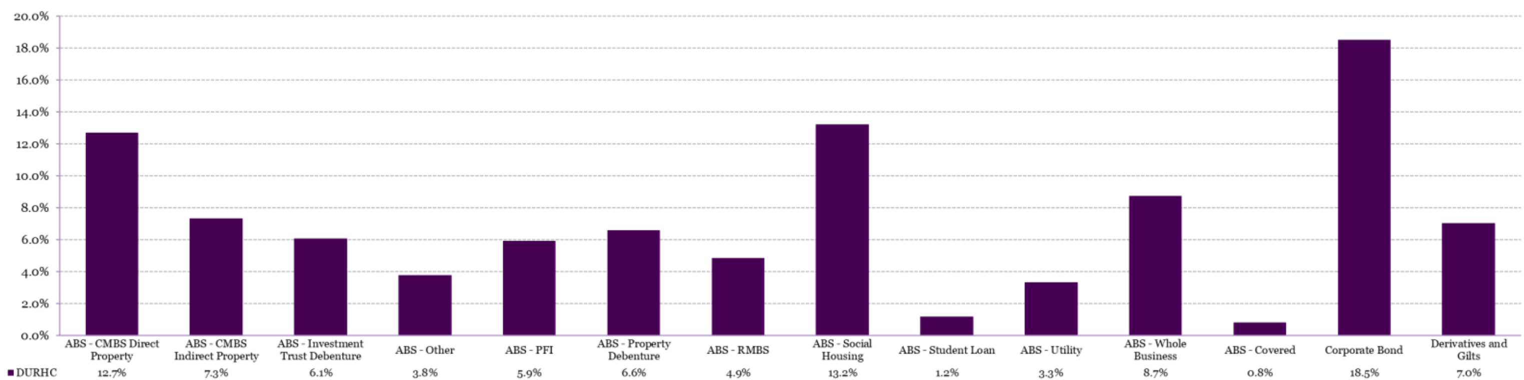
Source: RLAM, based on the Z share class. Launch date: 24.09.2012.
[1]Benchmark: SONIA.
[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[3]Excluding cash
[4]Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q3 2022	**-0.78**	**0.39**	**-1.17**
Year-to-date	-1.83	0.71	-2.54
Rolling 12 months	-0.96	0.72	-1.69
3 years p.a.	2.89	0.38	2.51
5 years p.a.	2.52	0.51	2.01
Since inception p.a. 24.09.2012	3.68	0.50	3.17

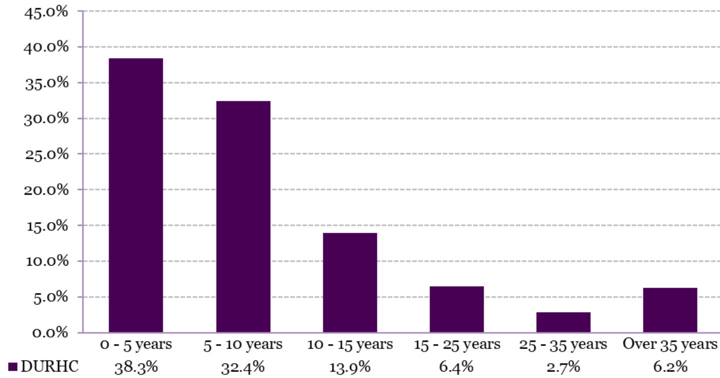
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding. 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.
Please note that fund name was changed from RL Duration Hedged Credit Fund on 21 December 2020, and the objective amended, while the benchmark of that fund changed from 3-month LIBOR to SONIA, effective 8 August 2019. Both changes are reflected in the returns shown above.
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

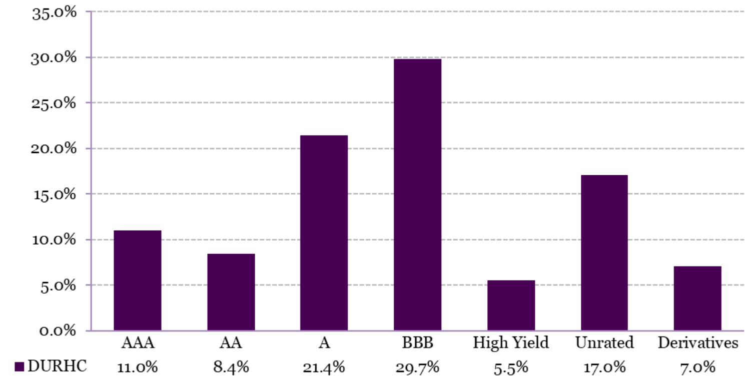


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Scottish Mortgage 6.875% 2023	1.8
Telereal Securitisation FRN 2033	1.5
British Land Co 5.264% 2035	1.4
Trafford Centre 2038	1.3
Taurus FRN 2028	1.3
CASTE 202	1.1
Grosvenor UK Finance 6.5% 2026	1.0
Finance for Residential Social Housing 8.368% 2058	1.0
Mercantile Investment Trust 6.125% 2030	1.0
Taurus FRN 2029	1.0
Total	**12.4**

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

Market commentary

- 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 Nord Stream gas pipelines from Russia to Germany suggests that energy will remain a key pawn in relations between NATO countries and Russia.
- Central banks 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 this year and in 2023. 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 composite PMI business survey indicator of activity in the economy deteriorated further as did consumer confidence. The level of activity in the UK economy is barely above where it was pre-pandemic.
- UK economic policy has been in a state of flux following Kwasi Kwarteng's 'mini-Budget' in late September. Following weakness in government bond and foreign exchange markets the BoE provided support to the long end of the gilt market. This helped to address the liquidity problems associated with the collateral requirements of some UK pension funds, following the steep rise in real and nominal yields. The appointment of Jeremy Hunt as Chancellor and the cancellation of some tax cuts has helped to calm market volatility.
- 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 5 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 negative gilt market returns took a heavy toll on the sterling investment grade credit market, which returned -11.01%. Although it appeared to outperform the gilt market, at around seven years the duration of the sterling credit index is lower than for the gilt market: corporate bonds underperformed gilts of an equal maturity as the average sterling investment grade credit spread 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.
- The price of Brent crude oil fell by 16.9%, but remains over $90 a barrel, and copper futures fell by another 8.0% in dollar terms on fears of a slowdown in China and global recession. Currency movements had a notable impact in the quarter, following the volatility in the first half of the year. The Fed's more aggressive approach to raising interest rates compared to other central banks has pushed the dollar higher. It was again the strongest major currency: it appreciated by over 6% against the yen and euro, and over 8% against sterling. These movements will impact global trade over coming months, and dollar strength will also be a risk for any emerging markets countries and companies that have borrowed in dollars.

Fund 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. Central banks reiterated their determination to tackle inflation with global yield curves reflecting the prospect of further significant tightening of monetary policy over the next six months.

- The fund's hedging of duration risk offset strong negative returns seen in the broader sterling credit market, although senior secured bonds, for which the fund has a strong preference, performed well relative to the overall ABS market, given the general underperformance of junior securitisations during a period of heightened risk and spread. While the main driver of negative returns in the period was the significant widening of credit spreads across sectors, including the financial, overall performance held up well due to the underlying focus on robust cashflows. Stock selection in the structured sector was positive with notable contributions to performance from **Income Contingent Student Loans** (ICSL), **Center Parcs**, **Greene King** and **Peterborough Progress**. As well as the benefit of security, this sector offers well-diversified bonds that are exposed to different areas of the economy. Despite market volatility, the perpetual bonds of **Santander** and **HSBC**, **Lloyds Banking Group** performed relatively well.
- Given the fund's preference for senior secured bonds, we utilised some of the excess cash created via the positive swap movements to take advantage of opportunities presented by volatile markets (and forced selling elsewhere) to purchase attractively priced securities across the wider secured space in the secondary market. We added to attractively priced asset-backed securities across both FRNs and fixed rate bonds, including **Together** (RMBS) and **Taurus 2018** (secured on Devonshire Square), **Taurus 2021-1** (secured on last-mile logistics assets) and **Taurus 2019-3** (secured on student accommodation). Spreads available remained very attractive for low fundamental risks. We also bought secured corporate bonds, including **Telereal** (secured on BT telephone exchanges), **Greene King**, **Mitchells & Butlers** and **Longstone**. We also bought longer-dated bonds in the social housing sector, such as **Saxon Weald**, **Jigsaw** and **Places for People Homes**. Bond sales were largely to fund new issues and maintain the balance of the fund.
- 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 a senior banks issue by **ING**, subordinated banks issues of **Sainsbury's Bank** and **Svenska Handelsbanken**, and covered bond issues by **HSBC** and **Clydesdale Bank. W**e also bought senior insurance bonds of **MetLife** and **New York Life**, and a subordinated insurance issue from **Zurich Finance**. Away from the financial sectors, we bought a new issue from **Orsted**, the Danish leader in offshore wind generation, and increased exposure to **Sanctuary Housing** in a tap of a 2050 social housing issue – this issuer offers robust cash flows and strong net benefit through the provision of affordable housing. Otherwise, we participated in two issues from real estate company **Annington**, and a seven-year issue from **PepsiCo**. The latter issue was sold after some outperformance.
- There were no defaults in the portfolio during the quarter and across the corporate sector failures remain at low levels. While defaults are likely to increase from the current very low levels as we transition back to more normal economic conditions, we believe that the fund is well positioned for this. The fund has a material exposure to BBB bonds where compensation for default risk remains elevated and losses are further dampened by security, strong covenants and, in the majority of cases, a senior claim on issuers' assets and cashflows. Credit risk is not something that should be taken unthinkingly but it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification. Critically, as economic challenges start to increase and asset prices begin to fall on higher yields, the fund has very limited exposure to the latent risks inherent in junior securitisations. As certain issuers struggle to refinance at economic levels, cash flow extension risk is increasing, potentially pushing the average lives (WALs) of junior bonds materially beyond previous expectations. These tranches also tend to be small and illiquid so price adjustments could be significantly negative as market conventions adjust.
- Our credit philosophy is based on the sustainability of our lending position over the long term. Environmental, social and governance (ESG) integration has to be a part of this consideration: these factors can play a part in determining the financial future of a company and are therefore integral for any effective assessment of credit risk. We continue to believe that lending on a senior secured basis, with strong covenants, can have a dampening effect on rising governance-related risks for a large part of the fund. From an environmental perspective, we continue to carry out bespoke engagement with issuers, with further detail available in our ESG integration report.

Key views within the portfolio

- A bias towards senior asset backed securities, an area that we believe still offers the best risk/return characteristics.
- Very limited exposure to junior tranches of securitisations, where downgrade, loss and extension risks are heightened and where latent risks came to the fore during recent periods.
- Selective exposure to unsecured debt (less than 20% of the corporate bond element), targeted at well-regulated financial debt and undervalued corporate debt.
- Zero exposure to supranational bonds, as we expect secured debt and corporate debt to outperform over the medium term.
- An exposure to credit risk with minimal exposure to interest rate risk (hedged with interest rate swaps).

Outlook

- It is likely that there will continue to be a yield premium associated with UK government bonds following the reputational damage incurred in recent weeks. While inflation is expected to peak in coming months there remains considerable uncertainty about energy prices and wage pressures.
- 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 very 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 10-year gilts yielding over 4% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is at the most compelling level for nearly 10 years, particularly if inflation starts to fall as we expect. 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 ultra-long end of markets where all-in yields still look challenging. The fund has a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.
- 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 gilt 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

- Our fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars, and other media. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of rlam.com, including regular *JP Journal* updates from Head of Fixed Income Jonathan Platt.
- We are experiencing unprecedented challenges in financial markets and the global economy with unsustainable energy prices, inflation at a multi-decade high and rising interest rates. Following the turbulence in fixed income and currency markets in late September, we hosted a webinar for Jonathan and our Head of Rates and Cash Craig Inches to discuss how the current situation and how central banks and policymakers might react. You can listen back to the webinar via the *Our Views* section of rlam.com.

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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