Royal London Global Bond Opportunities Fund

Quarterly Report 30 September 2022

Executive summary

- The fund returned -1.38% for the third quarter, gross of tax and management fees (Z class, Income). For the rolling 12-month period, the fund has returned -9.48%.
- The fund's Z share income distribution for the third quarter, payable at the end of November, is 1.40p, compared to the 1.25p distributed in respect of the second quarter of 2022.
- We continue to believe that both global investment grade and high yield bonds are attractive on a spread basis and that they overcompensate for default risk, while their level of income generation is also appealing on a relative basis.

Performance

	Fund (%)
Q3 2022	**-1.38**
Year-to-date	-9.92
Rolling 12 months	-9.48
3 years p.a.	0.52
5 years p.a.	2.32
Since inception p.a. 08.12.2015	4.06

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 in sterling, 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 Inc share class. Performance for the fund is calculated on a mid basis with income re-invested. Performance for other share classes available at www.rlam.com.

Yields

	Fund
Gross redemption yield	8.36%
Gross income yield	6.35%

Source: RLAM and State Street. Based on the Z Inc 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]	3.7 years
No. of stocks	187
Fund size	£176.3m
Launch date	08.12.2015

Fund strategy

- The fund aims to achieve a high level of income with the opportunity for capital growth, by seeking attractive investments across a broad spectrum of fixed income opportunities, encompassing sub-investment grade, unrated bonds and investment grade.
- The fund mitigates stock-specific risk by holding a diversified portfolio of investments, so that no individual allocation can in isolation have an undue impact on overall performance.
- The fund's assets are held in securities denominated across a range of G10 currencies, with currency exposures substantially hedged back to sterling.
- The average duration of the fund's portfolio is relatively short, at 3.7 years, and the sensitivity of the fund's performance to changes in government bond yields is consequently modest.

Market Background

Index	Total return (%)	Spread movement (basis points)
HY non-financial emerging markets ICE BofA ML emerging markets high yield ex. subordinated financial index	-1.10	-31
HY global non-financial corps ICE BofA ML global non-financial high yield index	-4.96	24
AT1 ICE BofA ML contingent capital index	-3.51	19
HY global non-financial hybrid corps ICE BofA ML global hybrid non-financial high yield index	1.21	-26
Sterling investment grade corporate bonds ICE BofA ML sterling corporate and collateralised index	-0.78	-23
IG global non-financial hybrid corps ICE BofA ML global hybrid non-financial corporate index	-5.11	3
Dollar investment grade corporate bonds ICE BofA ML US corporate index	-12.56	39
Euro investment grade corporate bonds ICE BofA ML euro corporate and Pfandbriefe index	-3.35	10

Source: Bloomberg.

- 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 US, Europe and the UK. 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 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 this year and in 2023. 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, it 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.

- 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 129 basis points (bps) from 2.80% 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 64bps to 3.83%; and the 10-year German bund yield rose by 57bps to 2.11%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk).
- These negative government bond returns took a toll on investment grade credit markets as spreads widened in anticipation of the probable economic recession. New issuance in the euro market was impacted by the volatile conditions: net issuance was negative as maturities exceeded new issues. Although new issuance in the sterling market recovered in the third quarter, it 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.
- After a particularly difficult first half of 2022, with such generous 'all-in yields' and the boost from currency movements for sterling investors in global assets, the third quarter was less challenging for high yield bonds than it was for government bonds and sterling investment grade credit. Although the weakness in the underlying treasury bonds increased the yield on the benchmark (ICE BofAML (BB-B) Global Non-Financial High Yield Index) to 9.1%, the benchmark returned -1.50% to sterling investors with the high yield spread tightening from 573bps to 540bps. Although it was notably weak again over the quarter, high yield new issuance showed signs of recovery in the final weeks of the quarter.
- 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 US Federal Reserve'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

- While the fund delivered negative absolute returns in the quarter – reflecting the weakness in government bond markets and wider credit spreads in many markets – it performed particularly well relative to the relevant benchmarks for the different areas in which it is able to invest. The low duration of the fund, which reduces sensitivity to rising government bonds yields; its highly diversified nature across asset classes, regions and sectors; and the ongoing high carry helped to mitigate the negative impact of wider credit spreads. In sector terms, the exposure to sectors that will perform well in an inflationary environment (such as energy, mining and shipping) was positive. Conversely, the fund's exposure to corporate hybrids was detrimental to returns; however, this impact was mitigated by our preference for short call dates, reducing the negative impact on performance.
- Due to the ongoing volatility, issuance in the high yield market was a fraction of the levels seen through much of 2021. New issuance came predominantly from the US, with minimal high yield issuance in euros. Investment grade credit issuance was also weak in euros and sterling, with both materially lower than for the comparable quarter in 2021. However, there were still opportunities to participate and we bought senior banks issues of **BPCE**, **Santander** and **Deutsche Bank** (all senior non-prefs), **UBS** and **Barclays**. We also participated in a junior banks issue by **BNP Paribas** and a subordinated insurance issue from **Prudential Financial**. Otherwise, we bought a shorter-dated issue of **NES Fircroft**, the specialist employment services company, a 10-year utility issue from **Vier Gas Transport** and a new issue by **Haleon**, the consumer health business that demerged from GSK.
- In terms of notable secondary market activity, we added to our existing holdings of **BPCE** (senior banks non-prefs) and **UBS** (senior banks), Belgian utility **Fluvius** and **DNO**, the Norwegian oil and gas operator. We also added to our holding of structured bonds of **Heathrow**. Otherwise, we established a new position in **Co-entreprise de Transport d'Electricité** (CTE), the holding company for RTE – the operator of the French electrical power transmission network. We sold some bonds of **Dominion Energy** to manage the fund's corporate hybrid exposure; and reduced the holding of **Getlink** following a market rally to reduce the allocation to high yield. Otherwise, we undertook some sales to manage liquidity and manage the shape of the fund after the market volatility.

- The fund remains well diversified, with low sensitivity to interest rates, and an attractive underlying yield that should support income generation.

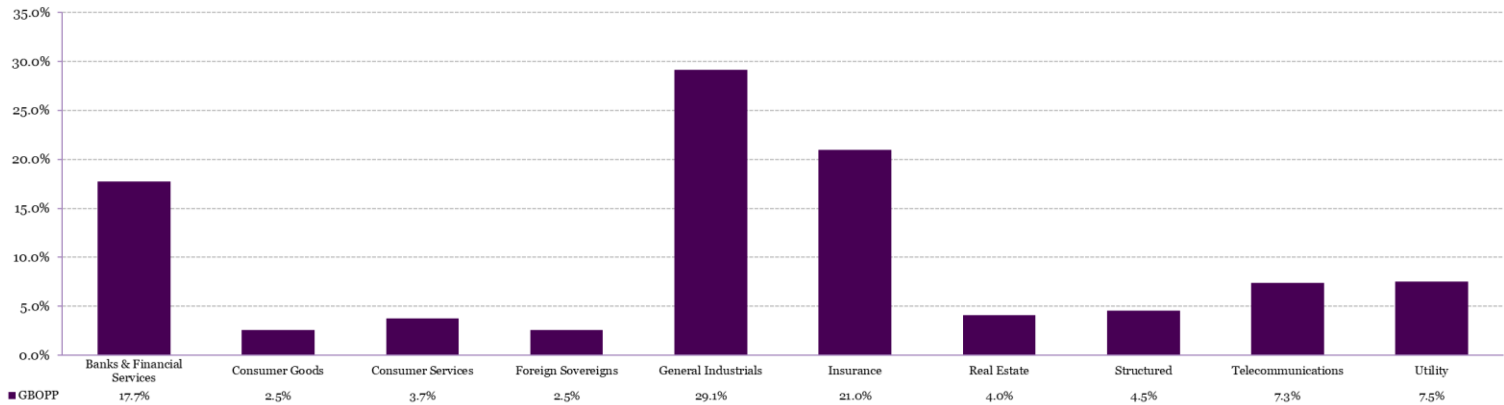
Investment outlook

- 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.
- 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 the coming months, there remains considerable uncertainty about energy prices and wage pressures.
- 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. The yields on gilts, sterling investment grade bonds, European sub-investment grade bonds and global sub-investment grade bonds rose to 4.10%, 6.21%, 8.21% and 9.81%, respectively, at end September, up from 0.94%, 1.83%, 2.89% and 4.71% at the start of the year. Investment grade credit is arguably at its most compelling level for nearly 10 years, particularly if inflation starts to fall: furthermore, the fund delivers a yield premium to the market.
- Following three quarters of weakness in government bond markets and negative returns, the high yield market is now pricing in a severe recession and offers excellent value. With spreads at over 619bps at the end of September, the implied five-year cumulative default rate is 31%. This compares to cumulative default rates of 25% during the Global Financial Crisis and 30%+ in the 1990s and early 2000s.The all-time high was 41% in the long and deep depression of the 1930s. So, while defaults are currently at record lows, the high yield market is discounting a major recession and commensurate level of defaults. Yet this implied default rate takes no account of the much higher quality and more robust nature of the high yield market today, compared to 2008/9; nor of the current financial state of issuers as we head towards the downturn. Most issuers are in a stronger position than normal at this stage of a cycle and default and recovery expectations remain extremely benign.
- The fund's unconstrained approach across a broad spectrum of fixed income opportunities – encompassing investment grade, sub-investment grade and unrated bonds in a wide range of credit markets – means that risks are diversified, while providing considerable opportunities. Furthermore, the short duration of the fund should limit the impact of the volatility that may continue to impact government bond markets.

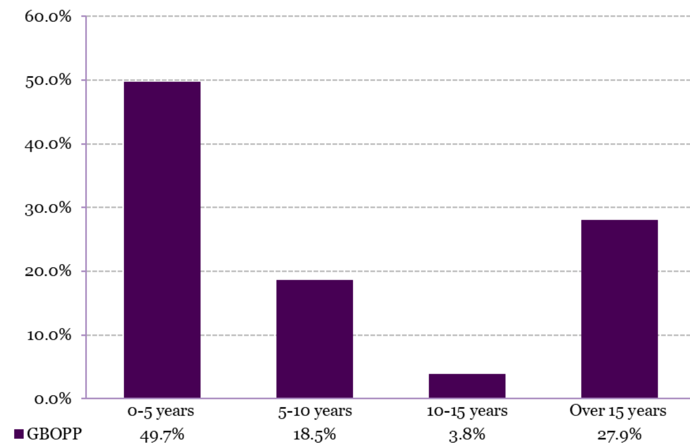
Additional information

- 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.

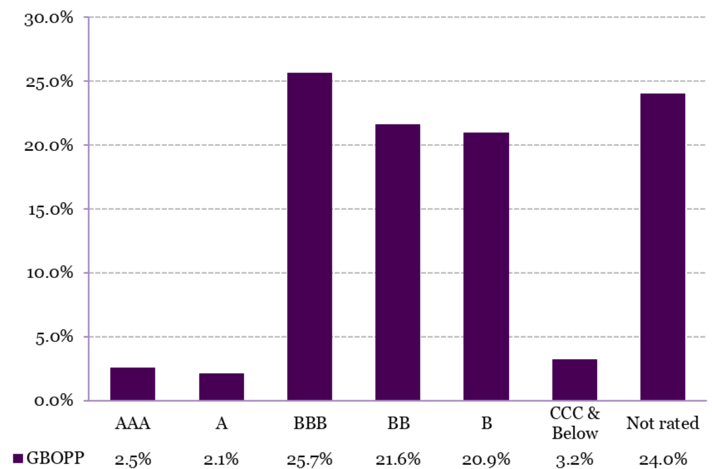
Sector breakdown



Maturity profile



Credit breakdown



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

Ten Largest Holdings

	Weighting (%)
US Treasury 2024	2.5
Aggregated Micro Power Infrastructure 8% 2036	1.7
QBE Insurance Group Ltd 6.75%2044	1.7
Electricité de France 5.375% Perpetual	1.6
M&G Plc 3.875% 2049	1.6
Rabobank 6.5% Perpetual	1.6
Energy Transfer LP 6.75% Perpetual	1.6
M&G Plc 6.5% 2048	1.6
Swiss Re 5.524% Perpetual	1.5
La Mondiale 6.75% 2044	1.4
Total	**16.9**

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

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