Royal London Multi Asset Credit Fund

Quarterly Report 30 September 2022

Asset split

	Fund (%)
Loans	29.1
Secured high yield	18.1
Short duration high yield	17.7
Conventional high yield	19.0
Asset backed securities	1.6
Investment grade corporate bonds	0.0
ROW	1.2
CLOs	13.3

Fund data

	Fund
Duration[1]	2.2 years
FX Adjusted Yield[2]	10.8%
Fund size	£905.1m

Source: RLAM and State Street. Based on the Z Inc share class.
Launch date of the share class: 09 October 2017.
Figures in relation to the asset spilt table exclude the impact of cash where held.
[1]Excluding cash
[2]FX adjusted yield is the gross rate of return to the expected maturity adjusted for hedging and includes the impact of 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.

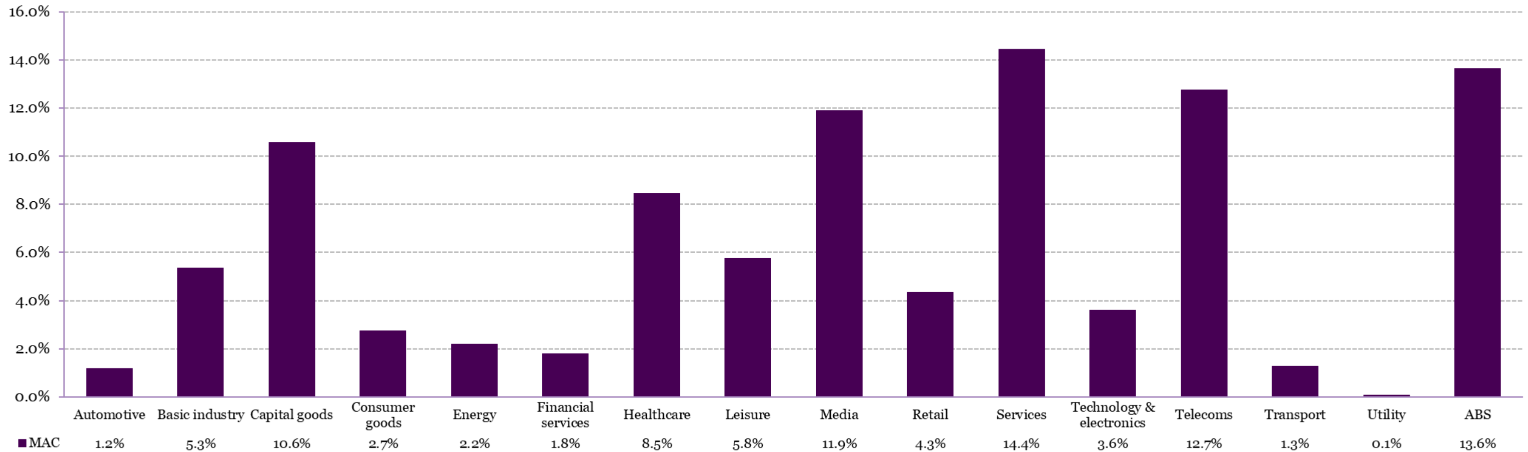
Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2022	**-0.68**	**0.39**	**-1.06**
Year-to-date	-11.44	0.71	-12.14
Rolling 12 months	-10.88	0.72	-11.61
3 years p.a.	-0.38	0.42	-0.80
Since inception p.a. 09.10.2017	1.23	0.54	0.69

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 Inc share class. Performance for the fund is calculated on a mid basis with income re-invested.
[1]Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 15 December 2020, and is reflected in the returns shown above.

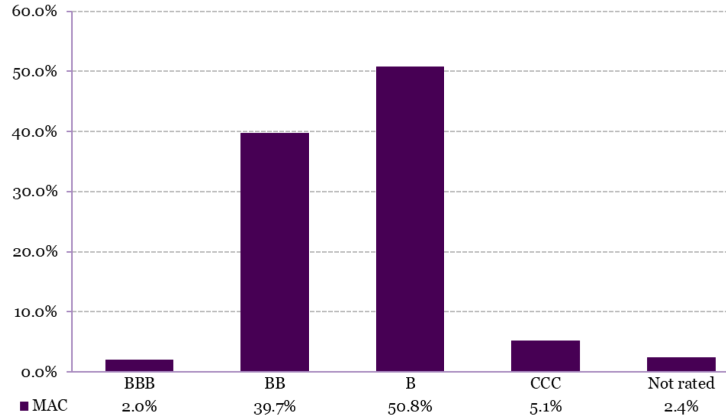
ROYAL LONDON
ASSET MANAGEMENT

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

Rating breakdown



Regional breakdown

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 influences, along with growing fears of a 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 that 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 Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. It has raised rates five times since March by 3% in aggregate – the 0.75% increases in June, July and September were the biggest individual 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, it ended its bond-buying programme in July and increased rates by 0.75% (its first hike for 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 UK gilt market was the worst performing major government bond market over the quarter, returning -12.85% as the benchmark 10-year gilt yield rose by 129 basis points (bps) 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).
- Currency movements also had a notable impact in the quarter. The Fed's more aggressive approach to raising interest rates compared to other central banks pushed the dollar higher and it was again the strongest major currency: it appreciated by over 6% against the yen and euro, and over 8% against sterling. Sterling's weakness benefits sterling investors in overseas assets as it boosts the returns over the quarter. However, these movements will impact global trade over coming months, and dollar strength will also be a risk for emerging markets countries and companies that have borrowed in dollars.
- After a particularly difficult first half of 2022, in which the high yield market fell over 15%, with such generous 'all-in yields' and the boost for sterling investors in global high yield from currency movements, the third quarter was less challenging than it was for government bonds and sterling investment grade credit. The high yield spread actually tightened from 573bps to 540bps, although the weakness in the underlying treasury bonds increased the yield on our benchmark (the ICE BofAML (BB-B) Global Non-Financial High Yield Index) to 9.1%. Although high yield issuance picked up slightly in the third quarter having more-or-less dried up since January, the adverse market conditions continued to impair new issuance and largely confined activity to the dollar market.
- The yield on the broad high yield index (including CCC rated bonds) rose to 10% over the third quarter. At this level, around half the market could default over a five-year period and, assuming normal rates of recovery, investors would make more than the risk-free rate. However, having moved to a firmly defensive stance in March as inflation pushed up interest rates, we maintain a broadly cautious stance even though yields look particularly attractive. At these levels, there is no need to take unnecessary risks and there are still a number of challenges with the macroeconomic environment. Given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment: we will keep our powder dry until there is more clarity about the overall outlook.
- By the end of 2022, monetary policy will be very tight and the global economy (as well as key areas such as housing) will be slowing sharply – as a result, we believe that there will definitely be a recession in the US, Europe and the UK (particularly with the impact of higher energy prices and possible rolling power cuts in the latter two economies). The outlook and timing may differ between regions, however, and there is still significant interest-rate risk in the US. Inflation remains embedded, and Fed Chair Powell has more freedom to act and put up rates as there is less political blowback, even with the mid-term elections approaching. In contrast, the UK feels more fragile and the BoE is more constrained by the specific dynamics of the UK housing market.

Portfolio commentary

- The fund underperformed its Sterling Overnight Index Average Rate (SONIA) benchmark due to the weakness in global bond markets. However, for broader comparison, the fund performed well versus the Lipper Global Bond GBP peer group, and performed broadly in line with a 50/50 Global High Yield/Loans reference index over the quarter.
- The fund's allocations to loans and collateralised loan obligations (CLOs) drove volatility, with these buckets performing strongly in the first two months of the quarter before reversing in September. As credit markets weakened in September, CLOs in particular underperformed materially due to technical pressure across ABS markets. As market sentiment and the outlook for the economy softened, we reduced the exposure to lower-rated credit in favour of higher quality B and BB credits. Asset class-wise, exposure to senior secured and short duration high yield was also increased with the aim of mitigating the impact of an economic slowdown and rising credit concerns.
- European credit also underperformed against the US and the fund's oversized exposure here led to underperformance. This was partially mitigated by its US credit holdings, which performed better on a relative basis, while low exposure to emerging markets enabled the fund to avoid the credit market sell-off in China and the wider Asia region. Exposure to CLOs negatively impacted performance this quarter as inflation concerns led to uncertainty about economic growth. CLO market technicals also hurt performance, including the negligible new issuance in the asset class.
- While at very low levels (particularly compared to expectations), there was still some new issuance in the period. However, we continued to be very selective, passing on companies with weak business models or poor fundamentals, and preferred to build up a cash buffer in the expectation of better quality new issues in the future.

- Over the quarter we reduced our loan exposure, selling names such as **Adevinta**, **Medline** and **Sivantos** and reducing **APX Group**, **Mauser Packaging Solutions**, **BB Hotels** and **Univision** – replacing these with low cash-priced, high quality BB bonds (**Ashtead**, **Ball**, **Broadcom**, **Centene**, **Catalent**, **Charter Communications**, **T-Mobile USA** and **United Rentals**).
- At quarter end, the yield on the fund was 9.87% (10.81% on an FX-adjusted basis), excluding the impact of cash, with a duration of 2.24 years.

Outlook

- We turned more defensive in March to navigate the remainder of 2022, de-risking our funds by reducing duration and increasing security. While the near term is relatively unthreatening and yields are undoubtedly attractive, the outlook for interest rates and economic growth remains unclear heading into 2023 and we will retain a defensive mindset until the prognosis for inflation is clearer.
- Following three quarters of weakness in government bond markets and negative returns, the high yield market is now pricing in a severe recession and we believe therefore 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. We believe that the future default cycle is unlikely to be as negative as prior cycles because the market composition has improved: the highest risk CCC rating band now only represents 9% of the market, compared to 17% in 2007; meanwhile, the BB rated band now accounts for 60% of the market. In addition, following the bumper issuance of 2020 and 2021 (and the strength of the energy sector in 2021 and the first half of 2022), most issuers are in a stronger position than normal at this stage of a cycle and default and recovery expectations remain extremely benign.
- While these figures are compelling, we don't feel that a higher-risk strategy is necessary. With yields at current levels and appealing potential returns, we will be paid sufficiently for maintaining a lower-risk position at least another quarter until there is more clarity about the outlook. Unlike equities, given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment. The way through difficult markets is to focus on those risks that you can control and know what you own. We will keep duration low and focus on the quality of issuers' financials, rather than relying on third-party ratings: at a sectoral level, cashflows are the key factor, so we need to know about on- and off-balance sheet leverage. We prefer not to wait for defaults as the recovery process can take time: however, should they occur, the key is to have an adequate solvency cushion.

Find out more

- 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 Head of Fixed Income Jonathan Platt 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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