Royal London Sterling Extra Yield Bond Fund

Quarterly Report 30 September 2022

Executive summary

- The fund recorded a return, gross of tax and management fees, of -3.85% for the quarter, giving a total return of -8.45% for the rolling 12-month period. Performance in the quarter reflects weakness in government bond markets, the widening of investment grade spreads and the sensitivity of some of the fund's holdings to higher interest rates; these factors were partly offset by strong performance from some areas of its broad range of investments and by robust income generation.
- 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. Although they have fallen back slightly, oil and gas 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 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 is in a state of flux following Kwasi Kwarteng's 'mini Budget' in late September. Following weakness in the gilts and foreign exchange markets, intervention by the BoE (but specifically not by its Monetary Policy Committee) and a series of U-turns by the Government, Jeremy Hunt has been appointed as Chancellor to replace the sacked Mr Kwarteng.
- 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). Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, 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%. In unprecedented volatility as the BoE intervened in the gilt market in the week following the mini-Budget, the 50-year index linked gilt traded within a price range of 38 to 92 within half a day, down from a peak price of 400 in December last year.
- 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 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 (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 25bps to 1.99% (iBoxx).
- Currency movements had a notable impact in the quarter. The Federal Reserve'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. As a result, global high yield markets returned -1.50% (ICE BofAML (BB-B) Global Non-Financial High Yield Index). 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.
- Distributions in respect of the third quarter, payable at the end of November, are 1.74p, 1.58p, 1.63p and 1.62p, respectively, for the A, B, Y and Z class income shares, higher than the 1.62p, 1.45p, 1.53p and 1.51p distributed for the second quarter of 2022, and also above the 1.62p, 1.45p, 1.54p and 1.52p distributed for the third quarter of 2021.

Performance

	Fund (Class A) (%)	Fund (Class Z) (%)
Q3 2022	**-3.85**	**-3.84**
Year-to-date	-8.63	-8.64
Rolling 12 months	-8.45	-8.44
3 years p.a.	0.88	0.88
5 years p.a.	2.93	2.93
10 years p.a.	6.95	-
Since inception p.a. 13.12.2013	-	5.69
Since inception p.a. 14.04.2003	7.37	-

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. 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.*

Fund commentary

- Against the background of the sharp moves in sterling fixed interest markets in the quarter, the decline in price of many of the longer-dated bonds in the fund exceeded 10%. Such bonds included financials **Lloyds Bank**, **M&G**, **Scottish Widows** and **Standard Chartered**, together with secured and structured bonds of **Tesco Property**, PFI deal **Connect M77/GSO**, pub business **Mitchells & Butlers** and **Premiertel**. In a quarter when the yield on the benchmark five-year gilt rose from 1.98% to 4.41% – corresponding to a quarterly return of worse than -10% – even many shorter-dated bonds in the fund declined sharply in price. The areas of relative strength were overseas currency bonds, as sterling bond markets were weaker than those in the US or eurozone, and bonds in the energy and energy services sectors, which were generally resilient – in many instances appreciating in price in the quarter, in addition to delivering robust income generation.
- Investable funds were enhanced by the repurchase bond tender offer by Brazilian state oil company **Petrobras**; the early repayment of bonds of **Lime Petroleum**, of **Hawk Debtco** (the small offshore servicing sector company recently acquired by a larger business) and of Norwegian continental shelf energy business **OKEA**, each at a premium to its par value; and the investor put option exercised in respect of the holding of **Siccar Point** bonds, triggered by the takeover of that UK North Sea energy company and again at a premium to their par value and market price. Fund liquidity was also increased by the repayment of **Thames Water** bonds and by further sales of the holding of **Norwegian Energy** shares, received as part of a bond restructuring in 2015, which had trebled in price this year on higher gas prices in Europe and prospects for the Tyra gas field offshore Denmark.
- Meanwhile the secured bonds of **Lendinvest**, the specialist mortgage lender, which redeemed in August were reinvested in the company's new 2027 secured bonds, which offered a 6.5% coupon. Funds available for investment were also increased by the repayment of pubs business **Spirit** 2028 secured bonds at a yield equivalent to the reference gilt, triggering a 3% uplift from their end August price when the reference gilt was down 8% in price in the month.
- New issues were limited by the volatile conditions throughout the quarter. Activity included participating in new issues of **BNP Paribas** (dollar-denominated BB rated and offering a 7.75% coupon until first call in 2029 and sold in the month, crystallising a capital gain), **Svenska Handelsbanken** and **Zurich Finance** – the latter two each sterling-denominated, A rated and offering 4.625% and 5.125% income to their first calls in 2027 and 2032, respectively. The fund also participated in a new issue from **Sainsbury's Bank** and from **NES Fircroft,** the specialist employment services company.
- Market purchases included investment grade hybrid bonds of **BP**, **Investec Bank**, **Virgin Money**, insurer **M&G**, utility **EDF**, **John Lewis**, **Tullow Oil**, and property groups **Bruntwood** and **Peel Holdings** (secured bonds). Sub-investment grade bonds of **Medical Properties Trust** and of **Thames Water** were purchased, while acquisitions of unrated assets included bonds on metals recycling business **Metalcorp**, and also investment in a small issue of preference shares of **Haleon**. Sales included bonds of financial groups **Julius Baer** and **Skandinaviska Enskilda**, and of structured bonds of PFI deal **Progress Healthcare**, issued to finance the refurbishment of Peterborough Hospital, which had performed relatively well in recent challenging market conditions. The holding of **iGas** shares was reduced after their sharp rise. Later in the period, holdings of oil and gas companies **DNO** and **OKEA** were sold or reduced to finance purchases in bonds that

had fallen sharply in the market setback, triggering a large shift in relative value. Finally, activity in short-dated **UK gilts** reflected short-term liquidity management in the fund.

Investment outlook

- It is too early to say whether the UK government will be forced into further U-turns in economic policy (or even a new Prime Minister), either by its backbenchers or the financial markets, but its reputation has been badly undermined by recent events. 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 in the coming months. 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. 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. Sterling 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.
- 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.

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.

Fund price and yields

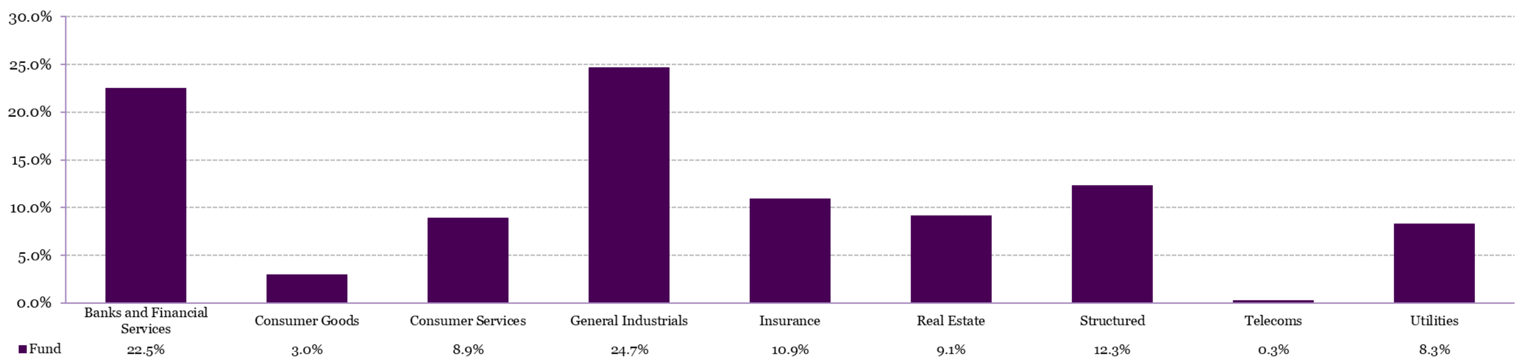
	Fund (Class A)	Fund (Class Z)
Gross redemption yield	8.36%	8.63%
Gross income yield	6.50%	6.76%

Source: RLAM and State Street. Based on the A and Z share class.
²Excluding 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

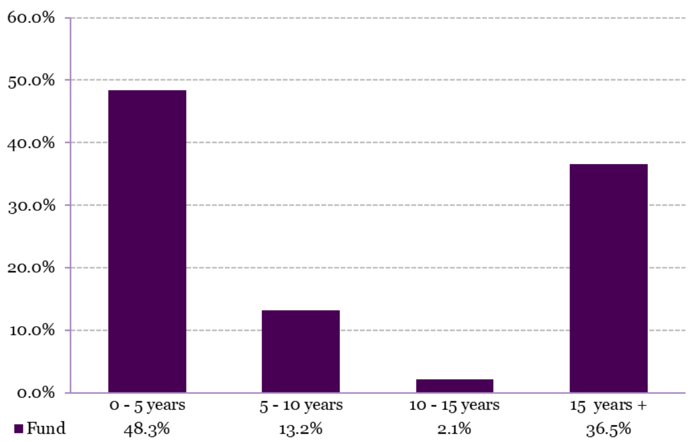
	Fund
Duration²	3.8 years
No. of stocks	209
Fund size	£1,531.9m
Launch date	11.04.2003

Sector breakdown



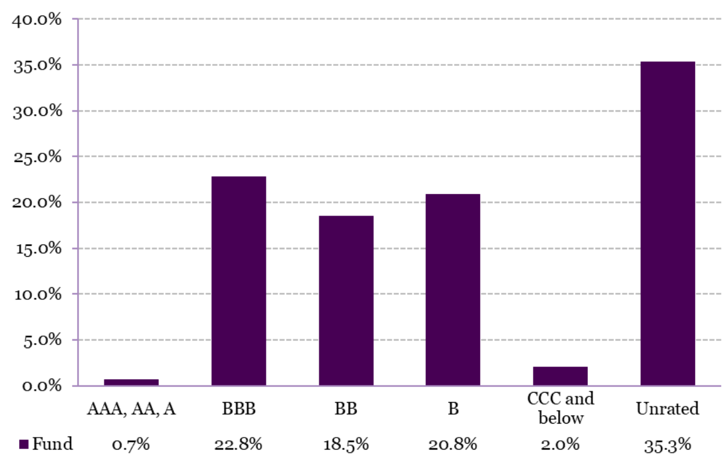
Source: RLAM. Figures include the impact of cash held.

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	2.4
Santander UK 10.0625%	2.3
Thames Water 4.625% 2026	2.1
Centrica 5.25% 2025/75	2.1
Électricité De France 5.875% 2029	2.0
Santander UK 10.375%	1.9
Metrocentre Finance 8.75% 2023	1.8
M&G 6.34% 2043/63	1.6
Heathrow Finance 4.375% 2027	1.5
Telereal C1 FRN 2031	1.5
Total	**19.2**

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

Currency breakdown

	Fund (%)
Sterling	74.0
US Dollar (hedged 12.0%)	16.4
Euro (hedged 4.9%)	5.7
Norwegian Krone	3.7
Swedish Krona	0.2
Canadian Dollar	0.0
Total	**100.0**

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

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