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Royal London Short Duration Credit Fund

Quarterly Investment Report

31 December 2023

Quarterly Report

The fund as at 31 December 2023

The purpose of this report is to provide an update on the Royal London Short Duration Credit Fund. The report has been produced by Royal London Asset Management. The report starts with a summary dashboard showing key information about the fund. A glossary is located at the end of the report covering the description of some of the more technical terms used within the report. All data is as at the report date unless otherwise stated.

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The fund

Fund performance objective and benchmark

The fund's investment objective is to achieve a total return over the medium term (3-5 years) by investing at least 80% in sterling denominated bonds, of which at least 70% will be short duration (5 years or less). The fund's performance target is to outperform the ICE Bank of America Merrill Lynch 1-5 Year Sterling Non-Gilt Index (the "Index") over a rolling 5-year period. For further information on the fund's index, please refer to the Prospectus.

Benchmark: ICE BofA ML 1-5 Year Sterling Non-Gilt Index

Fund value

	Total £m
31 December 2023	1,187.44

Asset allocation

	Fund (%)	Benchmark
Conventional credit bonds	94.78%	99.14%
Securitised	4.56%	-
Other	0.33%	-
Index linked credit bonds	0.33%	-
Conventional foreign sovereign	-	0.86%

Fund analytics

	Fund	Benchmark
Fund launch date	8 November 2013	
Base currency	GBP	
Duration (years)	3.09	2.41
Gross redemption yield (%)	7.03	4.60
Number of holdings	312	603
Number of issuers	197	294

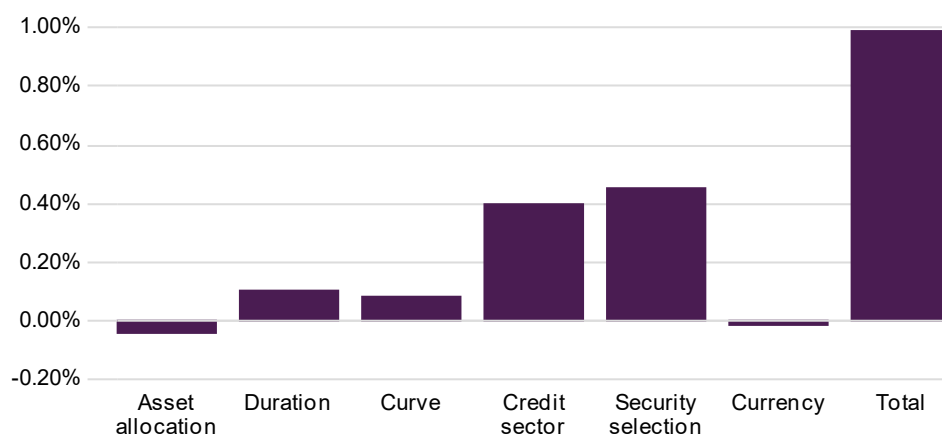
Performance and activity

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	5.63	4.07	1.57
1 Year	9.75	6.87	2.88
3 Years (p.a.)	1.33	(0.63)	1.96
5 Years (p.a.)	2.86	1.00	1.86
10 Years (p.a.)	3.21	1.63	1.58
Since inception (p.a.)	3.13	1.59	1.54

Past performance is not a guide to future performance. Please refer to the Glossary for the basis of calculation and impact of fees. Performance and since inception date based on RL Short Duration Credit Fund (Z Inc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 8 November 2013.

Attribution over the quarter



Performance commentary

The fund saw a positive return in the period and was ahead of the ICE BoA ML 1–5 Year Sterling Non-Gilt Index. The main driver of positive performance was our sector positioning, notably our underweight position in supranationals, which continued to lag the wider market having done so in the third quarter. Duration and curve positioning were positive – we were slightly long going into the quarter and the fall in yields and strong performance from longer-dated bonds therefore helped.

Stock selection effects were positive: we saw positive selection in banks, through our exposure to HSBC and Barclays, as well as insurance bonds, notably longer dated subordinated bonds from Prudential and Legal & General, slightly offset by negative selection effects in structured bonds, which generally have a lower sensitivity to wider market moves. Additionally, our exposure to Thames Water in the structured area was negative. We maintained exposure to Thames Water as part of a diversified portfolio, based on the attractiveness of the overall blended yield across holdings in operating company and holding company debt. Whilst structurally junior holding company debt underperformed and was downgraded, our larger exposure to the operating company debt was beneficial for performance over the quarter. We continue to believe that the sector remains attractively valued – largely based on our view that spreads in the sector overcompensate when compared to other regulated infrastructure assets such as UK electricity distribution.

Last quarter we highlighted an issue with our holding in HDL, where the principal was not repaid on maturity at the end of July. We are pleased to confirm that the bond was redeemed in full in November. We believe this is a good outcome as not only did holders receive full repayment, but also accrued interest at the coupon rate since the end of July. In our view, this demonstrates the power of covenants and how these can protect investors' interests in this sort of scenario. Naturally we prefer to avoid any default, but as we expressed in our initial update we had confidence in our position. It should be noted that, over time, the investment in HDL has been materially beneficial – despite the default.

Performance and activity

Fund activity

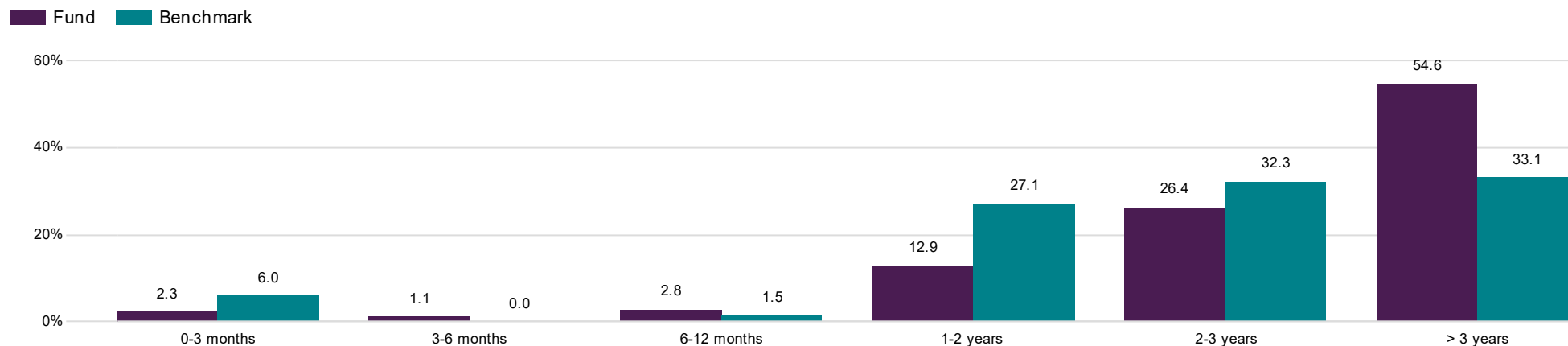
Financials remain the largest part of the market with issuance in 2023 skewed similarly. We continued to find opportunities across the financial sector, adding a new senior issue from Barclays early in the period, also adding senior bonds from US insurer Pacific Life, with the bonds ranking alongside policyholders in seniority. We are also happy to add subordinated bonds where we feel the risk/ reward profile is attractive, examples during the quarter including defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation. Finally we added AT1 subordinated new issues from UBS and Close Brothers, both at a yield in excess of 10%. This market, having been very quiet since the Credit Suisse rescue, has been active with investors now confident that such debt will rank higher than equity holders in US dollar, euro and sterling markets.

There were noteworthy new issues in the structured sector as well. We added a new issue of Stark Financing, a commercial mortgage-backed security secured against 103 UK property assets, predominantly 'last mile' warehouse assets. The floating rate A notes we bought are rated AAA and have an attractive loan-to-value, also paying an attractive premium to SONIA. We also added a five-year new issue from the RAC, these bonds yielding over 8% and benefiting from security over the business.

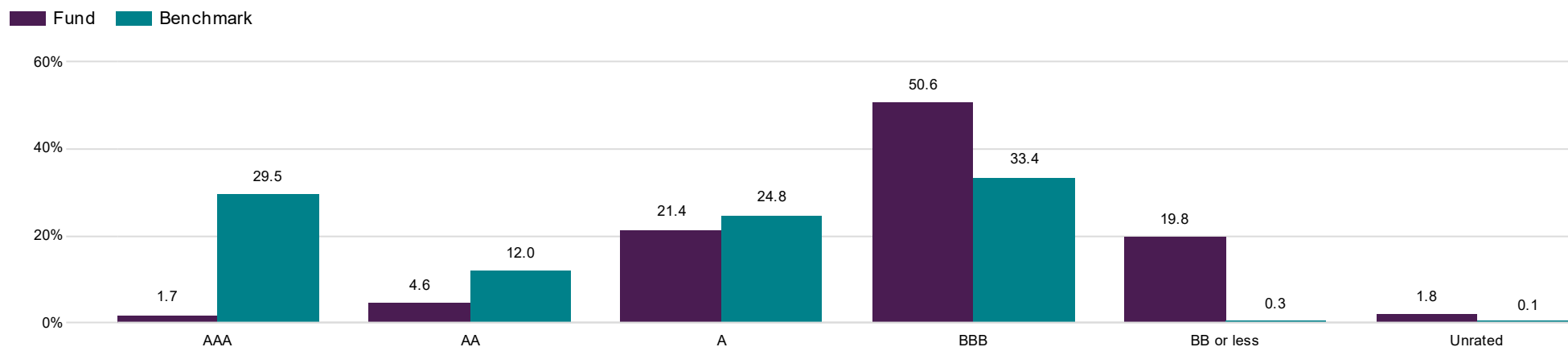
In the secondary market we added selectively to subordinated bank and insurance debt – where yields still remain elevated. However, underlying credit fundamentals mean that some of these bonds offer excellent value, such as legacy bonds from Aviva and Legal & General. We also added to AT1 bonds from preferred institutions such as NatWest and Société Générale.

Fund breakdown

Maturity profile

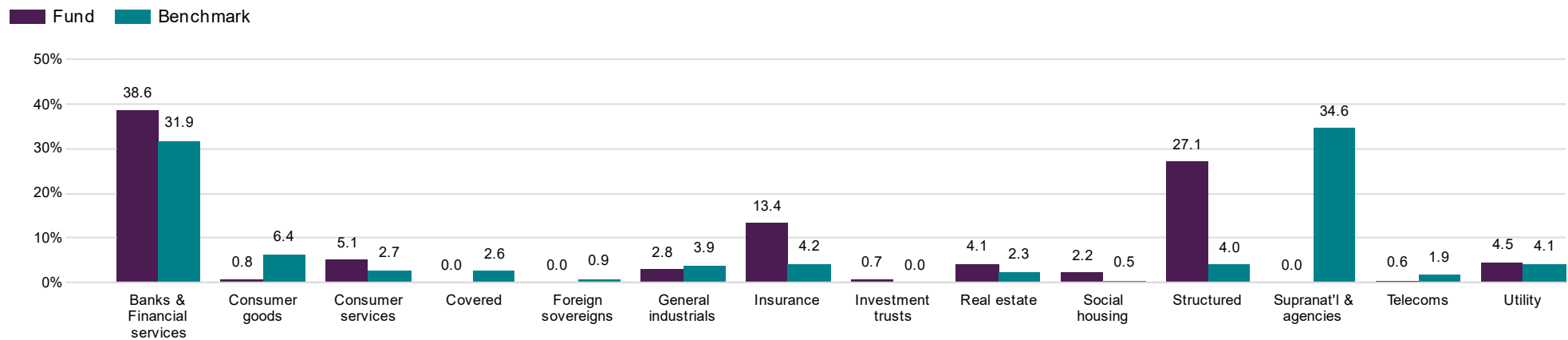


Credit ratings



Fund breakdown

Sector breakdown



Market commentary

Market overview

Economic attention over the quarter has been on inflation. At the start of the quarter investors focussed on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period. The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields in November and December. The fall in yields was such that yields along the length of the curve ended the quarter lower than they started, and closed 2023 at roughly the same levels as they started. UK government bonds produced strong returns due to falling yields, delivering an 8.1% return (FTSE Actuaries) over the fourth quarter with the benchmark 10-year gilt yield falling from 4.44% to 3.54%.

The sterling investment grade credit market (iBoxx non-gilt index) returned 7.35% over the quarter, helped by lower government bond yields and tighter credit spreads. This was lower than the return from gilts due to the shorter duration of the credit market index. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightened from 1.38% to 1.15% (iBoxx). Given the fall in yields, sectors with a greater proportion of long-dated bonds performed well, including utilities and social housing. Supranationals was the worst performing sector, while in financials, banks lagged slightly but insurance bonds modestly outperformed the market.

Issuance was relatively low in the fourth quarter, reflecting usual seasonal patterns. For the year as a whole, sterling issuance was £63.9 billion, or £28 billion in net terms, compared with £51.5 billion and -£2.7 billion respectively in 2022.

Outlook

Inflation has come down significantly in 2023 but remains well above the Bank of England's target, and now does not have the 'easy' wins of base effects to push this lower. In our view, wage inflation is the key metric to watch: we believe that the Bank will find it hard to start cutting rates if wages continue to rise at 5-6% per annum. Although the economic data remain very mixed, we still believe that higher interest rates will contribute to a slowdown in the UK. This could well impact company earnings and lead to some increase in pressure on credit markets. However, consumer resilience has been greater than expected in both the UK and globally, which has helped support growth and prevent a recession. How this continues into 2024 could prove critical.

As we came into November 2023, we felt that the all-in yield on sterling investment grade credit was looking very attractive, having risen significantly since the start of the year. The falls in gilt yields since then have largely reversed those rises. Our sterling credit strategy focuses on three sources of return: gilt yields, market credit spreads, and the additional credit spread we generate over credit benchmarks. Whilst ten-year gilt yields of 3.5% are not as attractive as the 4.5% seen in October, we feel that the excess yield available on investment grade credit overcompensates for default risk. Further, the additional yield embedded in our credit strategies, over that available from credit benchmarks, gives us confidence in our ability to deliver long-term outperformance.

We expect supply to weigh on credit markets in the first quarter but believe that underlying fundamentals will limit spread widening. Our emphasis remains on building diversified portfolios, with a high relative exposure to asset backed and strongly covenanted bonds offering attractive yields. This strategy underpins the excess yield of the portfolio relative to its benchmark.

Although recent outperformance means that the relative attractiveness of sterling credit bonds has reduced, we still favour holding them compared to UK government debt as credit spreads remain at levels that more than compensate for the credit risk. Given the potential challenges in the outlook, we remain focused on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.

Further Information

Please click on the links below for further information:



Find out more

Royal London Asset Management's Outlook 2024 document and podcasts are both available on our website. In this year's Outlook document, our fund managers assess the challenges and opportunities in their respective asset classes for 2024. With an environment of falling inflation and modest recession, the benefits or risk for equities or credit is not so clear cut and knowing your companies is key. We analyse the areas of concern and potential growth within this environment.

In our Outlook 2024 podcast, Piers Hillier, CIO, looks ahead to 2024 and discusses the issues he believes will be prominent over the next 12 months, and where the key investment risks and opportunities may lie.

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

Disclaimers

Important information

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Issued in January 2024 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

The Fund is a sub-fund of Royal London Bond Funds II ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC001128.

The Authorised Corporate Director (ACD) is Royal London Unit Trust Managers Limited, authorised and regulated by the Financial Conduct Authority, with firm reference number 144037.

For more information on the fund or the risks of investing, please refer to the Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.com.

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Risks and Warnings

Investment Risk

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk

Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

EPM Techniques

The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Interest Rate Risk

Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital. Unlike the income from a single fixed interest security, the level of income (yield) from a fund is not fixed and may go up and down. Bond yields (and as a consequence bond prices) are determined by market perception as to the appropriate level of yields given the economic background.

Liquidity Risk

In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Counterparty Risk

The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Charges from Capital Risk

Charges are taken from the capital of the Fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.

Performance to 31 December 2023

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years	3 Years (p.a.)	5 Years (p.a.)
Fund (gross)	5.63	7.86	9.75	4.06	15.13	1.33	2.86
Fund (net)	5.55	7.69	9.41	3.09	13.41	1.02	2.55

Annualised (%)

Year on year performance (%)

	31/12/2022 - 31/12/2023	31/12/2021 - 31/12/2022	31/12/2020 - 31/12/2021	31/12/2019 - 31/12/2020	31/12/2018 - 31/12/2019
Fund (gross)	9.75	(6.60)	1.51	4.06	6.32
Fund (net)	9.41	(6.89)	1.20	3.74	6.04

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

Source: RLAM as at 31 December 2023. All figures are mid-price to mid-price in GBP for the RL Short Duration Credit Fund (Z Inc).

Glossary

Asset allocation

Breakdown of the assets by asset classes. Based on RLAM asset classification scheme.

Attribution

Attribution is shown for the most recent quarter. Attribution figures are based on end of business returns for both the fund and the index whereas performance figures are based on midday returns for the fund and end of business for the index. Therefore the performance will not include market moves between midday when the fund is priced, and end of business when the index is calculated. This may result in a different figure being shown for the quarterly performance vs attribution data.

Credit ratings

Credit ratings are based on RLAM composite ratings which uses a hierarchy of S&P, Moody's and then the Fitch rating.

Duration

Measure of sensitivity of a Fixed Income instrument to changes in interest rates, indicating the potential impact of interest rate fluctuations on the value of the investment.

Fund Analytics

All figures exclude cash. Credit bonds include non-sterling bonds and CDs where held within the fund or benchmark.

This is applicable to the following sections: fund Asset Allocation, Duration, Yield curve, Sector breakdown, Financial holdings, Credit ratings.

Fund value

Total value of the fund as of the last business day of the calendar month. The fund value is as at close of business and on a mid-price basis.

Gross redemption yield

Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the fund is the average for its individual holdings, weighted by their current value, net of relevant fund management costs and gross of tax.

Number of holdings

Total number of unique holdings of the Fund excluding cash, currency and derivatives.

Number of issuers

Number of unique issuers of all assets held by the Fund, excluding cash, currency and derivatives.

Performance

Performance is calculated using the daily end of day NAV per share produced by HSBC based on the mid price.

Sector breakdown

Breakdown of the fixed income assets, excluding derivatives and cash by RLAM's internal industry sector classification scheme. Figures are subject to rounding.