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Royal London Sterling Extra Yield Bond Fund (A Inc)

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 Sterling Extra Yield Bond Fund (A Inc). 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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ROYAL LONDON
ASSET MANAGEMENT

The fund

Fund performance objective and benchmark

The investment objective of the fund is to achieve a high level of income. The fund seeks to achieve a gross redemption yield (GRY) of 1.25 times the gross redemption yield of the FTSE Actuaries British Government 15 Year index.

Fund value

	Total £m
31 December 2023	1,549.92

Fund analytics

	Fund
Fund launch date	14 April 2003
Base currency	GBP
Duration (years)	3.78
Gross redemption yield (%)	8.46
Number of holdings	223
Number of issuers	167

Performance and activity

Performance

	Fund (%)
Quarter	5.36
1 Year	10.29
3 Years (p.a.)	4.55
5 Years (p.a.)	4.96
10 Years (p.a.)	6.47
Since inception (p.a.)	7.64

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 Sterling Extra Yield Bond Fund (A Inc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 11 April 2003.

Performance commentary

The fund posted strong returns in the final quarter of 2023, leading to double-digit returns for the year, gross of fees. The sector returns across the fund were broadly positive, with no sector seeing a negative return. Our banking, insurance and utility holdings were the best performers while consumer goods, social housing and telecommunications were the relative underperformers. The boost to underlying performance in the fourth quarter was the sharp uptick in holdings in the financial sectors of banking and insurance, especially marked for longer maturity bonds.

Distributions in respect of the fourth quarter, payable at the end of February, are 1.69p, 1.54p, 1.58p and 1.57p respectively for the A, B, Y and Z class income shares. These are lower than the amounts of 1.96p, 1.80p, 1.82p and 1.81p distributed in respective of the third quarter 2023, but bring distributions for 2023 as a whole to 7.27p, 6.64p, 6.77p and 6.73p respectively compared to distributions of 6.81p, 6.16p, 6.40p and 6.34p respectively for 2022.

The buoyancy of fixed interest markets which commenced in November, primarily triggered by confidence that the peak of the interest rates had been reached, continued and accelerated into the year end. Sterling investment grade corporate bonds performed well – with a lower duration than gilts, and therefore lower sensitivity to the decline in yields than gilts, more than offsetting the positive influence of a decline in the average yield differential between sterling investment grade corporate bonds and reference gilts.

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.

In addition, our holding in Thames Water was also a detractor from performance over the quarter. We maintained exposure to Thames Water as part of a diversified portfolio. Whilst junior holding company debt underperformed and was downgraded, 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.

Performance and activity

Top 10 holdings

	Weighting (%)
ELECTRICITE DE FRANCE SA 5.875000000	2.54
CENTRICA PLC 5.250000000 2075-04-10	2.39
CO-OP GRP HLDS 7.500000000 2026-07-08	2.33
SANTANDER UK PLC	1.99
SANTANDER UK PLC 10.062500000	1.98
M&G PLC 6.340000000 2063-12-19	1.94
METROCENTRE FINANCE 8.750000000 2024-12-05	1.79
HEATHROW FINANCE PLC 3.875000000 2027-03-01	1.78
PHOENIX GRP HLD PLC 5.750000000	1.66
ELECTRICITE DE FRANCE SA 6.000000000	1.66
Total	**20.06**

Fund activity

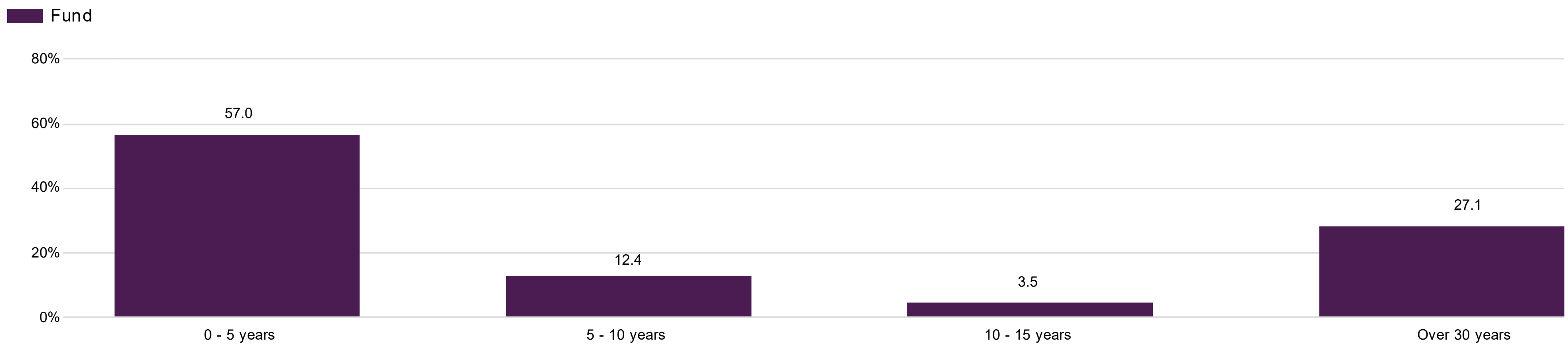
Ahead of the holiday period there were few new issue investment opportunities and in buoyant market conditions secondary market activity was relatively subdued. The fund benefitted from the early repayment of Nordic Capital Partners bonds at a premium to their par value, and partial repayments of Aggregated Micropower, BOA, Thesis and Doric Nimrod Air Two. The fund also seen the early repayment of bonds of mining group Copper Mountain at a 4% premium to their par value and of educational business Alpha Plus, providing the opportunity to raise income generation from the 5% coupon which was payable on this bond. These repayments increased the level of liquidity in the fund, held in short-dated gilts reflecting short term cash management, pending investment opportunities which seem likely to arise in the early weeks of 2024.

The fund participated in the strong flow of new issues in the month. Financials were dominant, including Close Brothers and UBS AT1 bonds, the latter US dollar-denominated and offering yields of 11⅛% and 9¼% respectively, insurers Aviva, Pension Insurance and Phoenix, each investment grade and offering yields of 6⅞%, 8% and 7¾% respectively. Other new issues purchased were euro-denominated ‘hybrid’ bonds of Australian infrastructure business APA, yielding 7⅛% and unrated, floating rate bonds of industrial business Fiven, a global market leader in production of silicon carbide.

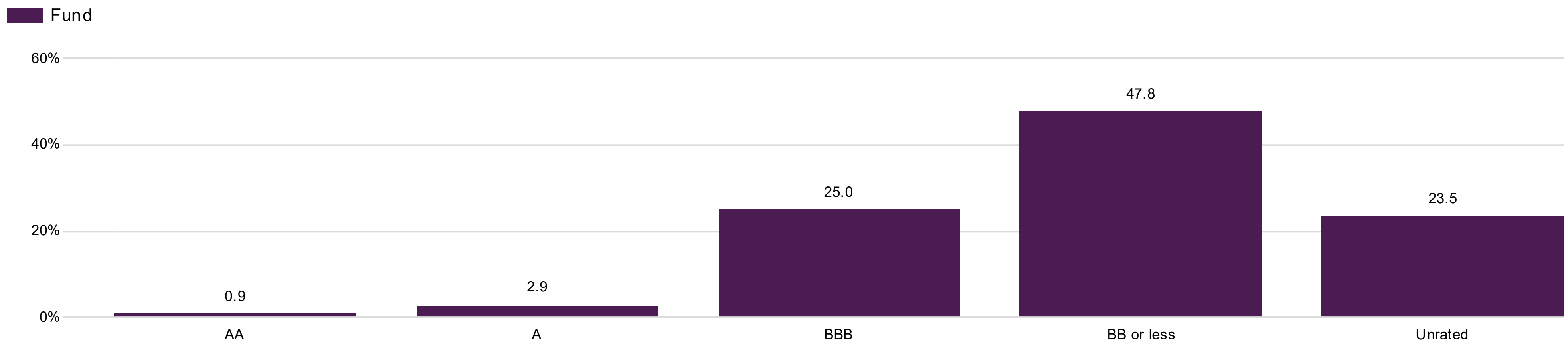
Sales in the period included AT1 bonds of Swiss banking business Julius Baer and of bonds of UK shopping centre group SGS, formerly part of the INTU group of businesses, which had risen on hopes of a refinancing of the business.

Fund breakdown

Maturity profile

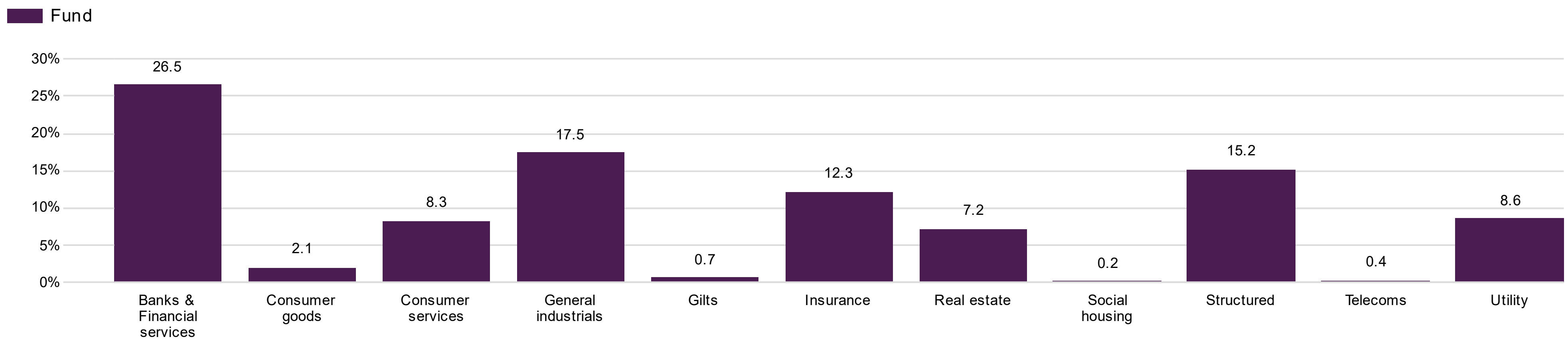


Credit ratings



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 fell in November and December. 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 falling yield environment was helpful for longer duration assets, with longer-dated bonds outperforming shorter-dated bonds.

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. The underperformance compared to the gilt market is the result of 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. In euro markets, total issuance in 2023 was €608.3 billion, or €165.7 billion in net terms, compared to €536.9 billion and €94.9 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.

As we came into November 2023, we felt that the all-in yield on investment grade credit was looking very attractive, having risen significantly since the start of the year. The falls in government bond yields since then have largely reversed those rises but we still feel that the excess yield available on investment grade and high yield credit overcompensates for default risk. 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.

Although recent strong performance means that the relative attractiveness of credit bonds has reduced, we still favour holding them compared to 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:

Stewardship and responsible investment at RLAM

Royal London Sterling credit ESG analysis

TCFD climate report

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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The Fund is a sub-fund of Royal London Asset Management Funds plc, an open-ended investment company with variable capital (ICVC), with segregated liability between sub-funds.

Incorporated with limited liability under the laws of Ireland and authorised by the Central Bank of Ireland as a UCITS Fund. It is a recognised scheme under the Financial Services and Markets Act 2000.

The Management Company is FundRock Management Company SA, Registered office: 33 rue de Gasperich, L - 5826 Hesperange, Luxembourg and is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF).

The Investment Manager is Royal London Asset Management Limited.

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.

Most of the protections provided by the UK regulatory system, and the compensation under the Financial Services Compensation Scheme, will not be available.

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FTSE makes no claim, prediction, warranty or representation either as to the results to be obtained from the Fund or the suitability of the Index for the purpose to which it is being put by Royal London Asset Management.

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.

Exchange Rate Risk

Changes in currency exchange rates may affect the value of your investment.

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.

Performance to 31 December 2023

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years
Fund (gross)	5.36	8.26	10.29	14.29	27.40
Fund (net)	5.14	7.80	9.37	11.45	22.31

Annualised (%)

	3 Years (p.a.)	5 Years (p.a.)
Fund (gross)	4.55	4.96
Fund (net)	3.68	4.11

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)	10.29	(4.36)	8.35	1.69	9.62
Fund (net)	9.37	(5.16)	7.45	0.87	8.80

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 Sterling Extra Yield Bond Fund (A Inc).

Glossary

Asset allocation

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

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.