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# Royal London Sterling Credit Fund

Quarterly Investment Report

30 September 2023

# Quarterly Report

## The fund as at 30 September 2023

The purpose of this report is to provide an update on the Royal London Sterling 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.

# Contents

The fund	3
Performance and activity	4
Fund breakdown	6
Market commentary	8
Further information	10
Disclaimers	11
Performance net and gross	13
Glossary	14

# The fund

## Fund performance objective and benchmark

The fund's investment objective is to achieve a total return over the medium term, which should be considered as a period of 3-5 years, by investing predominantly in sterling-denominated corporate bonds. The fund's performance target is to outperform, after the deduction of charges, the Markit iBoxx Sterling Non-Gilts Total Return GBP Index (the "Index") over a rolling 5-year period. The Index is regarded as a good measure of the performance of investment grade corporate bonds denominated in sterling. The fund is actively managed, meaning that the manager will use their expertise to select investments to meet the objective.

Benchmark: iBoxx Sterling Non-Gilt All Maturities Index

## Fund value

	Total £m
30 September 2023	2,238.15

## Asset allocation

	Fund (%)	Benchmark
Conventional credit bonds	96.22%	99.38%
Securitised	3.11%	-
Index linked credit bonds	0.34%	-
Other	0.18%	-
Conventional foreign sovereign	0.15%	0.62%

## Fund analytics

	Fund	Benchmark
Fund launch date	31 August 2008	
Base currency	GBP	
Duration (years)	5.61	5.36
Gross redemption yield (%)	7.74	5.88
Number of holdings	364	1,252
Number of issuers	238	499

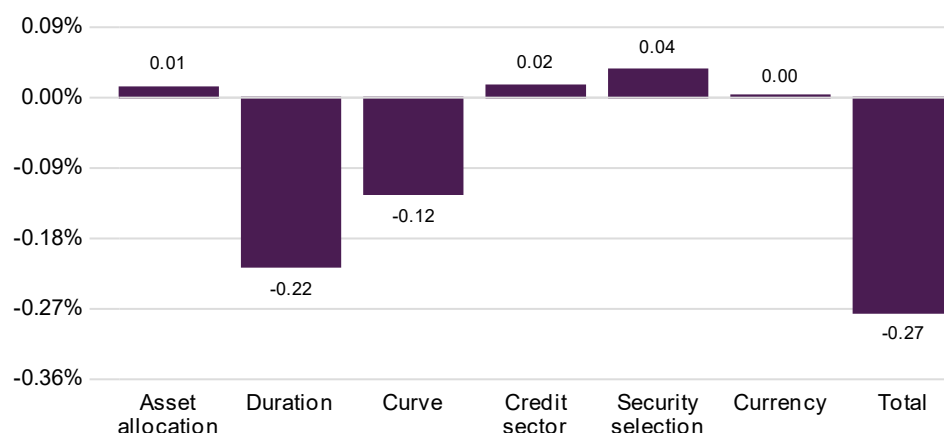
# Performance and activity

## Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	2.26	2.27	(0.01)
YTD	3.15	1.16	1.99
1 Year	9.84	6.96	2.88
3 Years (p.a.)	(3.22)	(5.96)	2.74
5 Years (p.a.)	0.78	(0.99)	1.78
10 Years (p.a.)	3.36	1.99	1.37
Since inception (p.a.)	5.26	3.67	1.59

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 Credit Fund (Z Inc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 1 September 2008.

## Attribution



## Performance commentary

The fund saw a positive return in the period and was slightly behind the iBoxx Sterling Non-Gilt index benchmark. The main drag on performance during the quarter was our duration position although sector allocation and stock selection partially offset this.

We had a small bias towards long duration and an underweight in short-dated (under five year) bonds. With yields ending the quarter slightly higher, and short-dated bonds outperforming long-dated, these biases impacted performance. Our investment process focuses on building portfolios from the bottom up, using a high level of diversification to reduce stock specific risk. This will create small biases in duration and curve positions that in any given quarter may have a positive or negative impact. We believe that long-term outperformance of our benchmark will primarily be driven by sector and security selection.

Given the attractions of underlying yields, the fund's interest rate sensitivity is greater than that of the benchmark and this proved to be detrimental in the quarter. Stated duration overstates the actual interest rate sensitivity as several bond holdings tend to trade on cash prices.

A positive contributor in the quarter was our sector allocation – in particular our overweight in banks and significant underweight in supranationals. Our real estate allocation also proved to be beneficial. Stock selection was a contributor to our overall performance, with our bank, insurance and structured holdings performing well. Early repayment and calls continue to be supportive, with the redemption of 2024 bonds from Go-Ahead at a premium to market pricing.

Exposure to floating rate notes (FRNs), where interest payments are linked to cash rates, has increased in recent quarters. This helps dampen interest rate risk and has boosted income receipts. Our holding in student loan provider ICSL is an example of this, where income payments are linked to Sterling Overnight Interbank Average (SONIA) rate; income on these securities has risen significantly over the time, reflecting higher SONIA rates.

One negative impact on performance for the quarter was HDL, which defaulted on its principal repayment. The bond has security over a specific pool of ring-fenced property assets and based on the latest valuation (June 2023) principal is covered by collateral. The issuer is discussions with bondholders with regards to options to facilitate repayment. We will continue to monitor and manage this situation actively.

# Performance and activity

## Fund activity

Primary activity was relatively low over the quarter. As well as the seasonal lull usually seen over the summer, rising overall yields means it is less attractive to raise debt capital. With a rising yield environment, many companies had brought capital raising forward to take advantage of low yields, and we would therefore expect issuance to remain somewhat lower in the next few quarters.

Financials remain the largest part of the market and dominated market issuance and our new issue activity during the quarter. We had a bias towards senior new issues over the period, reflecting the fact that credit spreads in these areas were very attractive. Early in the period we added a new issue five-year bond from Principality Building Society at a yield in excess of 8%, also adding further to this bond later in the quarter in the secondary market as the spread remained very attractive. We increased exposure to Nationwide Building Society, BNP, Santander UK, HSBC and Virgin Money through the purchase of new bonds.

In the consumer area, we bought a new issue from German car manufacturer Volkswagen – these euro denominated bonds coming with an attractive yield.

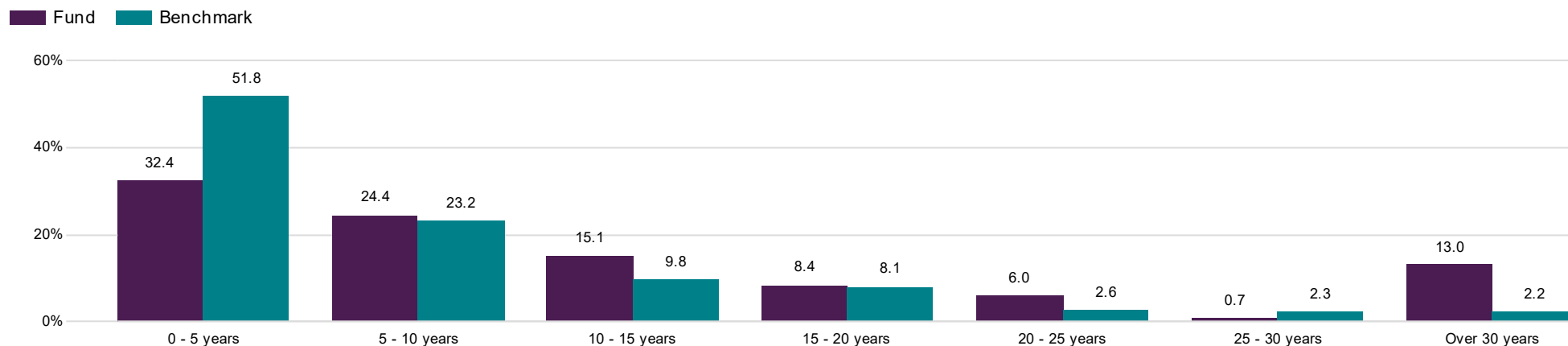
Market dynamics continue to provide opportunities to make switches where we can improve credit quality, yield or spread, picking up additional yield and within the capital structure of Rothesay Life.

In the secondary market we added selectively to subordinated bank and insurance debt – where yields still remain elevated following the rescue of Credit Suisse. However, underlying credit fundamentals mean that some of these bonds offer excellent value in our view, with legacy bonds from Assicurazioni Generali and Legal & General the most recent examples, while we also added subordinated bonds from Close Brothers at a very attractive cash price, and the Co-Operative bank, where we added bonds with a 12.5% yield to call.

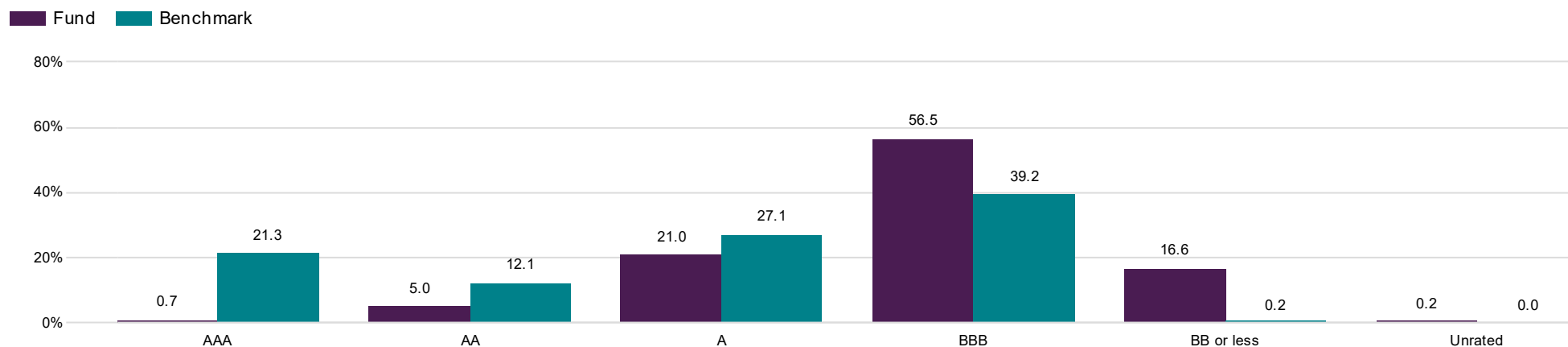
In the structured area, whilst primary issuance has been limited, we have continued to see secondary market availability. During the quarter we added PFI bonds from Derby Health, and Southern Water, the latter at very attractive levels for a regulated utility with an improving EPA score.

# Fund breakdown

## Maturity profile

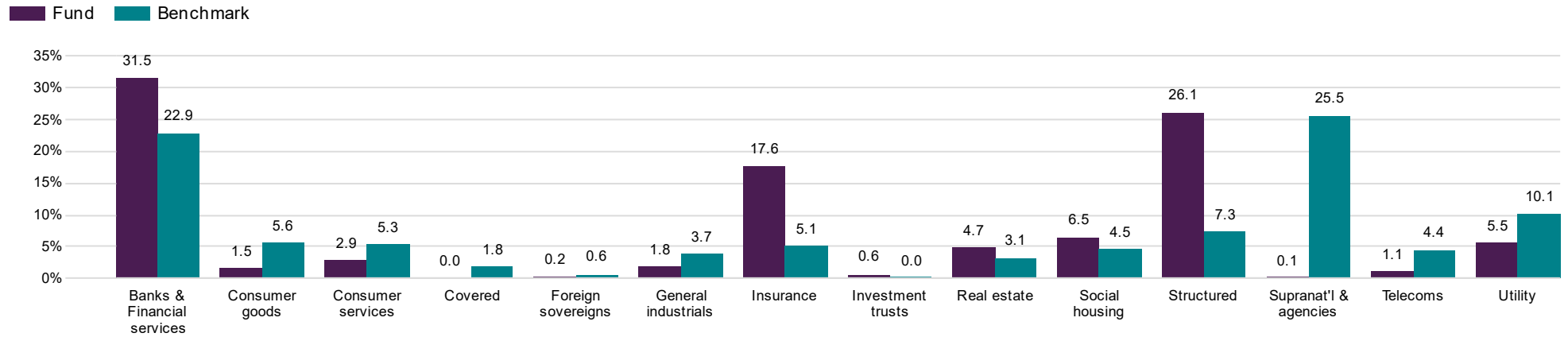


## Credit ratings



# Fund breakdown

## Sector breakdown



# Market commentary

## Market overview

The third quarter was characterised by mixed data around the world, with central banks coming towards the end of their rate hiking path, but with cuts still seemingly a while away. The global economic picture is rosier now than it was at the start of the year, but global growth is spluttering again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust.

Inflation has fallen significantly and, although higher energy prices threaten a widespread revival in headline inflation, other factors – including a weak economic activity backdrop – should pull inflation lower still. With taming inflation still the priority for central banks, there is still a possibility of further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but peak rates look to be near, with real rates now well into positive territory.

The outlook is still lacklustre in the UK. A technical recession is still assumed for the UK in the next 12 months, but a modest one. There are still risks from the housing sector and consumer spending has yet to respond fully to tighter monetary policy. GDP growth has been weak since late 2021 and PMI business surveys point to deterioration, falling into recessionary territory over the summer. Inflation should fall significantly at headline level, but domestically driven inflation continues to look strong, despite higher interest rates. The labour market is starting to look less tight and lead indicators of wage growth suggest some slowing ahead but so far, pay growth remains much too strong to be consistent with hitting a 2% inflation target.

In the US, the real economy has been surprisingly resilient in the face of tighter credit conditions. However, the fourth quarter looks set to see a few growth challenges, monetary policy is restrictive and employment growth has slowed. A number of recession indicators are still flashing. Business survey data paints a mixed picture, with PMIs consistent with flattish growth while ISM surveys look more upbeat. Employment gains have slowed on the non-farm payrolls data and job openings have fallen a long way from their highs consistent with a less tight labour market. Housing-related activity remain subdued.

The euro area economy may already be in mild recession and forecasts continue to pencil one in. Business surveys have deteriorated and look consistent with falling private sector output. Tighter monetary policy will still be feeding through to the real economy. Bank lending conditions have tightened and loan growth has slowed. High domestically driven inflation continues to point to the balance of risks being in the direction of further hikes.

Global government bond markets continued to see yields move higher – a trend that started in mid-2020, reflecting market views that rising inflation would necessitate higher interest rates and that the central banks and governments would ultimately have to withdraw the support measures put in place during the global financial crisis and then used further to help mitigate the economic impact of Covid. With the end of the rate rising cycle possibly in sight, but issuance expected to remain high, markets have become more volatile.

UK government bonds struggled, being impacted by the higher-than-expected inflation print. Gilts delivered a -0.63% return (FTSE Actuaries) over the third quarter with the benchmark 10-year gilt yield rising to 4.44% from 4.39% but pulled back from a 4.75% high seen in mid-August. There was a marked difference in maturities, with short-dated bonds materially outperforming longer-dated bonds, as expectations that rates may be at a peak helped short-dated bonds start to anticipate cuts in late 2024, while longer-dated bonds remained weak due to concerns about the long-term inflation environment and significant gilt supply. In the US, 10-year treasury yields rose to 4.57% from 3.84%, hitting heights not seen in fifteen years, while in Germany the 10-year bund yield increased to 2.84% from 2.39%.

UK index-linked markets significantly underperformed on a global basis, returning -4.69% (FTSE Actuaries) in the third quarter. Real yields on UK 10-year bonds saw a rise over the period, ending the quarter at 0.60%, up from 0.52%. On longer-term bonds, 30-year real yields increased 53bps to 1.48%. Yields on US 10-year index-linked bonds increased to 2.23% from 1.61%, while its German counterpart saw yields rise to 0.45% from 0.07%.

The sterling investment grade credit market (Non-gilt) returned 2.26% over the quarter, as the negative impact of higher government bond yields was offset by tighter credit spreads and the greater proportion of short-dated bonds (which performed well relatively to longer-dated equivalents) in credit indices. 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 1.48% to 1.38% (iBoxx). Banks and insurance bonds performed strongly in the quarter while senior insurance debt also enjoyed an impressive quarter. No sector saw negative returns, but real estate was broadly flat, and healthcare and transportation lagged other sectors. By rating, there was no standout performer in investment grade, with all bands posting returns between 1.8% and 2.5%. High yield bonds, however, saw a strong quarter, seeing returns of 3.7%. In duration terms, shorter-dated maturities performed significantly better than longer-dated equivalents.

Primary credit activity picked up after a particularly slow July. Sterling issuance was £11.2bn over the quarter, which was slightly behind the £11.5bn seen over the same time last year and significantly below the £17.4bn issued in the second quarter.



# Market commentary

## Outlook

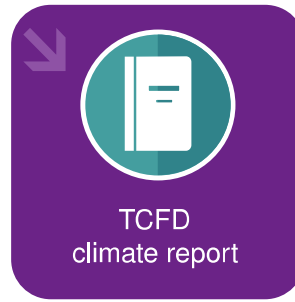
We expect the downward trend in inflation to continue through the rest of 2023, as energy and food price increases moderate and sluggish GDP weakens the labour market. Nonetheless, UK interest rates are likely to rise further as the BoE continues to focus on bringing inflation under control.

Although the economic data remain very mixed, we still believe that higher rates will lead to a slowdown in the UK, impacting company earnings and leading to some increase in credit rating downgrades and default rates. We still favour sterling credit bonds over government debt as credit spreads remain at reasonably attractive levels. However, recent outperformance means that their relative attractiveness has reduced. 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.

Our credit strategies generally have a material yield premium to the market, which we feel will support performance both in absolute terms and relative to the market. We retain a significant targeted exposure to BBB rated bonds and believe that compensation for default risk remains most attractive in this rating band.

## Further Information

Please click on the links below for further information:



### Find out more

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of [www.rlam.com](http://www.rlam.com), including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams. Notable publications in the third quarter include our annual Climate Report, as well as our annual Assessment of Value reports, available from the home page of [www.rlam.com](http://www.rlam.com).

# Disclaimers

## Important information

For professional clients only, not suitable for retail clients.

This is a financial promotion and is not investment advice.

Telephone calls may be recorded. For further information please see the Privacy Policy at [www.rlam.com](http://www.rlam.com).

Issued in October 2023 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 ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC000797.

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](http://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 30 September 2023

## Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years		
<b>Fund (gross)</b>	2.26	1.21	9.84	(9.34)	3.97	3 Years (p.a.)	5 Years (p.a.)
<b>Fund (net)</b>	2.17	1.03	9.45	(10.28)	2.20	(3.22)	0.78
						(3.55)	0.44

## Annualised (%)

## Year on year performance (%)

	30/09/2022 - 30/09/2023	30/09/2021 - 30/09/2022	30/09/2020 - 30/09/2021	30/09/2019 - 30/09/2020	30/09/2018 - 30/09/2019
<b>Fund (gross)</b>	9.84	(21.20)	4.74	3.85	10.43
<b>Fund (net)</b>	9.45	(21.47)	4.38	3.49	10.08

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 30 September 2023. All figures are mid-price to mid-price in GBP for the RL Sterling 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.