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Royal London Sterling Extra Yield Bond Fund (Z Inc)

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 Extra Yield Bond Fund (Z 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.

Contents

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
30 September 2023	1,486.43

Fund analytics

	Fund
Fund launch date	13 December 2013
Base currency	GBP
Duration (years)	3.24
Gross redemption yield (%)	9.24
Number of holdings	220
Number of issuers	168

Performance and activity

Performance

	Fund (%)
Quarter	2.74
YTD	4.67
1 Year	9.56
3 Years (p.a.)	4.83
5 Years (p.a.)	3.58
10 Years (p.a.)	-
Since inception (p.a.)	6.08

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 (Z Inc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 13 December 2013.

Performance commentary

The fund posted strong positive returns in the quarter, with high income produced more than offsetting the negative impact of rising bond yields. Across the fund, the sector returns were broadly positive, with strong returns from our bank, general industrial and structured holdings. At the end of the quarter, the overall positive return was also supported by resilience in the subordinated bonds in the financial sectors, by price appreciation in many of the fund's holdings of short-dated bonds, reflecting the move down in short-dated gilt yields in the month, and by robust income generation.

Distributions in respect of Q3 2023, payable at the end of November, are 1.96p, 1.80p, 1.82p and 1.81p respectively for the A, B, Y and Z class income shares, compared to the amounts of 1.82p, 1.67p, 1.70p and 1.69p distributed in respective of Q2 2023, and markedly higher than the amounts of 1.74p, 1.58p, 1.63p and 1.62p distributed in respect of Q3 2022. While there can be a fair degree of volatility from quarter to quarter in fund distributions, investments in FRNs (floating rate notes), where income is referenced to a margin over short term rates and thus has increased over the course of the past year, and the higher yield levels recently prevailing for investment of fund flows, have each contributed to this uplift in income generation.

While the overall duration of the fund is quite short, at 3.5 years, some holding of long dated bonds was sensitive to the rise in yields of longer dated gilts and in turn posted fall in price towards the end of the month. Amongst individual holdings: 2027 bonds of Lendinvest, the specialist lender, were lower on the terms of the refinancing of the company's 2023 bonds at a cost of 11.5% compared to their existing coupon of 5.375% (the fund benefitted from this uplift in respect of its holding in the 2023 bonds), Metro Bank bonds were weak as news of a delay in the regulator's acceptance of the company's internal risk model with a consequent focus on the bank's capital adequacy – this has been addressed in the early days of October by an equity capital raise and consensual revision of bond terms, and finally bonds of North Sea energy business Waldorf were lower on rising field closure costs, reflecting the higher cost of service provision in the sector – a feature that has been very beneficial to many of the fund's holdings in that sector. On the point, shares in DOF Group, the subsea services provider, which were acquired by the fund on the exchange from debt into equity over a prolonged process, were up 3% on the month, extending the move up in price from 28 at launch in June to 51 at the end of September – and at that price provided a significant fillip to fund performance compared to that which would have been delivered by the original holding of bonds.

Performance and activity

Top 10 holdings

	Weighting (%)
CENTRICA PLC 5.250000000 2075-04-10	2.41
ELECTRICITE DE FRANCE SA 5.875000000	2.35
CO-OP GRP HLDS 7.500000000 2026-07-08	2.29
SANTANDER UK PLC 10.062500000	2.11
SANTANDER UK PLC	1.97
METROCENTRE FINANCE 8.750000000 2023-12-06	1.87
M&G PLC 6.340000000 2063-12-19	1.80
HEATHROW FINANCE PLC 3.875000000 2027-03-01	1.72
THAMES WATER KEMBLE FINA 4.625000000 2026-05-19	1.66
PHOENIX GRP HLD PLC 5.750000000	1.60
Total	**19.78**

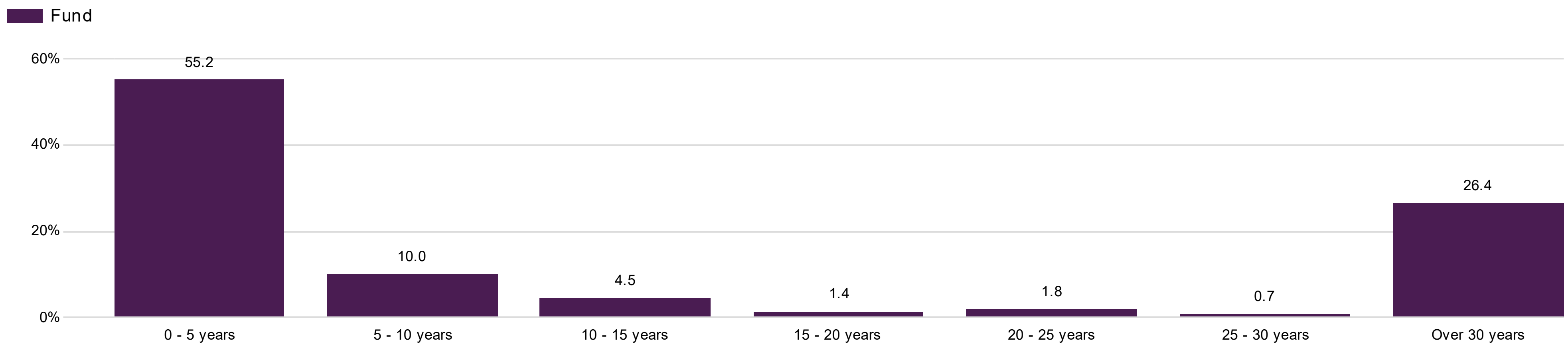
Fund activity

During the quarter, the fund participated in a flow of attractively priced new issues. These included bonds of Bulk Infrastructure, the property and data centre company, offering 5¾% over Norwegian krone short term interest rates until their 2028 maturity date – their initial coupon being 10½%, of shipping group Ocean Yield, similarly offering a margin over Norwegian krone short term interest rates until their 2028 maturity date but set at 3¾%, of United Trust Bank, the UK specialist lender, offering 13% yield until their call date in 2028. Also, we added 3-year secured bonds of North Sea energy business OKEA offering 9⅛%, and BB rated 'hybrid' green bonds of car manufacturer VW, offering a return of 7⅞% to first call in 2032.

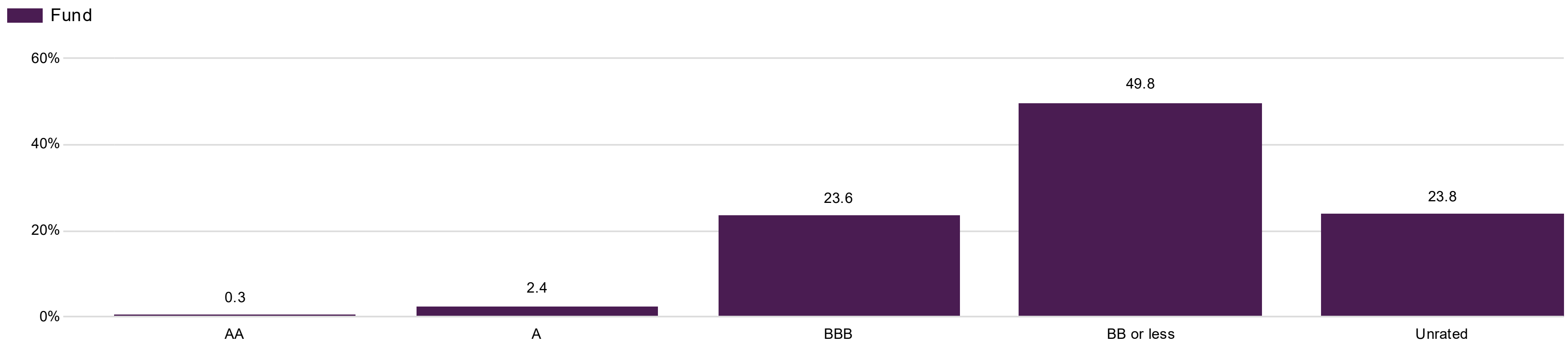
One negative impact on performance for the quarter was HDL. At the end of July, HDL Debenture Ltd – formerly Hemingway Properties PLC – as issuer of a bond secured on a pool of UK commercial property, confirmed that it was unable to pay the outstanding principal on the bond's maturity date (31st July 2023). The issuer did pay the bond's coupon on this date out of available resources, but the non-payment of principal constitutes an event of default under the bond documentation. This bond has security over a specific pool of ring-fenced assets and based on the latest property valuation dated June 2023, after netting off the available cash, bond principal is covered by property collateral by over 1.6x. The issuer is in ongoing discussions with a majority group of bondholders facilitated by The Investment Association with regards to the sale and/or refinancing of the underlying collateral in order to facilitate repayment of the bonds. Any terms for this would have to be acceptable to bondholders. Despite the excess level of asset cover and control that bondholders have over the situation to preserve our economic position, we have downgraded the internal rating on the bond to 'D' to reflect specifically the non-payment of principal at scheduled maturity rather than our expectation, at this time, of any economic loss. We will continue to monitor and manage this situation actively.

Fund breakdown

Maturity profile

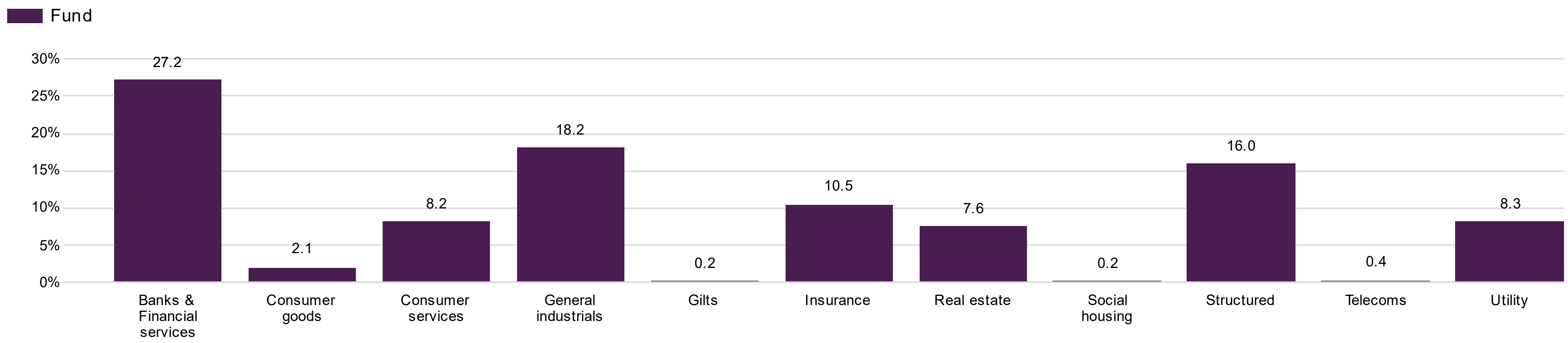


Credit ratings



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 soggy 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. 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:

- Stewardship and responsible investment at RLAM
- Royal London Sterling credit ESG analysis
- TCFD climate report

Find out more

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. 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.

Disclaimers

Important information

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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 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 30 September 2023

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years
Fund (gross)	2.74	3.09	9.56	15.20	19.22
Fund (net)	2.59	2.79	8.93	13.22	15.96

Annualised (%)

3 Years (p.a.)	5 Years (p.a.)
4.83	3.58
4.22	3.00

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
Fund (gross)	9.56	(8.45)	14.85	(2.35)	5.98
Fund (net)	8.93	(8.98)	14.18	(2.87)	5.45

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 Extra Yield Bond Fund (Z 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.