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# Royal London Diversified Asset-Backed Securities Fund

## Quarterly Investment Report

**31 March 2024**

# Quarterly Report

## The fund as at 31 March 2024

The purpose of this report is to provide an update on the Royal London Diversified Asset-Backed Securities 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

## Fund performance objective and benchmark

The Fund's investment objective is to achieve a positive absolute return in all market conditions over rolling 3-year periods, by predominantly investing in asset-backed securities and other sterling-denominated corporate bonds. The Fund's performance target is to outperform, before the deduction of charges, the Bank of England Sterling Overnight Interbank Average (SONIA) plus 2% per annum over rolling 3 year periods. The benchmark is considered suitable as it is consistent with how the Fund is managed in seeking to provide a "cash plus" performance outcome.

Benchmark: SONIA (Sterling Overnight Index Average)

## Fund value

| | Total £m |
|---|---|
| 31 March 2024 | 267.16 |

## Asset allocation

| | Fund (%) |
|---|---|
| Conventional credit bonds | 84.92% |
| Securitised | 12.09% |
| Conventional gilts | 2.71% |
| Conventional foreign sovereign | 0.19% |
| Index linked credit bonds | 0.09% |

## Fund analytics

| | Fund |
|---|---|
| Fund launch date | 24 September 2012 |
| Base currency | GBP |
| Duration (years) | 0.81 |
| Yield to worst (%) | 6.21 |
| Number of holdings | 304 |
| Number of issuers | 190 |

# Performance and activity

## Performance

| | Fund (%) | Benchmark (%) | Relative (%) |
|---|---|---|---|
| Quarter | 2.60 | 1.27 | 1.34 |
| 1 Year | 11.27 | 4.97 | 6.30 |
| 3 Years (p.a.) | 5.63 | 2.42 | 3.21 |
| 5 Years (p.a.) | 4.85 | 1.60 | 3.24 |
| 10 Years (p.a.) | 3.77 | 1.08 | 2.69 |
| Since inception (p.a.) | 4.20 | 1.00 | 3.19 |

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 Diversified Asset-Backed Securities Fund (Z Acc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 24 September 2012.

## Performance commentary

The fund saw a positive return in the period and was well ahead of its Sterling Overnight Index Average Rate (SONIA) benchmark. The main driver of positive performance was the combination of our sector allocation and stock positioning within the context of relatively strong corporate bond performance overall. Gilt yields increased over the period, with shorter dated yields rising around 40bps. Whilst there was a marginal negative impact from being long duration at the fund level, this was more than offset by the impact of tighter corporate bond spreads. At a sector level, our overweight in secured bonds was favourable and within the smaller unsecured allocation in the fund, our bias towards subordinated bonds issued by strongly capitalised insurance companies and banks was helpful.

Against this backdrop of good returns, the fund's holding in Thames Water was a negative contributor. Thames Water shareholders had previously announced an intention to inject £750m of equity into the utility by March 2025, with £500m of this anticipated by March 2024. In late March, and following discussions with OfWat, the necessary conditions for that initial injection had not been met. This has been negatively received by credit markets – as was the S&P downgrade to BBB- after the end of the quarter. We continue to believe that liquidity in the operating company remains satisfactory and that the business can continue to fund itself and serve its customers. Equally, until regulatory clarity is received, we expect newsflow to be negative. However, we believe that valuations remain attractive on a fundamental basis, given the strength of protection afforded via the regulated asset base and an expectation that a regulatory determination in June will ultimately support an asset value that underpins operating company debt. We believe that the risk in the business remains political in nature, as higher returns to incentivise the significant investment that is required to enhance the network will require price rises for consumers, and this is likely to create volatility until greater regulatory clarity is delivered.

# Performance and activity

## Fund activity

New issue activity remained a key focus over the quarter. A notable trend has been the reduction in the new issue premia (the additional yield required to sell new bonds) and at times, book building sizes have looked extraordinary – suggesting huge latent demand. This has led to some caution on our part – we still believe that credit spreads more than compensate credit investors for the risk of default but are equally aware that demand in certain parts of the market can lead to less favourable pricing.

Exposure to secured bonds remains the most fundamental cornerstone of the fund. Issuance has been somewhat lower in recent months compared to unsecured markets, but there were several attractive primary opportunities during the quarter. Examples included bonds issued by Land Securities and Gatwick Funding. We also added a new issue from Telereal, which is secured on British Telecom's telephone exchanges.

We continue to have good access to secured bonds in the secondary market and were able to add to some of our most favoured assets during the quarter. This included very lowly geared pub bonds, Mitchell's & Butlers and Unique, as well as over-collateralised and high quality property bonds, such as Broadgate and Canary Wharf. We also added to some floating rate securitisations, Highways, ICSL and Parkmore, that offer credit spreads above Sonia in excess of levels achievable from unsecured corporate bond indices, despite AAA ratings.

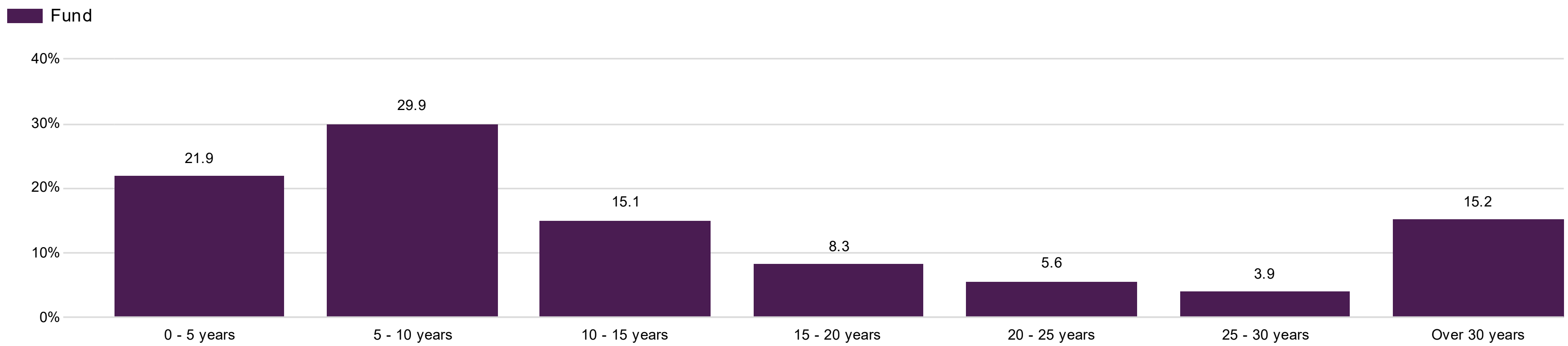
More broadly, financials continued to dominate primary market activity during the quarter, providing an opportunity to add selectively to unsecured allocations at attractive valuations. We purchased senior bonds issued by Barclays, at around 200bps over equivalent gilts, and UK mortgage specialist OSB at a yield of over 8.5%.

We remain cautious around utilities as valuations are generally not as appealing as other areas of the market. However, during the quarter, we felt that valuations in the gas sector, an area we had reduced in recent years, had improved, with spreads materially wider than those in the regulated electricity sector. As a result, we were happy to purchase a new issue from the UK's largest gas distribution network Cadent. In the water sector, there has been limited contagion from Thames Water, and we believe it is unlikely that we see removal of support from regulated asset bases across the sector. We added new issues of operating company level bonds from Northumbrian Water and Southern Water, both at attractive yield premiums.

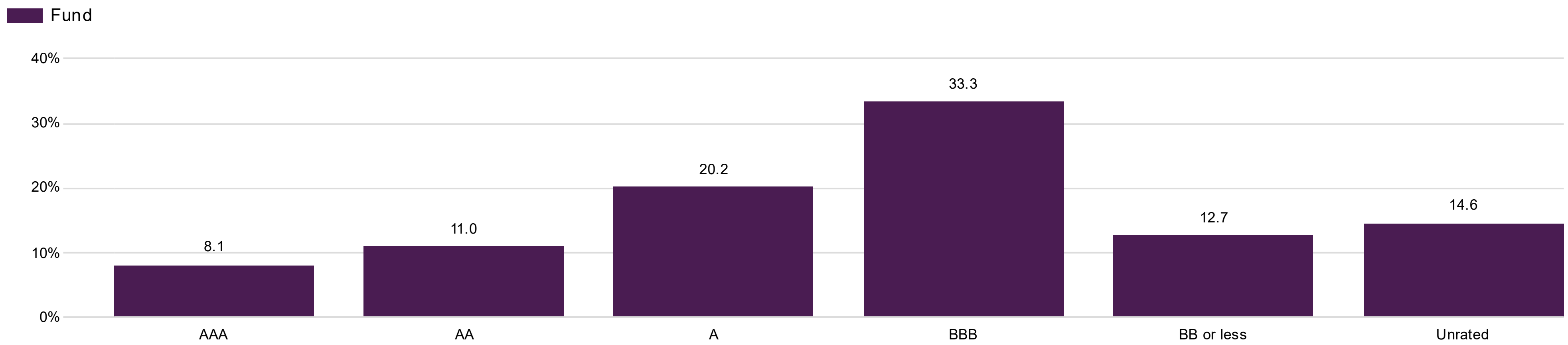
We also added a new 2054 bond from Motability, who help disabled people and their families lease vehicles, which was issued at a useful discount to the issuer's existing bonds. Whilst not secured, the bond does benefit from strong structural protections. After performing very strongly since purchase, we sold the position – reflecting our active approach to capturing excess return.

# Fund breakdown

## Maturity profile

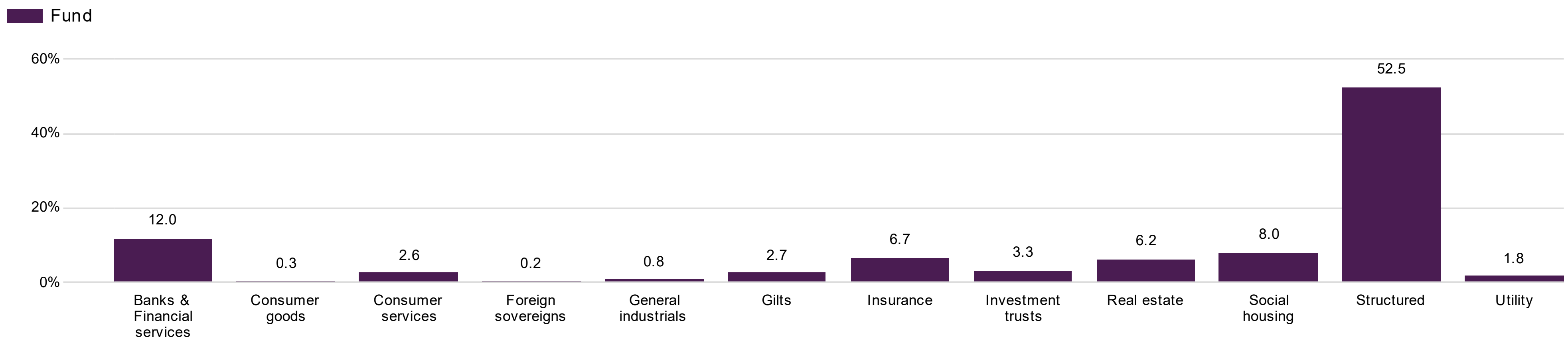



## Credit ratings



# Fund breakdown

## Sector breakdown



# Market commentary

## Market overview

A key theme to emerge during the quarter was indication of a more favourable global macro backdrop. Despite some mixed signals, the US economy remains resilient, while Europe and the UK show signs of gradually exiting their recessions. Activity in China also seems to be stabilising. At the same time, core central banks are still confident that the disinflation trend remains intact, despite some recent setbacks in inflation prints. Policymakers have often highlighted that they are in no rush to cut rates – with markets now generally pricing the start of the easing cycles to begin this summer. The Federal Reserve, European Central Bank and Bank of England all left interest rates unchanged over the quarter.

One major development over the quarter is that markets have recalibrated their pricing for expected central bank cuts over this year. At the end of last year, markets were pricing in an aggressive rate cutting cycle, but then swiftly move to temper those forecasts. This re-pricing contributed to negative returns for global government bond markets over the quarter. Despite the belief of many that it was the anticipation of a 'Fed-pivot' that contributed to the rally in equity markets in late 2023, equity markets proved to be immune to this bond market sell-off as global growth and business confidence showed signs of resilience and investors focused on the potential offered by AI.

Government yields rose in all the major markets. In the US, 10-year treasury yields rose from 3.88% to 4.21%, while German 10-year bunds similarly saw yields rise from 2.01% to 2.30%. Mirroring this backdrop of rising yields, UK government bonds produced a return of -1.62% (FTSE Actuaries) over the first quarter, with the benchmark 10-year gilt yield rising from 3.54% to 3.94%. The bulk of this move occurred in the first two weeks of January, before largely trading in a range between 4% and 4.2% for the rest of the quarter. The rising yield environment helped short-dated bonds to outperform their longer-dated equivalents.

In contrast to the losses in the government bond market, the sterling investment grade credit market (iBoxx non-gilt index) returned 0.06% over the quarter, with the effect of higher yields mitigated by tighter credit spreads and the higher carry in this area. The shorter duration of the credit market index also helped offset some of the government market headwind. 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 1.15% to 1.02% (iBoxx). Given the rise in yields, sectors with a greater proportion of long-dated bonds performed poorly, including utilities and social housing. Of the major sectors, supranationals was the worst performing sector, while in financials, the banks and insurance sectors performed well.

Issuance picked up in the first three months of the year compared to the fourth quarter of 2023, but overall supply in key areas such as financials was materially lower than the same period last year. This helped spreads tighten in bank and insurance sector.

## Outlook

The rally in bond yields seen late last year, prompted by hopes that falling inflation would lead to relatively rapid and numerous interest rate cuts, was largely unwound in the first two weeks of 2024. This reflects the change in interest rate expectations and the sensitivity of markets to incoming economic data. Looking at market pricing, UK base rates are projected to be around 4.5% at the end of 2024, this is in contrast to the 12-month outlook, where markets were projecting rates below 4%. We expect yields to remain sensitive to economic data, and unless there is a significant deterioration in underlying trends, we expect this to lead to range bound-yields and the opportunity to add/trim duration as markets react to individual data points.

Headline inflation is expected to reach the 2% Bank of England target level in the next few months. However, we are mindful that underlying pressures in the labour market and parts of the services sector mean that headline inflation figures may be somewhat misleading. In addition, data since the start of the year suggests that the UK is growing again – albeit slowly. This trend can be seen in the US and euro zone as well. Overall, the global tone is that rate cuts are not going to come through as quickly as anticipated and that the neutral level may be a bit higher than previously thought.

With bond yields generally higher than they were at the start of the year, and interest rate cuts now closer, we believe that overall government bond yields look attractive. Credit spreads have come in further – and are now looking somewhat tight in longer-dated bonds – but continue to compensate credit investors for the risk of default. From a credit spread perspective we continue to find better value in shorter-dated credit bonds, but with absolute yields at attractive levels we prefer to be broadly neutral in overall duration positioning, with a bias to extend on further rises in yields.

We target – and achieve – a material yield premium over the market level in our sterling credit strategies. We mitigate the risks by maintaining highly diversified portfolios, with a bias towards bonds that offer greater security and downside protection. Our view remains that over the medium term our focus on delivering greater income than the benchmark will generate outperformance.

# 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

In an uncertain geopolitical and economic environment, we recognise the importance of keeping our clients updated on our current investment thinking.

Articles, videos, podcasts and webinars giving the latest views of our investment experts 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

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.

Issued in April 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 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.

The "SONIA" mark is used under licence from the Bank of England (the benchmark administrator of SONIA), and the use of such mark does not imply or express any approval or endorsement by the Bank of England. "Bank of England" and "SONIA" are registered trademarks of the Bank of England.

# 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 risk**

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.

**Government and public securities risk**

The Fund can invest more than 35% of net assets in different Transferable Securities and Money Market Instruments issued or guaranteed by any EEA State, its local authorities, a third country or public international bodies of which one or more EEA States are members.

**Leverage risk**

The Fund employs leverage with the aim of increasing the Fund's returns or yield, however it also increases costs and its risk to capital. In adverse market conditions the Fund's losses can be magnified significantly.

# Performance to 31 March 2024

## Cumulative (%)

| | 3 Month | 6 Month | 1 Year | 3 Years | 5 Years |
|---|---|---|---|---|---|
| **Fund (gross)** | 2.60 | 6.82 | 11.27 | 17.89 | 26.74 |
| **Fund (net)** | 2.50 | 6.60 | 10.80 | 16.40 | 23.80 |

## Annualised (%)

| | 3 Years (p.a.) | 5 Years (p.a.) |
|---|---|---|
| **Fund (gross)** | 5.63 | 4.85 |
| **Fund (net)** | 5.19 | 4.36 |

## Year on year performance (%)

| | 31/03/2023 - 31/03/2024 | 31/03/2022 - 31/03/2023 | 31/03/2021 - 31/03/2022 | 31/03/2020 - 31/03/2021 | 31/03/2019 - 31/03/2020 |
|---|---|---|---|---|---|
| **Fund (gross)** | 11.27 | 1.91 | 3.97 | 10.33 | (2.56) |
| **Fund (net)** | 10.80 | 1.48 | 3.52 | 9.76 | (3.10) |

**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 March 2024. All figures are mid-price to mid-price in GBP for the RL Diversified Asset-Backed Securities Fund (Z Acc).

# 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.

### 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.

### Yield to worst

Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.