RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarterly Report 30 June 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.7	99.1
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.3	0.9
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	10.2 years	10.7 years
Gross redemption yield[4]	2.65%	1.88%
No. of stocks	460	739
Fund size	£239.4m	-

Source: RLAM, Launch date: 20.07.2007.

[1]Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.

[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[3]Excluding cash

[4]The gross redemption yield is calculated on a weighted average basis

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q2 2020	**7.75**	**9.12**	**-1.37**
Year-to-date	3.86	4.59	-0.74
Rolling 12 months	8.15	8.59	-0.44
3 years p.a.	6.08	5.53	0.55
5 years p.a.	7.35	6.87	0.49
Since inception p.a. 02.07.2007[2]	8.20	7.15	1.06

Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated.

Source: RLAM, [1]Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.

[2] The fund launched 02.07.2007 but its benchmark and objective changed on 30.06.2012.Performance prior to 30.06.2012 has therefore been omitted. If you require performance prior to this change, please contact your client account manager.

The fund objective is to outperform the benchmark by 0.80% per annum gross of the standard management fees.

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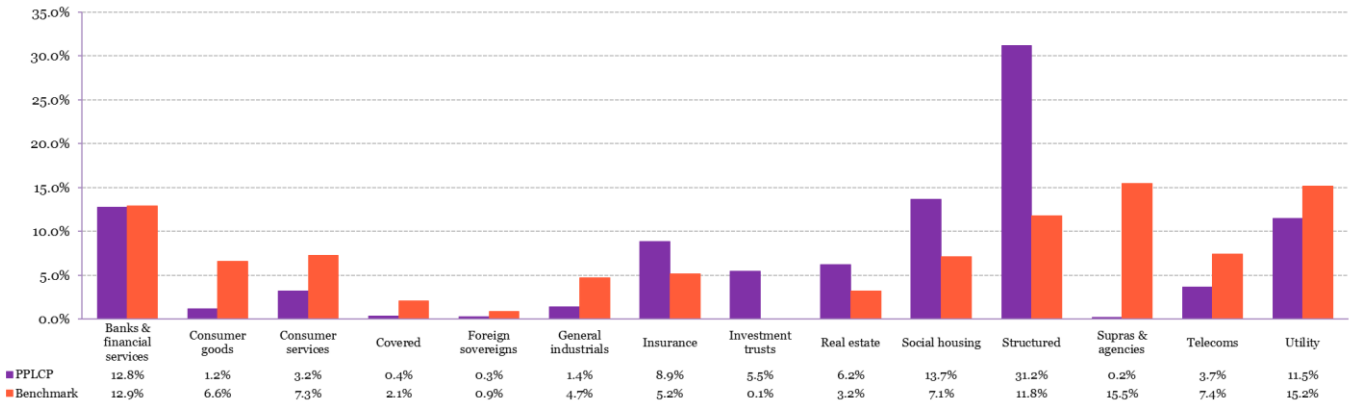
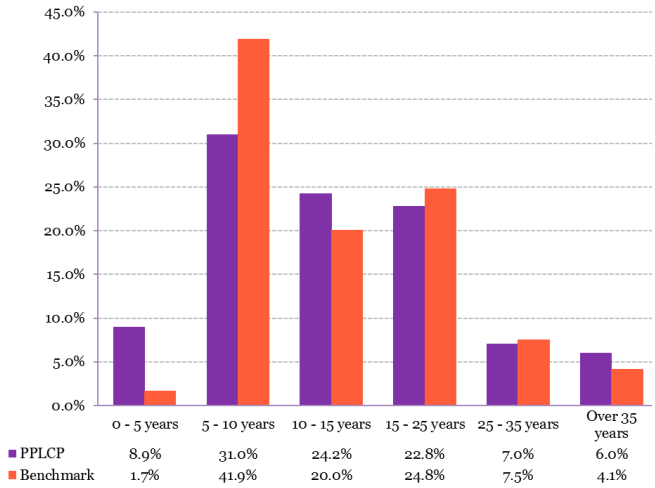
Sector breakdown

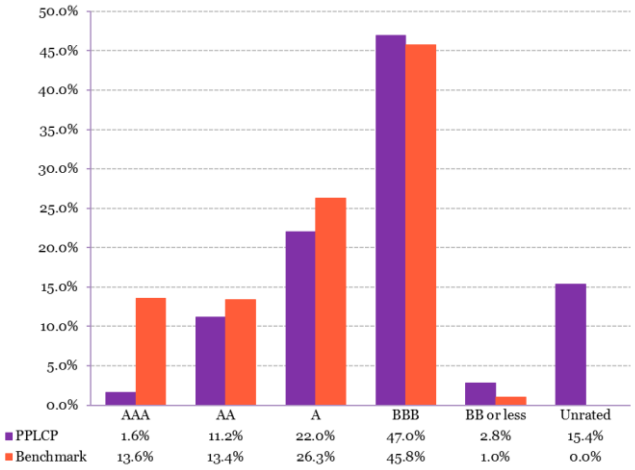


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
HSBC Bank 5.375% 2033	1.9
Innogy Finance 6.125% 2039	1.3
Électricité De France 6% 2114	1.3
Finance for Residential Social Housing 8.368% 2058	1.2
London And Quadrant Housing Trust 2.75% 2057	1.2
Thames Water Utilities 2 7.738% 2058	1.2
Exchequer Partnership 5.396% 2036	1.2
M&G Plc 5.7% 2063	1.1
Annes Gate Property 5.661% 2031	1.1
Dali Capital 4.79924% 2037	1.1
Total	**12.7**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

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Market overview

- One of the main challenges for fixed income investors during the first quarter was the sudden disappearance of market liquidity. The second quarter saw a marked improvement in this regard owing to the decisions taken by central banks to buy government and corporate debt. The bid-offer spread for investment grade sterling credit bonds, while higher than the prevalent levels in 2019, significantly narrowed from late March.
- The Corporate Bond Purchase Scheme from the Bank of England (BoE) was particularly important for the sterling credit market. It involved the purchase of selected corporate bonds in order to lower the cost of borrowing for companies. The Scheme had been launched in August 2016 following the Brexit vote and was boosted at the end of March when the BoE announced that it would buy an additional £10bn of bonds, with a focus on companies that play a part in economic activity in the UK. This did not include financials, non-standard bonds (which includes many structured bonds) or non-rated bonds however. Investors reacted quickly and the bonds which were eligible for BoE purchases outperformed the wider market.
- The UK government also continued to provide unprecedented support for the economy through its Coronavirus Job Retention Scheme, tax deferrals, business grants and loan guarantees. Prior to the crisis, the Office of Budget Responsibility (OBR) forecast that UK borrowing would be roughly £50bn for each of the next five years. These measures add another £130bn of borrowing and a similar amount can be expected for the economic impact in the near term. Borrowing is now likely to exceed 15% of national income, or over £300bn, for the current financial year; the biggest deficit since WWII.
- The BoE has played a major part in financing this government debt, pledging to inject further monetary stimulus into the UK economy during the quarter. As of the end of June, the BoE's asset purchase programme, covering conventional government and investment grade debt, now stands at £745bn. This intervention has provided significant reassurance to the market, containing volatility levels and pushing UK government bond yields lower. The yield on 10-year gilts at the end of June was just 0.17%, compared to 0.36% at the end of March. Gilts with maturities of less than seven years turned negative for the first time ever following news that the BoE was investigating the potential impact of negative interest rates.
- Against this background, credit outperformed gilts during the second quarter. The broad gilt market returned 2.45% over the quarter. In credit markets, credit spreads on the ML Sterling Non-Gilt index tightened from 212bps to 147bps, with the iBoxx sterling non-gilt index seeing a similar move and returning 6.95%.
- Rating agencies reduced their ratings for a number of issues over the quarter. Prominent examples include bonds of **British Airways**, **EDF**, **General Electric**, **Heathrow**, **Intu Properties** and **Rolls Royce**. We expect that downgrades will continue to be a feature of global investment grade credit markets as the economic consequences of the virus become more evident and government support is reduced. Our bias towards secured and covenanted debt should provide some mitigation and allow us to better protect our clients' interests.
- New issuance in the sterling investment grade credit market over the second quarter was broadly in line with levels seen over the same period in previous years. However, given such a strong start to the year in January and February, and even considering the minimal issuance through March, year-to-date issuance is at a record high of £28bn. Issuance has been dominated by banks and insurers and, unlike earlier in the year when overseas issuers constituted a significant proportion of sterling issuance, almost all primary market activity was domestic in the second quarter. The only meaningful exception to this was in relation to supranational and agency bonds, which covered around 19% of issuance.
- Overall, issuance was biased towards the lower end of the ratings spectrum and, aside from supranational and agency issuance, the largest concentration of issuance was in banks and insurance. Examples include £1bn of BBB rated 10-year bonds from **Royal Bank of Scotland** and £500m of A rated five-year bonds from **Barclays**. Strong issuance was seen across the consumer and industrial sectors, constituting around 20% of issuance collectively. Indeed the largest corporate (i.e. excluding supranational) issue was a £1.25bn BBB rated hybrid from energy company **BP**; the gigantic deal also included €4.75bn and $5bn of issuance. There was also a £500m issue of BBB rated eight-year bonds from tobacco business **BAT**. There were a number of secured bonds issued over the quarter, including £850m of AAA rated four-year covered bonds from **Coventry Building Society**.

Performance

- The fund performed positively in absolute terms over the quarter, but lagged the benchmark. This primarily reflects the fact that many of the bonds which we held in our fund were not eligible for the BoE's Corporate Bond Purchase Scheme. Our emphasis on secured and structured debt was therefore unfavourable over the quarter. More positively, our underweight exposures to supranational and covered bonds were beneficial. Likewise, our overweight allocation to the insurance sector, particularly such issuers as **Aviva**, **Prudential** and **Axa**, was beneficial. Duration had little overall impact on relative returns.

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- The structure of the BoE programme has been unhelpful for the short-term performance of RLAM's sterling credit portfolios. Our investment philosophy focuses on exploiting inefficiencies such as undue reliance on ratings and undervaluing security, whereas the Corporate Bond Purchase Scheme takes almost the opposite view but backs it with £10 billion. Only approximately 25% of the broad market is eligible for the Scheme, and the BoE has been keen to be seen to make progress with its purchase programme. By the end of June, the BoE had purchased approximately £6 billion of the additional £10 billion announced in March. We would therefore expect to see this effect continue in the near term.
- In the longer term, we believe that there will be some unwinding of the stronger performance seen in eligible bonds as the BoE winds down purchases – this having been evident in 2016 and 2017 when the BoE previously bought corporate bonds as part of its asset purchase programme. It is difficult to predict a timeframe for this. The 2016 effect took several quarters to unwind, and while it may be reasonable to suggest a similar timeframe today, the crisis is still not over and so a further expansion of the CPBS Scheme cannot be ruled out.
- There were no defaults in our fund over the quarter, although **Intu Properties** entered administration after failing to secure an agreement with creditors. The subsidiary companies which are the issuers of the secured debt are distant from the disruptive influence of the administration at the parent company level. There are, nevertheless, evident challenges at the business level which are reflected in the bond prices. We see some challenges ahead for the corporate sector more generally, as shown by the widespread reductions and cancellations of equity dividends. Clear challenges in sectors like hospitality, retail and travel are significant. In the financial sector, regulatory pressure has resulted in the cancellation of some dividends to protect business integrity in the uncertain times.
- Although representing a highly diversified range of economic exposures, the structured sector lagged the market on a broad basis over the quarter. This was due to a combination of poor technical factors (exclusion from the Corporate Bond Purchase Scheme) and more idiosyncratic COVID-19 impacts (such as mortgage payment holidays and lockdowns). Intu Properties was our most materially challenged holding, but a number of other issuers faced asset shutdowns; most notably in the pub, airport and retail property sectors.
- The fund's positions in these sectors are relatively modest and typically senior and secured on high quality collateral. One example is **Heathrow** which, despite being largely shut during the COVID-19 pandemic, retains significant excess liquidity. Other examples are highly rated and low-levered companies such as **Mitchells & Butlers**, which had a pre-coronavirus loan-to-value ratio of less than 20%. We continue to monitor issuers' trading performance and access to liquidity, which has been strongly underpinned by government policy, and our expectation of a strong future recovery remains high in these areas.
- Across the fund's holdings of secured bonds, the larger exposures are to sectors such as social housing, utilities, infrastructure, covered bonds and residential mortgage-backed-securities, which have proved resilient, both in terms of corporate performance and bond pricing. By contrast, the fund has underweight exposures to unsecured issuers in high-impact sectors such as general retail and real estate, where businesses could be more materially impacted by COVID-19.

Activity

- It is rational to question whether we should reduce or downscale our underweight allocations towards the inefficient market sectors which are currently being supported by the BoE, given that there is still a lot of buying to come. Our approach, however, has always been geared to acting as a long-term lender of our clients' assets, rather than as bond traders. As active managers, we would not wish to build portfolios based simply on what an authority is buying, risking significant underperformance when bonds drop off buy lists (for example, due to downgrades) or when buying stops.
- Our approach over the quarter has been to accept the short-term negative impact of our positioning, while looking to exploit the exacerbated inefficiencies that have been created by the purchase programme. We have therefore been selecting bonds in areas that are not price-distorted by the BoE which still offer relatively attractive spreads, while selling our price-distorted holdings into the market or the BoE. We participated in the purchase programme in those cases in which we thought that we could use the proceeds to enhance the risk/return characteristics of the fund.
- We remained fully invested in the market throughout the quarter, with liquidity only held to facilitate the purchase of new issues. We participated in a £500m issuance of BBB rated 20-year bonds from rail transport company **Eversholt**; a £450m issuance of BBB rated structured bonds from utility **Southern Water**; and £750m issuances of 8- and 15-year A rated bonds from pharmaceuticals company **GlaxoSmithKline**. Overall, we participated in 36 of the 59 new issues in the sterling investment grade credit market during the second quarter. The new issues we were involved in constituted 63% (£17bn) of the total amount issued (£28bn). For the issues in which we were involved, we reached £1bn (6%) of total issuance.

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- One consequence of the strong creditor position we have in the structured sector is the existence of restrictive operational and financial covenants that issuers need to comply with. This differs from the vast majority of unsecured corporate bonds. While these credit enhancements are a key protection and we engaged in a number of discussions with issuers during the quarter as a result regarding a bilateral approach to addressing the temporary challenges. We approached all these discussions with a common philosophy of balancing the need to be responsible lenders at a time of unprecedented social and economic disruption, while ensuring that we preserve our clients' interests. We typically agreed to the changes required, though in a number of cases we sought appropriate enhancements to maintain the correct balance between different stakeholders.

Outlook

- The COVID-19 virus, and the measures taken to control it, will continue to significantly influence global economic activity. Economies will remain impacted over the medium term, even as societies return to more normal conditions, because depressed tax receipts, higher government spending and greater state intervention significantly increase government debt at the global level. We expect this to result in an upward trend in long-term interest rates as the greater supply of government debt, which is presently being absorbed by central banks, leads investors to seek higher yields.
- Under our expected scenario, UK borrowing will fall in 2021-22 from this year's elevated levels. Along with a partial economic recovery, this is due to the assumption that the fiscal measures announced since the March Budget will not be extended further and so would not have a direct impact on borrowing in 2021-22. The enduring economic weakness would, however, continue to elevate the deficit, with borrowing still projected to be running at over 5% of national income, or £130 billion in 2024–25. This would be 3% of national income higher than forecast in the Budget, with the cash borrowing forecast about £70 billion higher. Even under a more optimistic growth scenario borrowing in 2024–25 could be about £40 billion, or two-thirds, higher than forecast in the Budget.
- Our base case is that global economies will bounce back in 2021 but that recovery will be more gradual than recent central bank forecasts have implied. There are many unknowns: the possibility of second waves, population immunity levels, vaccine availability, consumer confidence, business investment, corporate failures, and government and central bank policies. In the UK there is also the added complication of trading negotiations with the EU.
- We expect continued fiscal stimulus after lockdowns end, both to ensure economies recover and to tackle long-term challenges like climate change and demographic pressures. Asset purchase programmes are also likely to continue until robust recoveries are secure, topped up intermittently through 2021. We expect that central banks will focus on yield curve control and move towards purchasing a wider selection of assets if required.
- The longer-term implications are less clear, but it is likely that there will be structural shifts in the ways that economies work, the extent of state interventions and geopolitical tensions. We may see a slowdown, or even reversal, in the trend towards globalisation as corporate supply chains become less globally focused and tensions between the US and China rise.
- With regard to fixed income markets specifically, we expect that there will be more downgrades in investment grade credit, including into sub-investment grade, and higher default rates in high yield markets. There is likely to be greater demand for security over the assets of issuers and stronger covenant protections. The current credit spread remains attractive, offering significant compensation for default and other risks, and it is likely to be maintained around current levels through 2020 and into 2021. We expect that investment grade credit bonds will outperform UK government securities over the next three years.

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