RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarterly Report 30 September 2021

For professional clients only, not suitable for retail investors

ROYAL LONDON
ASSET MANAGEMENT

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.7	99.0
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	1.0
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]	10.4 years	10.3 years
Gross redemption yield[4]	2.61%	2.02%
No. of stocks	216	751
Fund size	£198.1m	-

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 (%)
Q3 2021	**-0.79**	**-1.38**	**0.59**
Year-to-date	-2.20	-5.05	2.86
Rolling 12 months	2.50	-1.12	3.62
3 years p.a.	6.88	5.57	1.31
5 years p.a.	4.67	3.13	1.54
Since inception p.a. 02.07.2007[2]	7.52	6.17	1.35

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.

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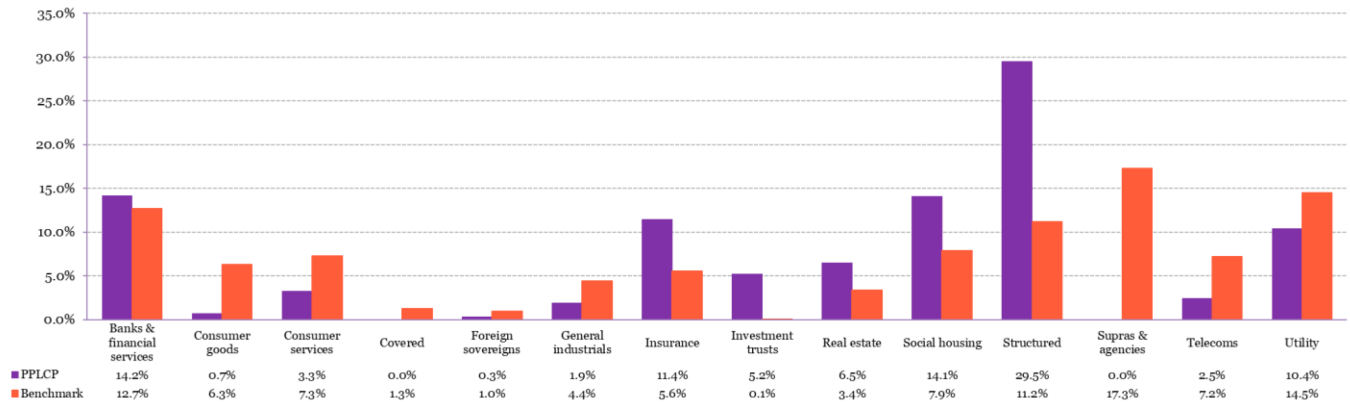
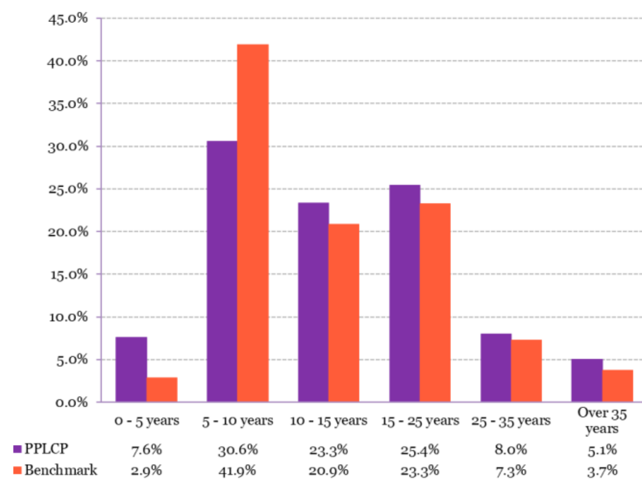
Sector breakdown

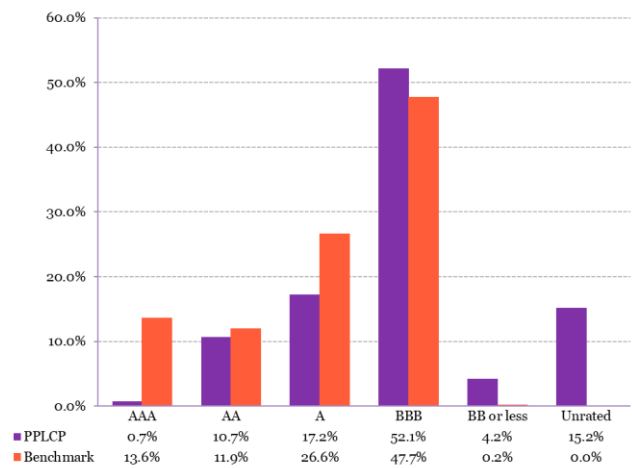


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
HSBC Bank 5.375% 2033	2.3
M&G Plc 5.7% 2063	1.6
Électricité De France 6% 2114	1.6
Thames Water Utilities 2 7.738% 2058	1.5
E On International Finance 6.125% 2039	1.4
Finance for Residential Social Housing 8.369% 2058	1.4
Dali Capital 4.79924% 2037	1.3
Annes Gate Property 5.661% 2031	1.3
Exchequer Partnership 5.396% 2036	1.3
Tesco Property Financial 5.6611% 2041	1.3
Total	**14.9**

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

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Market overview

- For much of the quarter, the prevailing sentiment in financial markets was 'more of the same' with the ongoing recovery in economic activity causing some supply chain frictions, interspersed with concern about inflation on the one hand or an autumn Covid spike on the other. The huge recovery in risk asset prices since March 2020, however, meant that markets were increasingly vulnerable to negative news. Several such shocks came more-or-less together in the last weeks of the quarter.
- First, the likely collapse of giant property conglomerate Evergrande shook investors and there were fears that this could be China's 'Lehman moment', with a single corporate bankruptcy leading to systemic failure. Subsequently, bottlenecks in supply chains caused by Covid disruption (and, in the UK, possibly exacerbated by Brexit) led to more-visible shortages and price spikes, which ultimately led central bankers to revise their forward guidance on the tapering of quantitative easing measures and interest rate rises.
- The quarter began with the Delta Covid variant increasingly prevalent across the US, eurozone, the UK and Asia. Over the period, the global picture became more varied, with cases rising in the US and UK, but with waves in Europe, Japan and China seemingly more contained. With vaccine programmes continuing, governments were reluctant to maintain or tighten social distancing restrictions, instead preferring to introduce booster jabs and vaccinate children.
- Global economic data was mixed, with inflation still causing concern and economic growth appearing to slow in the third quarter. In late September, the US Federal Reserve (Fed) made substantial changes to its economic forecasts, revising its growth outlook and increasing inflation expectations. Chair Jerome Powell suggested it could "easily move ahead" with plans to taper its $120bn monthly asset purchases programme as early as November. The market expects US inflation to peak at 4.2% this year before falling back to 2.2% in 2022. The Federal Open Market Committee also revised its interest rate path, signalling three potential interest rate rises of 25bps during 2022.
- In the same week, the Bank of England (BoE) said inflation could reach 4% over the winter months, largely due to rising energy and goods prices. However, it expects it will then fall back towards its 2% target in the medium term. The European Central Bank voted to keep interest rates unchanged at its September meeting, but opted to slow the pace of net asset purchases through the pandemic emergency purchase programme.
- In UK bond markets, the resurgence of inflation fears, and potential for less accommodative monetary policy was the main driver of a sell-off in yields, particularly in September. The benchmark 10-year gilt yield rose from 0.72% to 1.02% over the quarter, leading gilts to return -1.84% on an all-maturities basis (FTSE Actuaries). Credit market returns were also negative, due to the rise in underlying gilt yields, but somewhat tighter spreads and the yield on these assets somewhat offset this impact, with sterling investment grade credit returning -0.96%%. The average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) tightened from 0.91% to 0.87%.
- All sterling credit sectors delivered negative returns during the quarter, although there was some dispersion. The financial sectors (insurance, banks and covered bonds) performed relatively strongly, particularly subordinated insurance and specific subordinated banks bonds; and asset-backed securities were one of the strongest sectors. Supranationals performed broadly in line with the wider market, whereas the telecoms, healthcare and retail sectors notably underperformed. Shorter-dated bonds strongly outperformed longer-dated issues, but still delivered negative returns; and BBB rated bonds also outperformed their higher-rated peers.

Portfolio commentary

- The 'more of the same' theme that prevailed in financial markets for most of the third quarter was mirrored by the ongoing strong performance of our sterling credit strategies. Most strategies strongly outperformed their benchmarks and delivered top quartile returns; this sustained the year-to-date outperformance of the strategies. Duration made a positive contribution, but the bulk of the outperformance was derived from asset allocation across sectors and stock selection within them. Pleasingly, such balanced outperformance is a testament to the consistent application of our sterling credit investment philosophy and process across different funds, whether all maturities or shorter dated.
- From a sector perspective, our overweight positions in secured bonds, insurance (particularly subordinated insurance) and utility type bonds delivered strong performance; meanwhile, our very low allocation to supranational bonds made a positive relative contribution. Security selection within the banking sector was positive, especially **Santander** and **Lloyds Banking Group**; although these were partly offset by some weakness in HSBC, on heightened concerns about China and, in particular, its real estate market. We have added to legacy financial capital instruments over a number of years (such as **Santander** preference shares). Many of these bonds will not count as capital in the medium term become and we expect ongoing capital management (for example, buybacks).

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- Other notable stock performance came from **Thames Water** and **Peterborough Progress** (both structured bonds), and ultra-long-dated and perpetual bonds of French utility giant **EdF**.
- Activity reflected new issue opportunities and secondary market availability. Issuance tailed off in July and into August due to seasonal factors, but rebounded in September. Over the quarter, spreads on new issues were increasingly too low to interest us and a number of deals that looked attractive initially were tightened during the book building phase to levels where we passed. Several new issues struggled in the market choppiness at the end of the period and, if the current volatility continues, issuance for 2021 may only match that for 2020.
- We participated in a number of new issues during the period. We bought new senior bonds from **Investec** and **First Abu Dhabi Bank**. There were also a number of new issues in the social housing sector, including from **Metropolitan Housing** and **Clarion Housing**, the UK's largest Housing Association. Other activity reflected our ongoing focus on structured bonds. We added a new bond from university accommodation financing company **Uliving**. The bonds have been issued to fund new accommodation at the University of Essex and have an AA rating due to additional protections in the structure. We also added a new structured bond from the **AA**.
- There was further issuance of green and sustainable corporate bonds in the quarter. The UK also issued its first green gilt in September. Even though there has been no detail provided on use of proceeds the bond was issued at a price premium to existing gilts although this was less than the 'greenium' (price premium for Green bonds) attached to German green bonds, which is currently 6bps of yield. While we welcome the greater recognition of climate challenge and the higher focus on ESG, we do not believe that all labelled bonds offer value or clarity of objective. We will continue to focus on integrating ESG risk and to add incremental value in overlooked areas of the market.

Outlook

- After a relatively benign third quarter, the market volatility at the end of September and in the first week of October suggest that vigilance will be required in the coming months. However, while the change of gear has been somewhat abrupt, we are more sanguine than others appear to be about the outlook for inflation. Credit spreads ended the quarter close to their tightest level since 2007; we see little scope for further tightening but expect any pull back to be modest.
- We expect implied UK inflation (i.e. nominal yields minus real yields) to fall back from the highs recorded in September and early October. Higher energy costs will feed through to inflation in 2022 and we can still expect on-going supply disruptions to impact prices in some sectors. However, there are countervailing pressures. In the UK, businesses will face a significant squeeze next year as higher taxes, including National Insurance and increased wage costs impact profitability. Similarly, consumers real disposable income will come under pressure: higher energy bills, an end to the £20 Universal Credit uplift and the prospect of higher mortgage rates will impact. At a global level the deflating of the Chinese property market may impact the Chinese economy and have wider knock-on effects. Taken together we see inflation moderating through the second half of 2022.
- We expect tapering of quantitative easing in developed economies and it is likely that interest rates will rise a bit earlier than anticipated. However, global economies remain highly sensitive to tighter monetary policies and only relatively small increased in rates will have a dampening impact. Therefore, we retain of our view that the rise in government rates which we have expected will be modest and that we remain in a low interest rate environment.
- We will maintain our long-standing focus on risk management by seeking to identify companies with strong balance sheets; favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors and other factors. In addition, we expect to maintain an overweight position in subordinated financial bonds where credit spreads remain attractive.
- It is still our view that credit spreads compensate for the risk of default and credit will outperform government bonds over the medium term. Our portfolios have a material exposure to BBB bonds where compensation for default risk remains elevated. Credit risk is not something that should be taken unthinkingly but it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.

Find out more

- Join us online for the *2021 RLAM Investment Series* (our annual client conference) between 1st and 5th November. A range of our fund managers and other in-house specialists will address the macroeconomic environment and prospects for different asset classes, and the issues they are considering in positioning their funds. There will also be sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. For more details and to register, please visit rlam.co.uk.

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- In recent years, **social housing** has become an increasingly important component of our sterling credit and sustainable funds. However, it is crucial to find the right way to invest in the sector, in a manner which respects the strong social benefits that it provides. We prefer to lend to social housing associations through participation in credit issues, rather than make equity investments through real estate investment trusts (REITs). Shalin Shah and Tom Johnson write about the sector on rlam.co.uk. While it approaches social housing from a sustainable perspective, their article gives a good overview of the sector, and highlights why we believe that a thorough and well-resourced bottom-up active investment approach ultimately delivers the best results for clients.
- You can find more of our thoughts on the opportunities and risks in the sterling credit sector at rlam.co.uk. Head of Fixed Income Jonathan Platt writes a weekly blog each Monday on key issues in sterling credit and other fixed income markets.

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