ROYAL LONDON

ASSET MANAGEMENT

ROYAL LONDON FIXED INCOME

Fund Manager Commentary – January 2019

For professional clients only, not suitable for retail investors

CONTENTS

ECONOMIC DEVELOPMENTS

Economic developments

In the UK, political uncertainty linked to Brexit remained elevated: the government held a delayed parliamentary vote on the EU withdrawal agreement, and suffered a record defeat. After her government survived an Opposition confidence vote, Prime Minister Theresa May outlined her 'Plan B', which closely resembled the original accord. However, she committed to renegotiating the Irish border 'backstop' with the EU. Economic data suggested growth slowed, including very weak retail sales for December. Sterling strengthened for the first time in four months on speculation that a Brexit deal would be reached.

The US experienced its longest ever federal government shutdown, as President Donald Trump and the opposition Democrats reached an impasse over his demand for $5 billion to fund a border wall with Mexico. Meanwhile, as data increasingly suggested the economy was slowing, the Federal Reserve (Fed) softened its position on further rate rises, US-China trade tensions appeared to lessen and the Chinese government applied further economic stimulus measures. The dollar weakened for a second month on the Fed's more 'dovish' stance.

Euro area growth was unchanged in the fourth quarter from the prior three months at 0.2%, indicating stagnation. Germany deteriorated markedly, with retail sales falling the most in 11 years in December, and the Italian economy entered recession, but Spain recorded a strong performance. Economic confidence and business climate indicators are at their lowest levels since early 2017, and trending lower. The euro weakened modestly against the dollar and fell sharply against sterling.

RLAM CREDIT FUND PERFORMANCE

Fund performance

	1 month (%)	Rolling 12 months (%)
RL Corporate Bond Fund Z Inc	**1.80**	**0.34**
IA Sterling Corporate Bond Sector	1.61	-0.20
iBoxx Sterling Non-Gilts All Maturities Index	1.57	0.90
RL Ethical Bond Fund Z Inc	**1.54**	**0.85**
IA Sterling Strategic Bond Sector	1.73	-0.87
iBoxx Sterling Non-Gilts All Maturities Index	1.57	0.90
RL Global Bond Opportunities Fund Z Inc	**1.59**	**1.62**
RL Investment Grade Short Dated Credit Fund Z Inc	**0.66**	**0.77**
IA Sterling Corporate Bond Sector	1.61	-0.20
ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index	0.54	0.85
RL Short Duration Credit Fund Z Inc	**0.90**	**1.12**
IA Sterling Strategic Bond Sector	1.73	-0.87
ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index	0.54	0.85
RL Sterling Credit Fund Z Inc	**1.65**	**0.38**
IA Sterling Corporate Bond Sector	1.61	-0.20
iBoxx Sterling Non-Gilts All Maturities Index	1.57	0.90
RL Sterling Extra Yield Bond Fund A Inc	**1.89**	**2.64**
RL Sterling Extra Yield Bond Fund B Inc	**1.85**	**2.12**
RL Sterling Extra Yield Bond Fund Y Inc	**1.94**	**3.08**
RL Sterling Extra Yield Bond Fund Z Inc	**1.91**	**2.89**
IA Sterling Corporate Bond Sector	1.61	-0.20
IA Sterling High Yield Sector	2.91	-0.70
IA Sterling Strategic Bond Sector	1.73	-0.87

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.

Source: RLAM and FE, correct as of 31 January 2019. Returns quoted are net of fees.

[1]Please note that the benchmark pricing is end-of-day, and entails no currency conversion.

CREDIT MARKET REVIEW

Market highlights

Sterling Investment Grade Credit

- The benchmark 10-year UK gilt yield fell 6 basis points (bps) to 1.22% in January. UK government bonds (all maturities) returned 1.06%, underperforming sterling investment grade corporate debt (which returned 1.57%, all maturities) for the first time since August 2018. The average credit spread (the yield premium over gilt yields) narrowed by 11bps to 1.40%.
- Total returns were positive across sterling credit sectors. Within financials (banks and insurance), subordinated issues outperformed the wider market, while senior debt lagged behind. Among secured and structured sectors, real estate outperformed but asset backed securities underperformed, as did supranationals and covered bonds. By credit rating, lower rated debt outperformed higher rated issues. By maturity, longer and medium dated bonds outperformed shorter dated debt.
- Investment grade credit issuance rebounded from December's seasonal lows in both sterling and euro markets; compared with a year earlier, these markets modestly dropped and gained, respectively. Industrials led issuance in the euro market, and financials were the biggest sterling issuers.

ROYAL LONDON CORPORATE BOND FUND

Portfolio commentary

- The fund delivered a return, net of fee, of 1.80% in January, compared with the 1.61% average return for its sector (IA Sterling Corporate Bond).
- Fund performance benefitted from the prominent below benchmark allocation to supranational debt, which lagged the broad sterling credit market, and its underweight position in AAA rated bonds as they underperformed lower rated debt. Conversely, asset backed securities lagged slightly while the fund's duration position had no material impact.
- Overweight exposure to insurance and social housing, a substantial underweight in supranational bonds, and a bias towards secured and structured issues are the most noticeable features of sector positioning.
- New issue activity centred on banking in January, with purchases including senior debt from **Banque Fédérative du Crédit Mutuel, BNP Paribas** and **Groupe BPCE**. The largest individual purchase was a five-year senior unsecured bond from the German government-owned development bank **Kreditanstalt für Wiederaufbau (KfW)**. The fund also bought new issues from water supply services company **United Utilities**, telecommunications company **Orange** and the social housing providers **Clarion Housing Group** and **Hastoe Capital**.
- In the secondary market, the fund bought a covered bond of **Lloyds Bank** at an attractive level for its AAA rating. It took advantage of cash inflows to purchase debt from the beverage company **Anheuser-Busch Inbev Worldwide**. The fund made several purchases in long-dated debt of **GE Capital**, the financial services unit of General Electric, taking advantage of cheap prices relative to the tightening market. The fund sold its position in **Road Management** for liquidity management.

Investment outlook

- With the outcome of Brexit still unclear and the UK scheduled to leave the EU in March 2019, with or without a formal withdrawal agreement, we believe that uncertainty will constrain business investment. Against this background, we expect interest rates to remain at low levels.
- We continue to believe that portfolio diversification is important and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- The increase in investment grade credit spreads in the fourth quarter of 2018 was more pronounced than we would have expected against a background of moderating economic growth and higher risk aversion. We consider that the current credit spread is attractive and offers significant compensation for default and other risks (e.g. liquidity and rating migration). We expect investment grade credit bonds will outperform UK government securities over the next three years.

Key views within the fund

- The fund is diversified, with over 300 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall fund performance of any deterioration in the creditworthiness of an individual holding.
- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration broadly in line with that of the benchmark.
- An overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors and towards structured bonds, which benefit from a claim on assets and cashflows.

Jonathan Platt
Head of Fixed Income

Shalin Shah
Senior Fund Manager

ROYAL LONDON ETHICAL BOND FUND

Portfolio commentary

- The fund's Z class share delivered a return, net of fee, of 1.54% in January. This compares to the average returns recorded for the Investment Association (IA) Sterling Strategic Bond sector and the IA Sterling Corporate Bond sector of 1.73% and 1.61% respectively. The fund is a constituent of the former sector because its weighting in investment grade sterling corporate bonds is less than 80%, predominantly as a result of the holdings of unrated secured debt; however, in the context of its investment grade all-maturities benchmark, the fund's performance relative to the more homogeneous Sterling Corporate Bond sector is also relevant.
- The monthly performance of the fund benefitted from the below benchmark allocation to supranational debt, which underperformed the broad sterling credit market, and its underweight position in AAA rated bonds as they underperformed lower rated debt. The overweight allocation to financials was broadly neutral, given the mixed performance of these sectors. Exposure to secured and structured issues was also broadly neutral, as real estate outperformed while asset-backed securities lagged. The moderate short duration stance relative to the fund's benchmark had a moderately negative impact, with longer term issues outperforming.
- The overweight holding of financial bonds and social housing, the bias towards secured and structured debt, and the underweight exposure to supranational issues remained the fund's most notable sector characteristics.
- The largest new issue purchase was a five-year AAA covered bond in **Nationwide Building Society.** Taking advantage of attractive pricing in the social housing sector, the fund purchased a 10-year bond from **Clarion Housing Group** and added to its long-dated debt in **Hastoe Capital**. The fund purchased senior bonds from the banking groups **BNP Paribas** and **Banque Federative du Credit Mutuel**. It also increased its telecommunications exposure with a new issue from **Orange**.
- In the secondary market, there was some activity investing cashflows, with a notable increase in the fund's holding of structured debt in the toll road company **Road Management**. The banking sector saw a lot of activity from the fund, as it added to its subordinated debt in **Metro Bank,** reduced its junior subordinated debt in **Barclays Bank**, switching part of it for **HSBC**, and eliminated its **Credit Suisse** exposure in favour of the new **BNP Paribas** issue. Attractive prices led the fund to sell off its holding in utilities company **South West Water** and increase its holding in the consumer services company **Great Rolling Stock**.

Investment outlook

- With the outcome of Brexit still unclear and the UK scheduled to leave the EU in March 2019, with or without a formal withdrawal agreement, we believe that uncertainty will constrain business investment. Against this background, we expect interest rates to remain at low levels.
- We continue to believe that portfolio diversification is important and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- The increase in investment grade credit spreads has been more pronounced than we would have expected against a background of moderating economic growth and higher risk aversion. We consider that the current credit spread is attractive and offers significant compensation for default and other risks (e.g. liquidity and rating migration). We expect that investment grade credit bonds will outperform UK government securities over the next three years.

Key views within the fund

- The fund is diversified, with over 300 holdings, in order to improve portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual holding.
- The fund has a significant underweight position in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration within the fund is moderately shorter than that of the benchmark.

ROYAL LONDON ETHICAL BOND FUND

Key views within the fund continued

- The fund has an overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors, and towards structured bonds, which benefit from a claim on assets and cashflows.

FE ALPHA MANAGER 2018 ERIC HOLT

CITYWIRE AAA

Eric Holt
Head of Credit

ROYAL LONDON GLOBAL BOND OPPORTUNITIES FUND

Executive summary

- The fund recorded a net return of 1.59% in January, its best monthly performance since July 2016, as corporate bonds staged a strong rebound from the turbulence experienced in the fourth quarter of last year.
- Distributions payable at the end of February were 1.52p.

Market highlights

Index	Total return (%)	Spread movement (basis points)
HY global non-financial corps ICE BofA ML global non-financial high yield index	4.05	-89
AT1 ICE BofA ML contingent capital index	3.85	-65
HY non-financial emerging markets ICE BofA ML emerging markets high yield ex. subordinated financial index	3.57	-94
HY global non-financial hybrid corps ICE BofA ML global hybrid non-financial high yield index	2.47	-47
IG global non-financial hybrid corps ICE BofA ML global hybrid non-financial corporate index	2.45	-29
Dollar investment grade corporate bonds ICE BofA ML US corporate index	2.09	-21
Sterling investment grade corporate bonds ICE BofA ML sterling corporate and collateralised index	1.95	-13
Euro investment grade corporate bonds ICE BofA ML euro corporate and Pfandbriefe index	1.02	-10

Source: Bloomberg.

- Total returns were positive and credit spreads narrowed across corporate debt classes, retracing some of the marked widening seen in the last months of 2018. High yield issues and subordinated financial (banks and insurance) bonds strongly outperformed investment grade debt, helped by revived investor appetite for risk and by a sharp rise in the price of Brent crude oil that supported returns from the energy sector.

Portfolio commentary

- The fund took part in two new issues and a tap, as issuance revived after a very subdued December. Purchases included senior unsecured US dollar debt of brewer **Anheuser-Busch InBev**, which sold $15.5 billion of bonds with maturities of up to 40 years, while offering to buy back shorter dated debt. The fund bought bonds from the shortest maturity tranche, due in 2025. In financials, the fund participated in a $3 billion senior non-preferred issue by **Danske Bank** that was delayed because of developments in a money-laundering scandal. Non-preferred bonds are at risk of being ‘bailed in’ if an issuer collapses. Elsewhere, the fund purchased senior secured Norwegian krone bonds of shipping company **Havilafjord**, which reopened an existing issue.
- Away from new issues, cashflows were invested to enlarge positions including the fund’s biggest, secured Norwegian krone bonds of real estate company **ML 33**, backed by offices of energy company Equinor. In switching activity within financials, higher yields were achieved by selling bonds of **Standard Life Aberdeen** against **Phoenix Group** and by moving between issues of **La Mondiale**. German bunds maturing in 2048 were sold at a profit, along with subordinated debt of financials **BNP Paribas** and **Ethias**; ‘hybrid’ bonds of utility **Vattenfall** were sold after outperforming the wider market. The fund increased its allocations to **Danske Bank** and **Havilafjord**, in addition to participating in the new issue and the tap referenced above.
- A number of shorter dated ‘hybrid’ issues made significant contributions to returns during the month; these included US dollar bonds of industrial conglomerate **General Electric** and euro debt of utility **Électricité de France** and communications satellite operator **SES**. Subordinated US dollar bonds of insurers **La Mondiale** and **Prudential** also performed well. At the other end of the scale, detractors included structured debt of utility **Freshwater Finance** and of **Premiertel**, secured against properties occupied by telecommunications company BT Group, along with subordinated bonds of **Santander UK**, all denominated in sterling.
- The fund maintains a 2.5% hedge through the iTraxx Europe CDS (Credit Default Swap) Crossover index.

ROYAL LONDON GLOBAL BOND OPPORTUNITIES FUND

Investment outlook

- We have lowered our global growth forecast slightly and now expect an outcome closer to 3.4% by the end of 2019. We anticipate a slowdown in the US, rather than a recession, but we take recession risk seriously. Economic growth in the eurozone disappointed in 2018, and the current year may not be much better. UK growth should pick up somewhat this year, assuming a Brexit withdrawal agreement is reached.
- We expect the Fed to keep raising rates at a gradual pace, stopping near a neutral level after two more 25bp hikes. December was the final month of the European Central Bank's monetary stimulus; we expect rates to rise very gradually, with the first hike late in 2019's third quarter.
- We believe that present pricing of corporate bonds is still attractive over the medium term, while their level of income generation is also appealing with the prospect of short-term interest rates staying lower for longer. We believe credit valuations are underpinned by strong company balance sheets and a low default rate environment, which is pushing investors to broaden their search for yield.

Rachid Semaoune
Senior Fund Manager

Eric Holt
Head of Credit

ROYAL LONDON INVESTMENT GRADE SHORT DATED CREDIT FUND

Portfolio commentary

- The fund recorded a net return of 0.66% in January, against the 0.54% gross return of the ICE BofA Merrill Lynch 1-5 Year Sterling Non-Gilt Index and the 1.61% average return of its sector (IA Sterling Corporate Bond).
- The overweight holding of subordinated financial (banks and insurance) issues and below benchmark position in supranational debt were supportive for performance, as these sectors outperformed and lagged behind the wider sterling credit market, respectively. The preferences for lower rated bonds and for shorter dated securities had respective positive and negative effects; while AAA and AA rated debt underperformed, longer maturity issues had stronger returns. The significant allocations to covered bonds and asset backed securities, which underperformed the broad market, were disadvantageous.
- Underweight exposure to supranational bonds, the overweight holding of financial debt and the bias towards secured and structured issues remained the fund's most notable sector characteristics.
- The fund took part in six new issues, all by financial companies, as issuance revived after a very subdued December. Purchases included AAA rated floating rate covered bonds of **Nationwide Building Society** and **Australia and New Zealand Banking Group**, both backed by pools of mortgage loans and linked to the Sterling Overnight Index Average (Sonia), the planned replacement for Libor. Commercial issuers including Lloyds and Yorkshire Building Society have sold Sonia linked debt after the European Investment Bank's pioneering issue of 2018, and ANZ was the first non-UK issuer. Elsewhere, the fund bought new senior bonds of **Citigroup** and **Banque Fédérative du Crédit Mutuel** (both unsecured), **Groupe BPCE** (preferred) and **BNP Paribas** (non-preferred). Senior non-preferred bonds are subject to being 'bailed in' should an issuer fail.
- Away from new issues, cashflows were invested to increase holdings of **London Stock Exchange** and **Porterbrook Rail Finance**, as well as perpetual debt of **HSBC**. Within covered bonds, allocations to fixed rate debt of **Swedbank Hypotek**, **Toronto-Dominion Bank** and **Bayerische Landesbank** were sold to recycle funds into floating rate issues, and the sales of positions in **Royal Bank of Canada**, **Westpac** and **Royal Bank of Scotland** reflected duration management. Elsewhere, bonds of **Pohjola Bank** and German carmaker **Volkswagen** were sold to manage cash.

Investment outlook

- With the outcome of Brexit still unclear and the UK scheduled to leave the EU in March 2019, with or without a formal withdrawal agreement, we believe that uncertainty will constrain business investment. Against this background, we expect interest rates to remain at low levels.
- We continue to believe that portfolio diversification is important and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- The increase in investment grade credit spreads in the fourth quarter of 2018 was more pronounced than we would have expected against a background of moderating economic growth and higher risk aversion. We consider that the current credit spread is attractive and offers significant compensation for default and other risks (e.g. liquidity and rating migration). We expect investment grade credit bonds will outperform UK government securities over the next three years.

Key views within the fund

- The fund is diversified, with almost 300 holdings, in order to improve general portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual exposure.
- A significant underweight in supranational bonds, as we expect corporate debt to outperform over the medium term.
- Duration moderately shorter than that of the benchmark.
- An overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards structured debt, which benefits from a claim on assets and cashflows; secured issues in the asset-rich property and social housing sectors; and covered bonds (i.e. senior bank debt benefiting from a first claim on a specified over-collateralised pool of assets

Richard Nelson
Senior Fund Manager

CITYWIRE AAA

Paola Binns
Senior Fund Manager

ELITE PROVIDER
rated for bonds by FundCalibre.com

ROYAL LONDON SHORT DURATION CREDIT FUND

Portfolio commentary

- The fund delivered a net return of 0.90% in January, against the 0.54% gross return of the ICE BofA Merrill Lynch 1-5 Year Sterling Non-Gilt Index and the 1.73% average return of the IA Sterling Strategic Bond sector.
- The fund outperformed its benchmark over the month. It benefitted from its underweight position in supranational debt, which lagged the broad market, and in higher rated bonds as they underperformed lower rated debt. Exposure to financials was broadly positive, given the underperformance of senior debt, which is an underweight position. Exposure to secured and structured issues was also broadly neutral, as real estate outperformed but asset backed securities lagged slightly. The moderate short duration position relative to the fund's benchmark had a small negative impact as longer dated debt outperformed.
- Overweight exposure to financial bonds, a bias towards secured and structured issues, and significant underweight exposure to supranational debt remained the most notable aspects of sector positioning.
- The fund participated in six new issues, all by banks, as issuance revived as credit markets recovered after the volatility in December. Purchases included AAA rated floating rate covered bonds of **Nationwide Building Society**, backed by pools of mortgage loans and linked to the Sterling Overnight Index Average (Sonia), the planned replacement for Libor. Otherwise, the fund bought new senior bonds of **Citigroup** and **Banque Fédérative du Crédit Mutuel** (both unsecured), **Groupe BPCE** (preferred), **BNP Paribas** (non-preferred) and **Danske Bank** (non-preferred). Senior non-preferred bonds are subject to being 'bailed in' should an issuer fail.
- In the secondary market, activity centred on investing cashflows, switching between issues to increase yield or reduce duration, or managing liquidity. Purchases to invest cashflow included social housing company **THFC**, pub operator **Mitchells & Butlers**, German utility **RWE**, mobile telecoms operator **Orange** and structured debt in **Telereal**, the property and investment group. Current positions were added to in banking group **Barclays**, **Income Contingent Student Loans 1** and secured debt in **Marstons**, the brewer and pub and hotel operator. Switching activity included between existing bonds and the new issue in **Banque Féderative du Credit Mutuel**, between different bonds in GE Capital and from Barclays into **HSBC**. A position was initiated in **DNO ASA**, the Norwegian oil and gas company. Sales included financials **BNP Paribas**, **New York Life** and **UBS**.
- Bonds in French electric utility **Engie** were called away from the portfolio.

Investment outlook

- With the outcome of Brexit still unclear and the UK scheduled to leave the EU in March, with or without a formal withdrawal agreement, we believe that uncertainty will constrain business investment. Against this background, we expect interest rates to remain at low levels.
- We continue to believe that portfolio diversification is important and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- The increase in investment grade credit spreads has been more pronounced that we would have expected against a background of moderating economic growth and higher risk aversion. We consider that the current credit spread is attractive and offers significant compensation for default and other risks (e.g. liquidity and rating migration). We expect investment grade credit bonds will outperform UK government securities over the next three years.

Key views within the fund

- The fund is diversified, with more than 300 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual exposure.
- The fund has a significant underweight in supranational bonds, as we expect corporate debt to outperform over the medium term.

ROYAL LONDON SHORT DURATION CREDIT FUND

Key views continued

- Fund duration is modestly short relative to that of the benchmark.
- The fund has an overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors, and towards structured issues, which benefit from a claim on assets and cashflows.

CITYWIRE AAA

Paola Binns
Senior Fund Manager

ROYAL LONDON STERLING CREDIT FUND

Portfolio commentary

- The fund recorded a net return of 1.65% in January, compared with the 1.61% average return for its sector (IA Sterling Corporate Bond).
- Above benchmark exposure to financial (banks and insurance) bonds was positive for returns, as insurance and subordinated banks strongly outperformed the wider market. Senior insurance was in line with the broad market while senior banks underperformed. The underweight positions in supranational issues and covered bonds, which underperformed, were beneficial. The holdings of secured and structured debt were neutral overall, as real estate outperformed but asset backed securities lagged behind. Underweight exposure to AAA rated bonds, which underperformed lower rated debt, was supportive. The moderate short duration stance relative to the fund's benchmark had a negative impact on performance as longer rated debt outperformed.
- Overweight exposure to financial debt, a substantial underweight in supranational bonds, and a bias towards secured and structured issues remained the most noticeable features of sector positioning.
- After a subdued December, the fund took part in a number of new issues in January. Among its largest purchases were a perpetual bond of Belgian company **AG Insurance** and a seven year bond of **BNP Paribas**. The fund continued its trend of buying into social housing with a long-dated bond of **Hastoe Capital**, taking advantage of attractive pricing. The holding of seven year debt in **Bank of America** was sold in order to raise cash against the new issues.
- In the secondary market, the fund took a position in the Norwegian oil and gas operator **DNO ASA**, which had an attractive yield after its 100% acquisition of oil and gas company **Faroe Petroleum** and also offered credit positive geographical diversification. Much of the activity came from investing cashflows, adding to positions in debt issuer **Delamare Finance** and real estate such as **Shaftesbury Carnaby** and **Shaftesbury Chinatown**. The fund sold its holding in German electric utilities company **RWE AG** in order to manage its exposure to sub-investment grade credit and its position in German automaker **Volkswagen** due to a relatively high offer.

Investment outlook

- With the outcome of Brexit still unclear and the UK scheduled to leave the EU in March 2019, with or without a formal withdrawal agreement, we believe that uncertainty will constrain business investment. Against this background, we expect interest rates to remain at low levels.
- We continue to believe that portfolio diversification is important and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- The increase in investment grade credit spreads in Q4 2018 was more pronounced than we would have expected against a background of moderating economic growth and higher risk aversion. We consider that the current credit spread is attractive and offers significant compensation for default and other risks (e.g. liquidity and rating migration). We expect investment grade credit bonds will outperform UK government securities over the next three years.

Key views within the fund

- The fund is diversified, with more than 300 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual holding.
- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration moderately shorter than that of the benchmark.
- An overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors, and structured bonds, which benefit from a claim on assets and cashflows.

CITYWIRE AAA

Paola Binns
Senior Fund Manager

ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Portfolio commentary

- In January, the returns of the A, B, Y and Z class shares were 1.89%, 1.85%, 1.94% and 1.91%, respectively.
- After the sharp deterioration in financial markets in the final months of last year, eroding the 2018 performance of shares in the fund to only modestly positive returns, a robust rebound took place in January from subdued levels. Sterling investment grade bonds posted a 1.71% index return in the month, well ahead of the 1.15% return from gilts and reflecting a sharp narrowing of the average yield differential between the asset classes to 1.40% from 1.51%. European and global high yield bonds also rebounded very strongly, posting respective index returns of 2.24% and 3.97%.
- Within the fund's overall performance in the month, there were a handful of extraordinarily strong individual returns. Bonds of US industrial conglomerate **General Electric** were up over 14% in price in January after the dramatic 25% fall last November, when bonds were purchased for the fund. In insurance, long-dated bonds of **Legal & General** and **Scottish Widows** were up almost 10%, with **AXA** and **Prudential** not far behind. Returns from the fund's holdings of bank bonds were lower, with just **Standard Chartered** standing out prominently with a return of 7%. Meanwhile, bonds of **Tesco Property**, amortising and backed by operating assets and lease obligations of the parent retailer, were up around 4% in January, regaining their highest levels since purchase in early 2016. Across the wider portfolio, individual performances were generally much more modest, but – unsurprisingly in the context of buoyant market conditions – predominantly posted positive price performance in addition to robust income generation.
- Activity in the month focused primarily on investing cash inflows into the market at the more attractive levels prevailing. Purchases including adding modestly to **Co-op Wholesale** and **Ei Group**, two of the fund's largest holdings; increasing exposures to secured debt of **Spirit** and **Mitchells & Butlers** in the pub sector; and expanding allocations to **AG Insurance** (US dollar denominated BBB rated bonds of the Belgian insurance company, callable at the issuer's option in March), **Clydesdale Bank**, **Phoenix Life** and **Investec** in financials. A position in 'hybrid' bonds of German utility **RWE** was re-established – the holding in these had been sold at a price around 107 in late 2017 – at a price just above 100, reflecting the first call in March, which the issuer has since announced they will exercise. Within smaller unrated issues, holdings of renewable energy group **Etrion** and Norwegian ferry service operator **Havilafjord** were increased, and a position in secured first lien bonds of shipping group **Songa Container** was initiated at a modest discount to their issue price in November last year. Selling in the month related predominantly to liquidity management, via sales of transient holdings of short-dated gilts.

Investment outlook

- With the outcome of Brexit still unclear and the UK scheduled to leave the EU in March 2019, with or without a formal withdrawal agreement, we believe that uncertainty will constrain business investment. Against this background, we expect interest rates to remain at low levels.
- We continue to believe that portfolio diversification is important and a focus on bonds supported by stable income streams and structural enhancements should provide protection in times of market turbulence.
- The increase in investment grade credit spreads in Q4 2018 was more pronounced than we would have expected against a background of moderating economic growth and higher risk aversion. We consider that the current credit spread is attractive and offers significant compensation for default and other risks (e.g. liquidity and rating migration). We expect investment grade credit bonds will outperform UK government securities over the next three years.

Key views within the fund

- The fund's objective is to achieve a high level of income by seeking attractive investments across a broad spectrum of fixed income opportunities, encompassing investment grade, sub-investment grade and unrated bonds.
- The fund mitigates stock specific risk by holding a diversified portfolio of investments, so that no individual investment can in isolation have an undue impact on overall performance. In addition, where possible within the yield objective of the fund, investments are focused on bonds where risk is mitigated by structure or a claim on assets or cashflows.

FE ALPHA MANAGER 2018 ERIC HOLT

CITYWIRE AAA

Eric Holt
Head of Credit

MONEY OBSERVER RATED FUND 2019

ROYAL LONDON

RLAM GOVERNMENT BOND FUND PERFORMANCE

Fund performance

	1 month (%)	Rolling 12 months (%)
RL Global Index Linked Bond Fund Z Inc	**1.10**	**0.51**
IA Global Bonds Sector	-0.11	1.83
Barclays World Government Inflation-Linked Bond Index (hedged)	0.88	0.93
RL Index Linked Bond Fund M Inc	**1.28**	**2.98**
IA UK Index Linked Gilts Sector	0.90	2.43
FTSE Actuaries UK Index-Linked All Stocks Index	0.61	3.06
RL Short Duration Gilt Fund Z Inc	**0.10**	**0.80**
IA UK Gilts Sector	1.28	3.48
FTSE Actuaries UK Conventional Gilts up to 5 Years Index	0.07	1.01
RL Short Duration Global Index Linked Bond Fund Z Inc	**0.69**	**0.71**
IA Global Bonds Sector	-0.11	1.83
RL Short Duration Global Index Linked Composite Benchmark1[1 2]	0.56	1.12
RL UK Government Bond Fund Z Inc	**1.25**	**3.01**
IA UK Gilts Sector	1.28	3.48
FTSE Actuaries UK Conventional Gilts All Stocks Index	1.06	3.71

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.

Source: RLAM and FE, correct as of 31 January 2019. Returns quoted are net of fees.

[1]Please note that the benchmark is priced end-of-day.

[2]The composite benchmark consists of: 30% Barclays UK Government Inflation Linked Bond 1-10 year index, 70% Barclays World Government Inflation Linked Bond (ex UK) 1-10 year index (GBP hedged).

GOVERNMENT BOND MARKET REVIEW

Market highlights

- It was a buoyant month for equity and bond markets alike in January, after a clear dovish policy shift from central banks. With Brexit uncertainty as prevalent as it has ever been, ongoing concerns around US-China trade talks, and abundant data revealing an economic slowdown, government bond markets performed positively; even as a multitude of governments flooded the market with fresh debt issuance.

Gilts

- The yield on benchmark 10-year UK government bonds fell six basis points (bps) to 1.22%. Longer dated gilts (>15 years) outperformed shorter dated issues (<5 years), returning 2.10% and 0.07% respectively. Overall, gilts (all maturities) returned 1.06%, below sterling investment grade corporate debt (which returned 1.57%, all maturities). The average sterling investment grade credit spread (the extra yield available from a corporate bond compared with government debt of equal maturity) narrowed to 1.40%.
- The curve remains very flat, reflecting strong demand for longer dated government bonds, whilst yields on short-dated government bonds trade close to the Bank of England base rates at 0.75%. The ultra-long end of the UK yield curve remains inverted; with 30-year bonds yielding more than 40- and 50-year issues.
- Gilts performed moderately strongly relative to government bond markets in other developed economies (in sterling terms). Among sovereign >1 year issues, Spain was the standout performer, followed by Italy and the UK. The US, Sweden and Japan saw the worst returns.

UK

- Index linked UK government bonds (all maturities) returned 0.61%, underperforming conventional gilts. Returns from longer dated (>15 years) index linked issues had the strongest performance, while their shorter dated (<5 years) counterparts were the main drag on the market, returning 0.94% and 0.08% respectively. The yield on 5-year index linked gilts ended January four basis points lower at -2.27%, while yields on 10-year issues remained unchanged at -2.02%. 30-year index linked gilts declined three basis points to -1.55%, while the 50-year issues declined six basis points to -1.54%.
- The 10-year breakeven (implied) inflation rate decreased to 3.14%, as the market increasingly reduced its probabilities of a hard Brexit, reflected in the steady strengthening of trade-weighted sterling by 2.17% over the month.

Overseas

- Returns in overseas government bond markets were generally positive, with Greece a clear standout after the successful issuance of its first debt outside of a bailout programme in nearly a decade. Spain and Belgium also performed strongly in the month.
- Global index linked sovereign bonds returned 0.99%. Among 10-year issues, the UK index linked bond yield was unchanged, while US TIPS and German bund yields fell 0.21% and 0.11% respectively. The yield spread between UK index linked bonds and US TIPS narrowed to 278bps at the end of January.
- The US 10-year breakeven (implied) inflation rate increased to 1.86%, and the German equivalent remained steady at 0.96%.

ROYAL LONDON SHORT DURATION GILT FUND

Portfolio commentary

- Portfolio duration ended January at -0.2 years short versus the benchmark, having been in line with it at the start of the month. The fund performed in line with its benchmark, reflecting a lack of movement in short-dated yields in the month. After the curve flattened at the back end of last year almost all of the bonds in the fund are now trading at 75-80 bps. Given that this is the level of current BoE base rates, yields were unable to fall much further.
- We maintained our 2s-5s steepener bias. Given that the short curve was marginally flatter over the month, with 5 year gilt yields falling slightly as 2 year yields slightly rose, this negatively impacted performance.
- The fund had no exposure to overseas markets.
- The fund's modest exposure to highly rated sterling corporate bonds made a positive contribution to performance as yield spreads tightened. This reflected an improved backdrop for risk assets, with equity markets rallying and the Federal Reserve putting further interest rate hikes on hold. The fund sold a covered bond of the Swedish mortgage provider **Swedbank Hypotek**, while it made no additions to its portfolio.

Investment outlook

- We expect global government bond yields to rise gradually from current levels. We expect the Fed to hike just once in 2019, with no further hikes expected over the forecast period to end 2020. We anticipate a BoE rate increase in the second half of 2019, assuming a Brexit withdrawal deal is reached, with subsequent rises once every three quarters.
- We continue to look for tactical and strategic positions in overseas government bonds, where appropriate to the fund's risk and return objectives.
- We continue to believe that both gilt and index linked real yields do not reflect longer term fundamentals, and as such, we will maintain a strategic short duration position relative to the benchmark.

Key views within the fund

- The portfolio currently has a small duration short position relative to its benchmark. We expect a gradual rise in UK government bond yields.
- The fund is positioned for higher yields and steeper curves at the very front end.
- The portfolio has an allocation to high quality corporate bonds, which we expect to outperform gilts in a low-yielding environment.
- The fund has no exposure to overseas markets.
- The portfolio may look to trade index linked gilts to take advantage of mispricing opportunities, but currently has no exposure.

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Craig Inches
Head of Rates and Cash

Ben Nicholl
Assistant Fund Manager

ROYAL LONDON UK GOVERNMENT BOND FUND

Portfolio commentary

- Portfolio duration ended January slightly shorter against the benchmark at -0.5yrs short, compared with -0.4 years short at the start of the month. With yields falling, duration positioning was a small negative over the month. However, yield curve positioning more than offset this impact, with the fund's bias towards longer dated issues proving beneficial as yields fell in that part of the curve, while yields on short-dated issues were little changed.
- The yield curve flattened further after yields fell strongly at the longer end of the curve. This was the result of a combination of supply and demand factors, as well as a reflection of the limited capacity of short-dated yields to fall further given how close they are to current Bank of England base rates.
- The fund held no UK inflation exposure. While a no-deal Brexit may lead to higher levels of inflation as a result of a currency devaluation, alternative Brexit scenarios could lead to very different inflationary outcomes. Additionally, a House of Lords inquiry into RPI may result in RPI inflation being recalculated at lower levels, which would negatively impact UK index-linked bondholders.
- Overall, trading in overseas markets was positive in January. Having started the month without any exposure to overseas markets, the fund bought several issues in the month. US Treasury Inflation-Protected Securities (TIPS) were the most significant contributor to performance, and this was unwound at a profit as the month progressed. Japanese Inflation-Index Bonds (JGBIs) were a slight detractor.
- The fund's modest exposure to highly rated sterling corporate bonds made a positive contribution to performance as yield spreads tightened. This reflected an improved backdrop for risk assets, with equity markets rallying and the Federal Reserve (Fed) putting further interest rate hikes on hold. There were no additions to or sales from the portfolio during the month.

Investment outlook

- We expect global government bond yields to rise gradually from current levels. We expect the Fed to hike just once in 2019, with no further hikes expected over the forecast period to end 2020. We anticipate a BoE rate increase in the second half of 2019, assuming a Brexit withdrawal deal is reached, with subsequent rises once every three quarters.
- We continue to look for opportunities to take both tactical and strategic positions in overseas government bonds, where appropriate to the fund's risk and return objectives.
- We continue to believe both gilt and index linked real yields do not reflect longer term fundamentals, and as such, we will maintain a strategic short duration position relative to the benchmark.

Key views within the fund

- The portfolio's duration is -0.5 years shorter than the benchmark. We expect a gradual increase in UK government bond yields as the year progresses.
- The fund is positioned for higher yields across the curve, with a preference to be underweight 5-year and 10-year maturity, as well as ultra-long bonds such as the 40-year area, with a preference for 25- and 30-year bonds.
- The fund currently has no overseas exposure, but will look for opportunities to take such positions on a relative basis. With the Royal London view that a Brexit deal will be agreed, we would expect UK yields to underperform their global peers as the BoE moves rates away from emergency levels, helped by continued improvement in economic fundamentals, and Brexit pessimism recedes.
- The portfolio has allocations to longer dated, high quality corporate bonds, which we expect to outperform gilts in a low-yielding environment.
- The portfolio continues to tactically trade index linked gilts to take advantage of mispricing opportunities, although held no inflation positions at the end of the month.

Craig Inches
Head of Rates and Cash

Ben Nicholl
Assistant Fund Manager

RLAM GLOBAL HIGH YIELD FUND PERFORMANCE

Fund performance

	1 month (%)	Rolling 12 months (%)
RL Global High Yield Bond Fund A Inc	**3.12**	**-0.22**
RL Global High Yield Bond Fund M Inc	**3.14**	**0.14**
RL Global High Yield Bond Fund Z Inc	**3.16**	**0.39**
IA Sterling High Yield Sector	2.91	-0.70
ICE BofA ML BB-B Global Non-Financial High Yield Constrained Index	3.66	-0.25
RL Short Duration Global High Yield Bond Fund A Inc	**1.70**	**1.65**
RL Short Duration Global High Yield Bond Fund M Inc	**1.72**	**2.04**
RL Short Duration Global High Yield Bond Fund Z Inc	**1.73**	**2.15**
IA Sterling High Yield Sector	2.91	-0.70
3 month LIBOR	0.08	0.76

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.

Source: RLAM and FE, correct as of 31 January 2019. Returns quoted are net of fees.

GLOBAL HIGH YIELD MARKET REVIEW

Market highlights

The global high yield benchmark returned 3.66% in January. BB rated bonds underperformed lower rated issues, returning 3.38%; that compares with respective returns of 4.05% and 4.85% for B rated debt and for bonds rated CCC and lower. In terms of maturity, longer dated issues outperformed medium and shorter dated debt.

Global high yield new issuance picked up slightly in January, though remains at a dramatically lower level than a year earlier, continuing the trend from the latter half of 2018 towards more subdued issuance levels.

The global high yield rolling 12-month default rate was 1.07%, lower than the prior month. Regionally, default rates were 1.73% in the US, 0.36% in Europe and 0.87% in emerging markets. The global default rate is noticeably lower compared with the year-earlier level of 2.23%, and the most marked decline took place in the US.

The most significant default in the market in January was Pacific Gas and Electricity (PG&E). The company, which is California's largest utility, provides natural gas and electricity to more than six million households. PG&E filed for Chapter 11 bankruptcy protection as it faced billions of dollars in potential damages from the California wildfires. California law currently holds utility companies entirely liable for any damage caused by their equipment, regardless of whether they were at fault. PG&E was not held by the fund. There were no defaults in the fund's holdings in January.

All figures are based on ICE BofA Merrill Lynch data

ROYAL LONDON GLOBAL HIGH YIELD BOND FUND

Portfolio commentary

- The fund underperformed the benchmark in January on a gross basis, returning 3.20% versus the benchmark return of 3.66%.
- The global high yield market began the year by producing the largest monthly total return since March 2016. Strong returns were witnessed across regions, ratings and sectors. Overall, yields in the market were lower, predominately due to tighter credit spreads.
- The month began with positive rhetoric from the Chair of the Federal Reserve (Fed) and supportive monetary policy in China, while the potential for progress on trade talks between the two countries was considered to be encouraging by the market. Fresh US economic data provided further grounds for optimism. The oil price recovered some of the steep decline witnessed at the end of 2018.
- Index performance during the month was influenced by positive income return of 0.51%, while the price and hedging returns were 3.38% and -0.23% respectively.
- The yield on the fund's benchmark index ended January at 6.00%, compared with 6.90% at the beginning of the period. The fund yield stood at 5.54% at month end, and its duration was shorter than that of the index.

Investment outlook

- We continue to believe that global high yield bonds are attractive on a spread basis and that they overcompensate for default risk, while their level of income generation is also appealing on a relative basis.
- The current growth and rate environment provides a moderate default climate with ongoing refinancing opportunities.

Key views within the fund

- The fund's objective is to achieve a combination of capital growth and income. The fund seeks to achieve its investment objective by outperforming its benchmark, the BofA Merrill Lynch BB-B Global Non-Financial High Yield Constrained index, 100% hedged to sterling, by 1% per annum over rolling three year periods.
- The fund seeks to mitigate stock specific risk by holding a diversified portfolio of investments, so that no individual investment can, in isolation, have an excessive adverse impact on overall fund performance. Currency risk associated with holdings of bonds is hedged through the use of forward currency transactions.
- We expect bouts of market volatility due to market expectations surrounding the tightening of monetary policy by the Fed. As such, we believe bonds with near-term catalysts, which mitigate market risk, are an important attribute underpinning investment performance over the medium term.

Azhar Hussain
Head of Global High Yield

Stephen Tapley
Global High Yield Fund Manager

ROYAL LONDON SHORT DURATION GLOBAL HIGH YIELD BOND FUND

Portfolio commentary

- The fund outperformed the benchmark on a gross basis in January, returning 1.76% versus the benchmark return of 0.08%.[1]
- The global high yield market began the year by producing the largest monthly total return since March 2016. Strong returns were witnessed across regions, ratings and sectors. Overall, yields in the market were lower, predominately due to tighter credit spreads.
- The month began with positive rhetoric from the Chair of the Federal Reserve and supportive monetary policy in China, while the potential for progress on trade talks between the two countries was considered to be encouraging by the market. Fresh US economic data provided further grounds for optimism. The oil price recovered some of the steep decline witnessed at the end of 2018.
- At month-end, the expected yield on the fund was 3.91% (2.81% on a currency-adjusted basis), with an expected maturity of 0.96 years.

Investment outlook

- We continue to believe that short duration global high yield bonds are attractive on a relative and absolute basis and overcompensate for default, illiquidity and volatility risks.
- The current growth and rate environment provides a moderate default climate with ongoing refinancing opportunities.

Key views within the fund

- The fund is diversified, with over 300 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall fund performance of any deterioration in the creditworthiness of an individual holding.

Azhar Hussain
Head of Global High Yield

Stephen Tapley
Global High Yield Fund Manager

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