



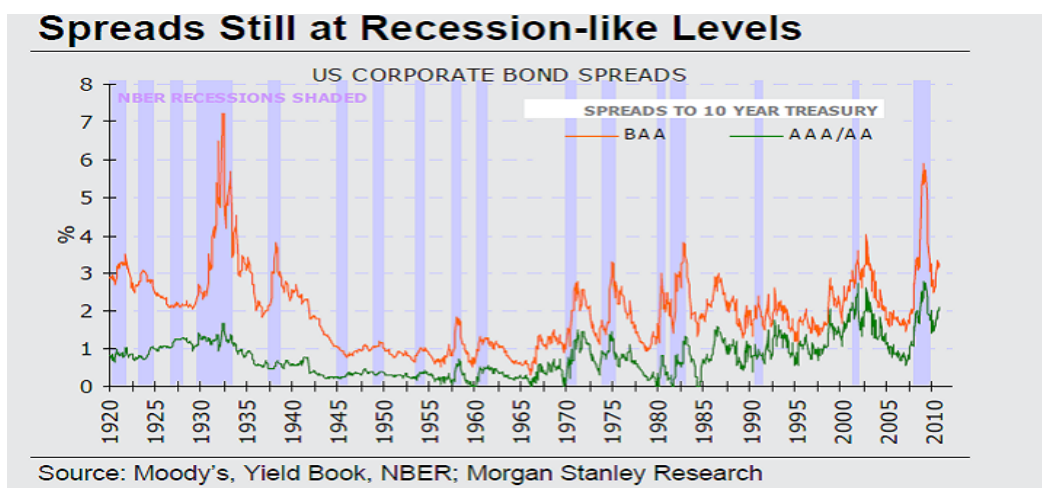
**Sajiv Vaid**  
**Manager, Royal London Corporate Bond Fund**

**Corporate bonds – strategic thinking within investment grade**

**Credit spreads still above pre-crisis levels**

Although credit spreads contracted sharply in 2009, the extended levels that they reached in the aftermath of the financial turmoil of late 2008 were the widest in post-war history. In contrast, spreads were little changed in 2010 and remain significantly above both pre-crisis levels and historical averages. As Chart 1 shows, despite the post-crisis contraction the market as a whole continues to represent very attractive value. The chart relates to the US market, although the pattern in the UK is very similar. However, the overall level masks some disparities; some areas of the market are trading at pre-crisis levels, while others are at much more compelling valuation levels.

**Chart 1: Corporate bond spreads**



**Selected ABS offer attractive yield opportunities**

Meanwhile with interest rates remaining at historic lows, the search for yield continues. With the ten year benchmark UK gilt yielding around 3.75%, issuers continue to bring bonds to market at attractive levels, offering excess yield and security. One area offering such attributes is asset-backed securities (ABS), which benefit from being secured over clearly defined assets and place investors in an advantageous position relative to unsecured creditors in the event of default or financial distress. The assets on which they are secured are diverse and can include fixed assets such as buildings, as well as financial assets such as the income stream

from mortgage payments. An example of a recent new issue in this area is the sterling-denominated covered bond from Nationwide Building Society. This issue forms part of Nationwide's senior debt, and is backed by a claim on a doubly over-collateralised pool of prime UK residential mortgages - the amount of the bond is below the value of the mortgages, which in turn is far less than the value of the underlying mortgaged properties. This robust structure is reflected in the AAA credit rating of the bonds, which were issued at a yield premium to gilts of 1½%. Somewhat counter-intuitively, some secured bonds trade at an enhanced yield premium relative to unsecured bonds, offering the opportunity to lock in attractive returns from bonds with lower credit risk and volatility. This is an area of the market where we are clearly a long way away from normalisation and one which offers good long term potential. It accounts for over 30% of our portfolio, setting us apart from many of our peers.

**Modest domestic recovery accompanied by low interest rates**

In tandem with the environment of low interest rates is one of subdued growth, which is positive for corporate bonds. Although we expect global GDP growth to remain robust in 2011, supported by buoyant emerging economies and continued economic recovery in the US and northern Europe, we nonetheless expect the recovery in the UK to continue to be slow. While monetary conditions remain loose, growth continues to be constrained by higher taxation and cuts in public spending. Inflation is set to remain above target throughout the year, due in part to a further rise in VAT. Despite the inflation backdrop, we expect a modest rise in interest rates in the latter half of the year, although significantly we do not expect the peak of this rate cycle to be more than 2%.

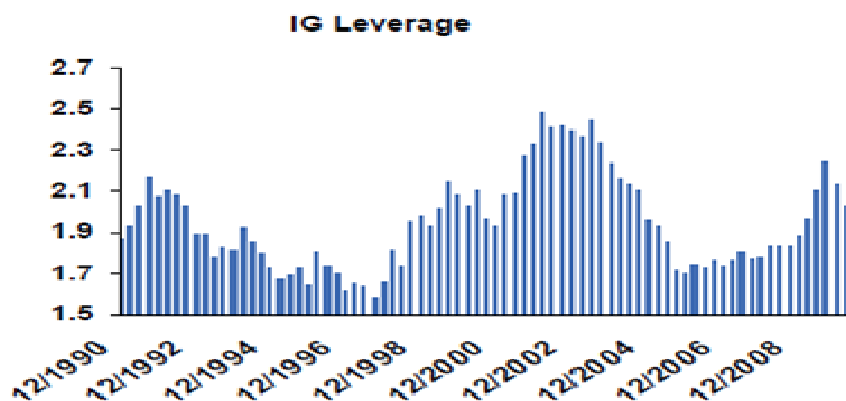
**Slow growth environment beneficial for corporate bonds**

Corporate bonds clearly do not tend to flourish in a recessionary environment – in other words when default rates are on the increase - although conversely neither is an environment of strong economic growth beneficial, as under such a scenario corporate management teams can become over-confident, increasing borrowing to fund acquisitions, dividends and share buybacks, all of which are detrimental to credit quality. Historical data suggests that the most favourable environment for corporate bonds is one that is 'not too hot' or 'not too cold'. The current middle ground of modest growth is therefore one in which corporate bonds should perform well, with conservatism and prudence the predominant themes as management teams focus on rebuilding balance sheets.

**Corporate balance sheets healthy due to stringent cost cutting**

Indeed corporate balance sheets are looking currently at their healthiest in a long time as companies went to considerable lengths to cut costs in the wake of the financial crisis. Companies are cash rich, meaning that they are not only able to meet their debt obligations, but are also in a healthier state to refinance through the bond market. Chart 2 shows the extent to which corporate borrowing has declined since the pre-crisis peak, compared to the longer term.

**Chart 2: Corporate borrowing**



**Current conditions favour active management**

In summary, the combination of low interest rates, spreads at attractive levels, modest domestic economic growth and healthy corporate balance sheets should enable corporate bonds to perform well and that notwithstanding the challenging UK economic outlook, prices appear attractive on a medium term view. Whereas in the recent past the key driver of the market's progress has been momentum, the next phase will require much more active management in order to drive returns. Our management style of extracting value should therefore ensure that we are well placed to continue to deliver returns in such an environment.

**Yield argument remains compelling**

With the gilt market forecast to return around 4½% this year, corporate bonds yielding 2% in excess of gilts and the Royal London Corporate Bond Fund currently yielding 1% more than the benchmark index, our central scenario is for a return of around 7½%. This is clearly highly attractive relative to cash rates and in such a low return environment, and can only be enhanced further by any additional yield compression. We therefore believe that the yield argument is no less a compelling one than it was last year.

**Contact Details**

Ian Goulsbra  
Head of Wholesale  
Relationships  
020 7506-6775  
[ian.goulsbra@rlam.co.uk](mailto:ian.goulsbra@rlam.co.uk)



Jonathan Rehbein  
Business Development  
Manager  
020 7506-6657  
[jonathan.rehbein@rlam.co.uk](mailto:jonathan.rehbein@rlam.co.uk)



Tony Taylor  
Business Development  
Manager  
01904 701-444  
[tony.taylor@rlam.co.uk](mailto:tony.taylor@rlam.co.uk)



David Billyard  
Business Development  
Manager  
020 7506-6559  
[David.billyard@rlam.co.uk](mailto:David.billyard@rlam.co.uk)



Nina Redfern  
Head of Consultant  
Relationships  
020 7506 6558  
[nina.redfern@rlam.co.uk](mailto:nina.redfern@rlam.co.uk)



Alan Bunce  
Head of Institutional  
Business Development Direct  
020 7506-6570  
[Alan.bunce@rlam.co.uk](mailto:Alan.bunce@rlam.co.uk)



Dean Heaney  
Institutional Business  
Development Manager  
020 7506 6568  
[dean.heaney@rlam.co.uk](mailto:dean.heaney@rlam.co.uk)

Source: **rlam** as at February 2011 unless otherwise stated.

**rlam** is a marketing brand including the following companies: **Royal London Asset Management Limited** registered in England & Wales number 2244297; Financial Services Authority (FSA) register number 141665. **Royal London Pooled Pensions Company Limited** registered in Scotland number SC048729; FSA register number 110456. **Royal London Unit Trust Managers Limited** registered in England & Wales number 2372439; FSA register number 144037. **Royal London Cash Management Limited** registered in England & Wales number 19632; FSA register number 121844. All of the above are authorised and regulated by the Financial Services Authority.

It also includes **Royal London Asset Management Bond Funds Plc** registered in Ireland number 364259 and regulated by the Central Bank of Ireland.

All these companies are subsidiaries of **The Royal London Mutual Insurance Society Limited** registered in England and Wales number 0099064 (FSA registration number 117672). Head office: 55 Gracechurch Street, London EC3V 0RL

098-PRO-03/2011-SS