ROYAL LONDON CASH PLUS FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Fund data

	Fund
Gross redemption yield[1]	0.18%
No. of issuers	122
Fund size	£5,809.6m
Weighted average maturity	0.3 years
Weighted average life	1.2 years

Source: RLAM, based on the Z share class. Launch date: 20.06.2011.
[1]The gross redemption yield is calculated on a weighted average basis.
[2]The underlying yield aligns closely with the gross redemption yield of the fund taking in account expenses. Please see glossary for more detail.

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 (%) (income)	Fund (%) (accumulation)	Benchmark[1] (%)	Relative[2] (%)
Q4 2020	**0.12**	**0.14**	**0.01**	**0.13**
Year-to-date	1.00	1.02	0.19	0.83
Rolling 12 months	1.00	1.02	0.19	0.83
3 years p.a.	0.95	0.96	0.43	0.53
5 year p.a.	0.87	0.84	0.34	0.50
Since inception p.a. 22.05.2012 (income)	0.97	-	0.36	0.60
Since inception p.a. 20.06.2011 (accumulation)	-	0.85	0.38	0.47

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.

[1]Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 20 May 2019, and is reflected in the returns shown above.

[2]All commentary within this report is based on comparison with the Z accumulation units which have a longer track record.

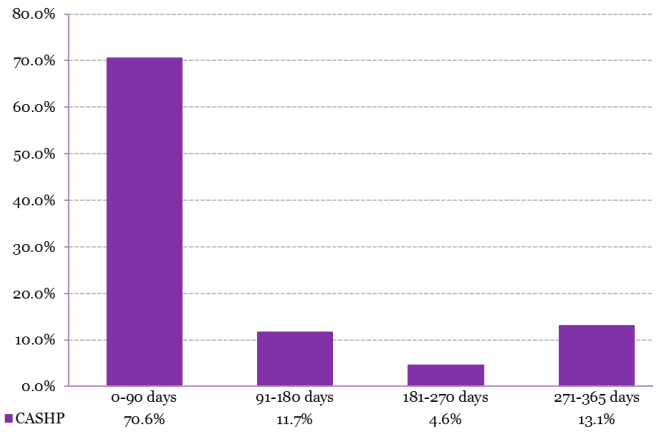
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Top ten issuers

	Weighting (%)
Royal Bank of Canada	4.1
Lloyds Bank Plc	4.0
Barclays Bank	3.9
National Westminster Bank	3.4
UK Government	3.2
Canadian Imperial Bank of Commerce	3.0
Toronto Dominion	3.0
Wells Fargo	3.0
UBS AG	3.0
ANZ Banking Group	2.8
Total	**33.4**

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

Duration profile



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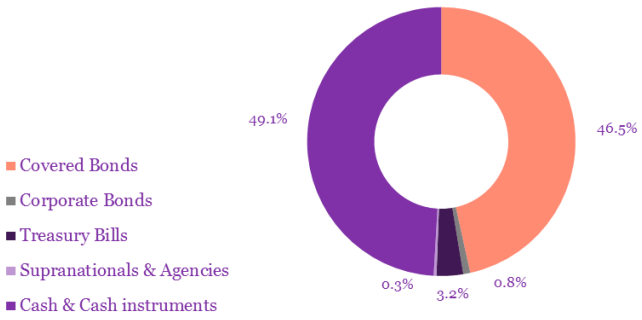
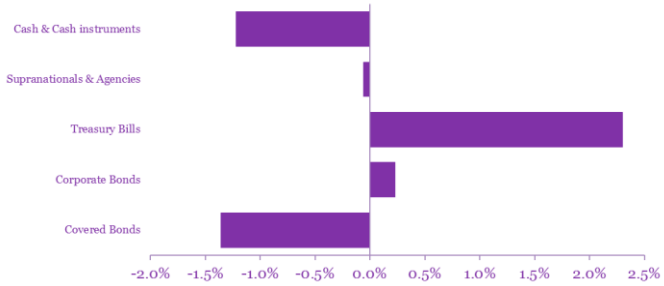
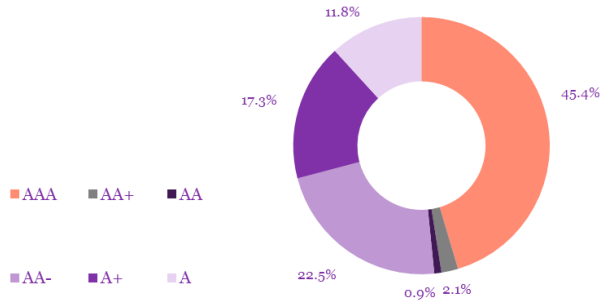
Asset allocation profile Q4 2020



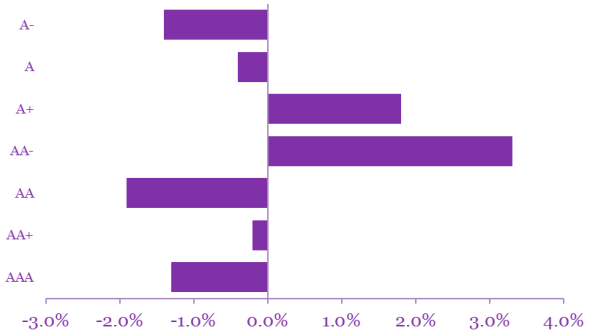
Change since last quarter



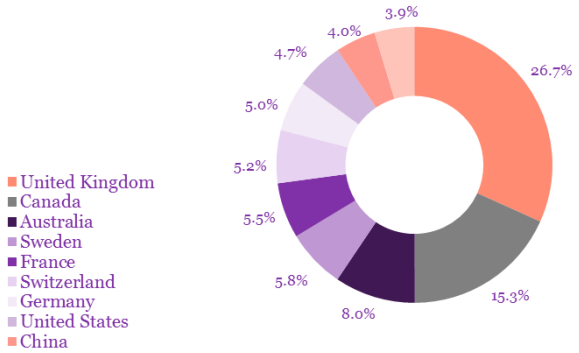
Credit rating profile Q4 2020



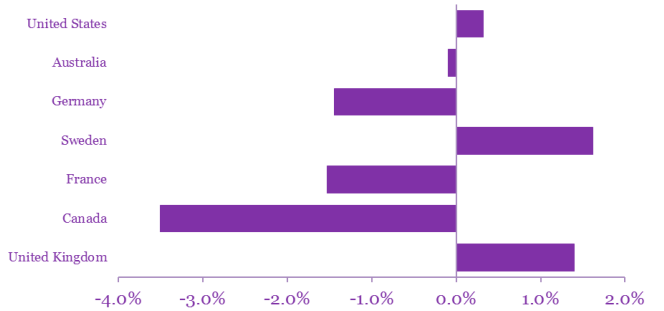
Change since last quarter



Top ten geographic allocation (ex gilts) Q4 2020



Change since last quarter



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Market overview

- Covid-19 cases and deaths surged across the UK, Europe and the US during the quarter, with several new strains emerging, prompting widespread national lockdowns. However, a series of successful vaccine trials enabled the initial rollout of vaccines in several countries. This lifted market sentiment as it raised the prospects of a return to normality for societies in 2021. The outlook was further improved when the UK and European Union agreed to a new trade deal shortly before the end of the year, avoiding a 'no deal' Brexit. The market impact of this was limited, however, since it had been widely expected by investors.
- Credit spreads finished the year below the levels they had been at the start of the year. The simultaneous contraction of corporate bond spreads and decline in government bond yields reflects the liquidity-driven nature of the market rally. That is to say, rather than being driven by changes in investor risk appetite, the market was predominantly led by an influx of investment in bonds. In turn, this reveals the impact of quantitative easing (QE) from central banks. In November, the Bank of England (BoE) announced an additional £150bn of UK government bond purchases, above the market expectations for £100bn of purchases. This will take the total stock of bonds held by the BoE's Asset Purchase Facility to £895bn, of which just £20bn is projected to be sterling investment grade credit bonds.
- Cash markets saw little change over the quarter. For 2020 as a whole, overnight rates fell sharply in late March as the extent of the crisis became apparent. SONIA, the benchmark overnight rate, started the year at 0.71% and as the Bank of England slashed rates and other policy responses were announced, this collapsed briefly to 20bps and then to 7 basis points. Since late March, this has moved slightly lower as it became apparent that policy support would remain in place for an extended period of time, to end the year at 5bps.
- The collapse in rates across the longer parts of the money market curve in 2020 may have taken slightly longer, but were no less dramatic. Across the LIBOR curve, we saw a distinct pattern, with rates falling in the early part of the year, then a sharp spike as the pandemic broke on concerns over the economic impact and potential health of the financial sector, before government and central bank support pushed rates sharply lower in April and May, with rates continuing to fall in the second half of the year. Three month LIBOR started the year at 80bps but ended it at just 3bps, with 12 month LIBOR ending the year at 8bps having started January at 98bps. The collapse in rates reflected significant BoE support, plus the move by investors to look for longer-dated exposure in their search for yield.

Performance and activity

- Performance for RLAM funds was driven by the nature of the investment objective and the subsequent portfolio mix. We always try to avoid holding too much short term liquidity coming into year-end as counterparty banks are usually looking to reduce short-term cash on their balance sheet. This year, with uncertainty over Brexit only accentuating this trend, we have been buying CDs with 2021 maturities to avoid this period of volatility, while being mindful of the need to maintain strong liquidity in case of client needs. It was important to get this balance right, given that as we entered December, the January 2021 gilt that would be the 'overflow' for any excess short term cash, was yielding an annualised -30bps. Our strategy during December meant we did not need to shift any assets into this gilt.
- The Cash Plus fund looks to provide cash investors with returns over and above those on more traditional liquidity funds, by adding targeted exposure to non-money market instruments, using covered floating rate notes as part of this strategy. These contain limited credit risk, and saw spreads widen in the initial panic, but have more than recovered all of this and ended the year tighter.
- The strength of covered bonds has added to the positive impact we've had from traditional money market instruments, where rates for these instruments have been at historic lows throughout the quarter, impacting absolute returns. However, returns relative to benchmark have remained positive, driven by selected exposure to longer dated paper and adding very selectively to assets beyond those classic money market instruments. Covered bonds, while highly rated and regulated, do still have credit risk and the additional yield this provides supported performance in the fourth quarter.
- Covered bonds remain a good example of how the initial market reaction was somewhat panicked, and then fundamentals reasserted themselves over the rest of the year. Going into the first lockdown, covered spreads were around 60bps over SONIA. In the panic-mode sell-off that followed, spreads widened to around 150bps. Our view was always that the dual recourse structure of these bonds and the quality of the underlying portfolios, meant that spreads at these levels overcompensated investors for the risk, and hence we were happy to maintain our exposure and add to it where possible. However, as the year progressed, it became harder to source covered bonds. Many institutions issue these as they provide low funding costs, but the Bank of England Term Financing scheme meant that institutions could obtain funding at lower rates than they would have to pay on covered issuance. This restriction on supply has coincided with increased demand as banks can post covered bonds as collateral. While this demand / supply dynamic was helpful for our existing covered exposure, pushing overall spreads to around 20bps, it has made it harder to replace maturing paper.

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- There is therefore little credit activity of note during the quarter. As an established presence in the covered market, we were able to source a few opportunities to add attractive bonds, including one-year highly rated covered bonds from Swedish state-owned bank **SBAB** and four-year bonds from **National Australia Bank**. Outside of covered bonds, we added senior short-dated floating rate notes from **MacQuarie** and **Banque Federative Du Credit Mutuel** at attractive spreads.

Outlook

- Coming into the last months of 2020, sentiment was dominated by the US presidential election, Brexit, and Covid-19. As at the start of January, the discussion has moved on. In the US, at the time of writing it does appear that the Democrats have taken the Senate, alongside Presidency and House of Representatives. This suggests a more stimulative approach from the US, but obviously we will see more over the coming months. On Brexit, the deal finally agreed was rather slim; in our view the fact that a deal was agreed was positive, but it is important to remember that this is just the start of a process of adjustment: more negotiations will follow but the effects of the exit from the EU were always going to take years to play out, irrespective of a deal on 31st December.
- Covid-19 is still the dominant consideration. The approval of the first vaccines has moved expectations – certainly in the UK, the Government is planning to have vaccinated a material part of the population by the end of the first quarter. The third lockdown will of course be damaging economically, but we expect markets to look through this to the hoped-for post vaccine world.
- Yields will be driven by policy action and forecasts around a potential economic recovery. If we start to see indications that growth will recover as we move towards the second half of the year, then we would expect cash rates to reverse 2020 falls and start trending higher. Rising rates is always a headwind for cash funds, but in this instance, the short-term impact this might have should be offset by a more attractive medium-term return profile.
- We still believe that negative rates are unlikely, but the news on the virus and additional lockdowns and restrictions currently in place both in the UK and beyond, mean that these cannot be ruled out. As we pointed out at the end of October, the Bank will be cautious in taking this step and would want a degree of confidence that the benefits will outweigh the costs. If news deteriorates in the very near term and pushes the Bank towards negative interest rates, this would push returns down in very short-term cash markets, but we believe that the structure of our funds and the selective longer cash instruments and targeted short-term credit would provide some insulation from this.
- However, in the near term, our bias will be to remain close to overnight – reflecting the fact that term rates (eg three month LIBOR) are in fact lower than overnight. Given the credit and term risk implicit in those rates, we believe that rates at these levels would only be attractive if there were to be further significant and lengthy falls in overnight rates. As mentioned above, this cannot be ruled out, but is not our base case.
- For money market exposure in our funds, we will manage these to achieve what we feel is the best combination of yield and liquidity, accepting that the former will be depressed. For exposure outside of these areas, our approach has always placed an emphasis on security and credit quality, both in the nature of assets we buy (such as covered bonds) but also in the way we assess credit quality, with our preference for bonds with security or covenants that we feel offer a degree of protection to investors. A high proportion of the assets in our funds are exempt from bail-in, and we will continue to favour such assets given these provide our clients with greater security. This approach mitigated the initial impact of the crisis on our funds, and with no immediate end in sight, we believe that this remains the most appropriate way to manage these funds.

ROYAL LONDON
ASSET MANAGEMENT

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