RLPPC BUY AND MAINTAIN CREDIT FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Conventional credit bonds[1]	99.3
Index linked credit bonds	0.4
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.3
Foreign index linked sovereign	0.0
Derivatives	0.0

Fund data

	Fund
Duration[2]	8.6 years
Gross redemption yield[3]	1.75%
No. of stocks	248
Fund size	£51.6m
Spread	1.52%

Source: RLAM. Launch date: 24.06.2015.

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

[2]Excluding cash

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

Figures in relation to the asset spilt table exclude the impact of cash where held.

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 (%) (Accumulation)	Reference index[1] (%)
Q4 2020	**3.40**	**3.11**
Year-to-date	8.63	7.79
Rolling 12 months	8.63	7.79
3 years p.a.	5.72	5.07
5 years p.a	6.63	6.01
Since inception p.a. 24.06.2015	6.41	5.67

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, subject to rounding.

Source: RLAM, gross of standard management fees.

[1]There is no benchmark for the fund. The index data presented in this report is that of the iBoxx Sterling Non-Gilts All Maturities Index and is for reference purposes only. This index is a broad universe of investment grade sterling credit bonds and is therefore a representative comparison.

Downgrades

Representative portfolio	% downgraded to sub-investment grade
RLPPC Buy & Maintain	1.03%
iBoxx Sterling Non-Gilt All Maturities Index	5.88%

Source: RLAM, showing downgrades since fund inception. Portfolio and benchmark percentages are based on weight prior to downgrade. Worst of Moodys, S&P and Fitch ratings are considered. RLAM internal ratings used in absence of any public ratings. Only first downgrades are included in the table.

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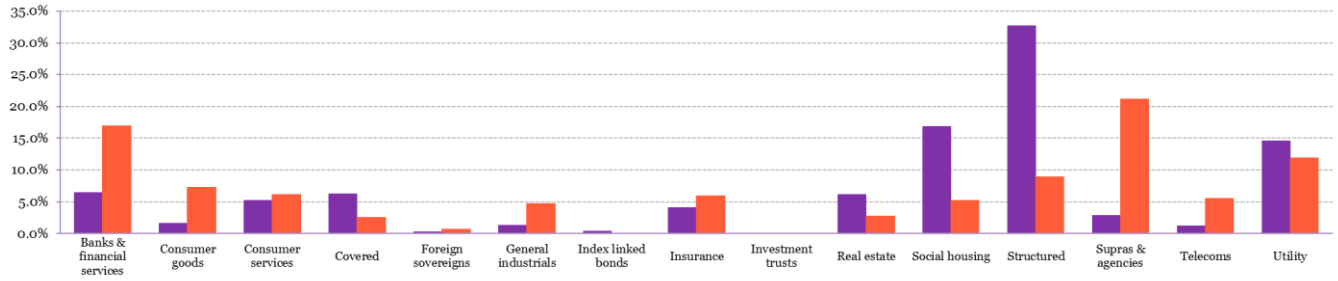
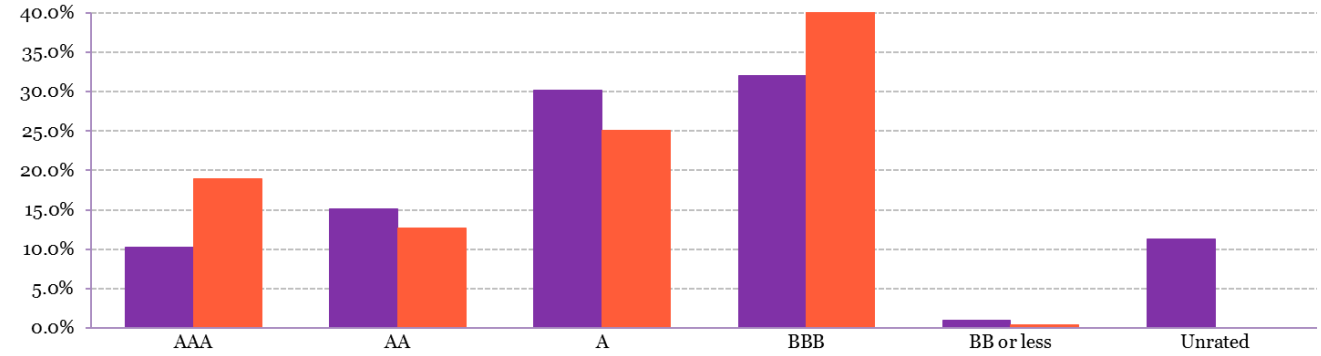
Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Index linked bonds	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
PPBAM	6.5%	1.6%	5.2%	6.2%	0.3%	1.3%	0.4%	4.1%	0.1%	6.2%	16.9%	32.7%	2.9%	1.2%	14.6%
Index	16.9%	7.3%	6.1%	2.6%	0.7%	4.8%	0.0%	5.9%	0.0%	2.8%	5.2%	8.9%	21.2%	5.6%	11.9%

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

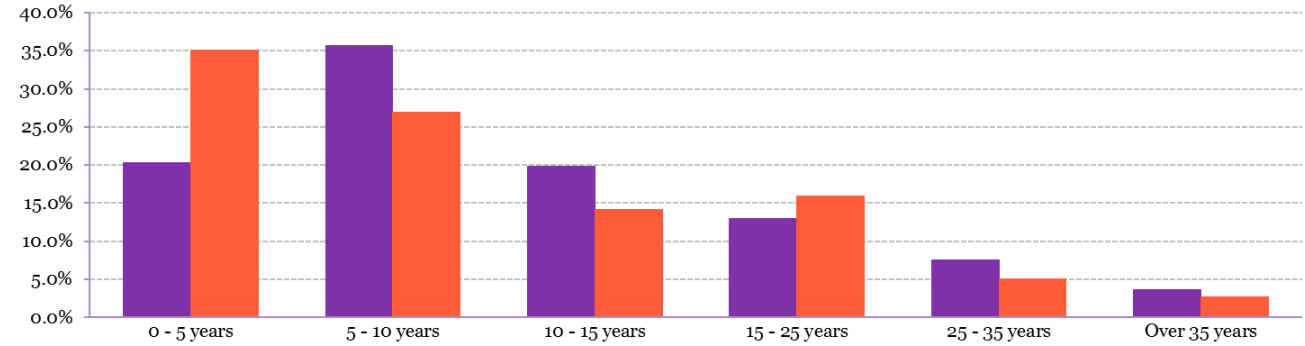
Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPBAM	10.3%	15.1%	30.2%	32.1%	1.0%	11.3%
Index	19.0%	12.7%	25.1%	42.8%	0.4%	0.0%

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

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPBAM	20.3%	35.7%	19.8%	13.0%	7.5%	3.7%
Index	35.1%	27.0%	14.1%	16.0%	5.1%	2.7%

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

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Ten largest holdings

	Weighting (%)
Électricité De France 6% 2114	1.9
Western Power Distribution 5.75% 2032	1.8
Southern Gas Network 4.875% 2029	1.1
Equity Release 5.7% 2031	1.1
Housing And Care 21 3.288% 2049	1.1
Abbey National Treasury 5.75% 2026	1.0
PRS Finance 2026	1.0
Finance For Residence Social Housing 8.569% 2058	1.0
Co-operative Bank 4.75% 2021	0.9
Thames Water Utilities Finance 7.738% 2058	0.9
Total	**11.8**

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

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 average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) narrowed from 1.29% to 0.99% during the quarter, which compares with an average spread of 1.14% at the end of 2019. This is a remarkable turnaround considering that the average spread had been as wide as 2.25% at the peak of the market sell-off in March. Corporate bond yields are also lower in absolute terms, with the underlying benchmark 10-year gilt yield having declined to 0.20% from 0.23% over the quarter, and from 0.82% over 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.
- All sterling credit sectors outperformed gilts and delivered positive absolute returns during the quarter. The subordinated financial sectors (banks and insurance) were among the best performing sectors in the market, with spreads contracting significantly as investors searched for higher yields. At the other end of the spectrum, the weakest returns came from supranational and covered bonds, which are considered less risky and so feature lower yields. Reflecting all of these dynamics more broadly, lower-rated and longer-dated debt outperformed. Aside from the lagging performance of covered bonds, secured and structured bonds performed strongly with real estate and asset-backed securities markedly beating the market over the quarter.
- Sterling investment grade credit issuance had been very high in the first half of the year, as companies sought to raise liquidity to protect themselves from a potentially protracted period with severely reduced revenues. In stark contrast to this, issuance dropped markedly in the second half of the year. While issuance was still relatively high for the year overall (the third biggest year in the past decade), there was no end-of-year surge, which used to be a feature of the market. The euro investment grade credit market followed a similar pattern, with hefty amounts of supply in the first half of the year, followed by a significant drop in the second half. Overall, it was the biggest year for euro issuance in the post-global financial crisis period, albeit only marginally more than in 2019.

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Performance

- For 2020 as a whole, the portfolio has produced strong positive returns, underpinned by lower gilt yields, but with the slight tightening in credit spreads also contributing. Our buy & maintain approach naturally gravitates towards a lower beta approach to credit investing, focusing on producing an attractive spread premium in a risk-controlled fashion. During the year this has been evident in performing much better than the broad market when it was in freefall, but then lagging the rallies driven by higher risk bonds.
- Performance for the fourth quarter was positive in absolute terms, and ahead of the broader sterling credit market. Relative performance was helped by our long-standing very low weighting in supranationals, given our overall positive view on the capacity for credit to outperform government bonds and the low yield spreads these provide. Banks and insurance exposure was mixed. With sentiment positive as the news of vaccine progress spread, riskier assets such as financial bonds (and particularly subordinated bonds) performed well. While helpful in absolute terms, we have a much lower exposure than seen in broad market indices and this was a drag on relative performance. Given that a buy & maintain approach is more conservative, we remain comfortable with our exposure to banks and insurance, which remains targeted at selective names within the senior and subordinated space within risk-controlled limits.
- We retain a high exposure to structured bonds. These performed strongly in aggregate during the quarter, and so the portfolio's exposure to the sector was positive. However, the sector is highly diverse, and while a number of the portfolio's holdings within the sector did very well during the quarter, it lacked some of the market's best performers, meaning that our overall exposure performed less well than the market. The less liquid bonds typically underperformed the sector given their lack of sensitivity to the liquidity-driven market rally and the fact they were not on the Bank of England buy lists during recent QE programs. We nevertheless expect that these bonds will ultimately perform strongly as the rally eventually transitions away from the most liquid assets.
- Covered bonds remain a key component of the portfolio's strategy, thanks to the mixture of dual recourse security these offer, as well as the floating rate nature of many of these, which provides an element of interest rate risk mitigation. These performed well in the quarter, seeing gains as very low issuance and increased demand pushed spreads tighter. However, these are seen as less geared to economic and market direction, and hence produced softer gains than the broader market.
- Throughout the past year we have been meeting with issuers as we sought to protect our clients' interests, while appreciating the need to be responsible lenders at a time of unprecedented economic and social disruption. Our orientation towards bonds with security has been highly valuable in enabling this, providing a natural justification for regular meetings. The meetings give us opportunities to express our concerns on financial, environmental, social and governance issues, and we typically find that issuers welcome this feedback. Ultimately, we want issuers to deliver sustainable cashflows, and we most effectively influence this by acting as a long-term, responsible investor. The holders of unsecured bonds do not get the same opportunities, particularly if the bonds have weak covenants, leaving them exposed to the vicissitudes of the market.

Activity

- Activity during the quarter remained relatively low despite increased new issue activity. For our Buy & Maintain strategy, activity is driven by reducing holdings where we believe that there has been deterioration in the quality of the credit, or where new issues give us an opportunity to replace holdings with another that offers more attractive spread, lower risk, or both.
- Most of our activity was focused on the new issue market in the fourth quarter. Record low yields prompted a number of companies to come to market. This presented a number of interesting opportunities for us to enhance risk / reward characteristics of the portfolio. The buoyant market conditions meant that most of the new issues we selected saw spread tightening in the secondary market.
- Secured bonds remain a significant part of the portfolio, representing over half of the total assets. These have not performed as well this year given that the Bank of England corporate bond purchase programme did not include these. This may have had a short-term impact on performance that was unwelcome, but this does mean that we continue to see attractive yield premia that can be added to the portfolio, while having the security of underlying assets backing both principal and cashflows. During the quarter we added a new 2029 issue from **Heathrow** – which we feel is the most attractive airport in terms of underlying credit fundamentals. We already held Heathrow bonds and were happy to add this issue at a spread of 260bps.
- Social housing issuance has increased in recent years and we remained active in this area. We bought a new 2038 issue from UK housing association **Orbit Group** at a spread of 135bps. Orbit had not issued in the market for a little over two years and while the issue was oversubscribed, the spread is attractive given the underlying credit quality. As in earlier quarters, we funded some of these purchases through reducing exposure to **APT Pipelines** which we feel reduces longer-term risk, as gas distribution assets could face long-term pressures from the decarbonisation trend and 'net zero' Government objective.

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- In financials, we added a new issue senior 2030 bank bond from **Close Brothers** at a spread of 145bps. The debt was issued out the operating company, which lends to small and medium sized enterprises on a secured basis. This was effected as a switch, funded by switching out of **Met Life** senior bonds at a spread of 67bps, for a material spread enhancement. We added two new subordinated insurance bonds from the **Pension Insurance Corporation** at very attractive levels of 330bps.

Outlook

- We expect a further extension of QE in 2021 because the government and BoE will wish to avoid the increase in government bond yields that would result from a substantial increase in net supply. Nevertheless, the level of QE is likely to be reduced over time, and that diminished support for the market is likely to result in higher long-term yields.
- We think that real yields are too low and will rise over time. Conversely, inflation protection, on a global basis, looks undervalued. This is not because we expect a surge in inflation, but due to the asymmetry of risk in an environment with a high level of uncertainty. Inflation is priced to reflect the circumstances of the last 30 years, yet the Covid-19 pandemic is an unprecedented event. Central banks and governments may be happy for inflation to overrun as they prioritise economic growth.
- Given that the upside in fixed income is capped, we place a heavy emphasis upon protection for our clients. We are focused on whether our issuers will survive through to the period in which societies have been widely vaccinated against Covid-19 and can return to normality, and so far this has been very encouraging. While corporate bond yields are low in absolute terms, the yields on UK government bonds with maturities of less than seven years are currently in negative territory. We continue to believe that credit spreads are attractive and that corporate bonds will outperform government debt in 2021.
- We remain committed to ensuring that we are sufficiently compensated for all of the risks that we take. We believe that our approach of capturing excess income, while mitigating risk through strong covenants, a preference for secured bonds, and security and sector diversification is ideally suited for the challenges lying ahead. You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2021 document.

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