ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES 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[2]	92.3
Index linked credit bonds	0.2
Sterling conventional gilts	10.9
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.4
Foreign index linked sovereign	0.0
Derivatives	-3.8
Other	0.0

Fund data

	Fund
Duration[3]	0.1 years
Gross redemption yield[4]	2.22%
No. of stocks	204
Fund size	£202.8m

Source: RLAM, based on the Z share class. Launch date: 24.09.2012.

[1]Benchmark: SONIA.

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

[3]Excluding cash

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

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q4 2020	**3.04**	**0.07**	**2.97**
Year-to-date	2.00	0.25	1.75
Rolling 12 months	2.00	0.25	1.75
3 years p.a.	2.44	0.58	1.85
5 years p.a.	3.69	0.52	3.17
Since inception p.a. 24.09.2012	3.94	0.53	3.42

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, based on the Z share class.

Please note that fund name was changed from RL Duration Hedged Credit Fund on 21 December 2020, and the objective amended, while the benchmark of that fund changed from 3-month LIBOR to SONIA, effective 8 August 2019. Both changes are reflected in the returns shown above.

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

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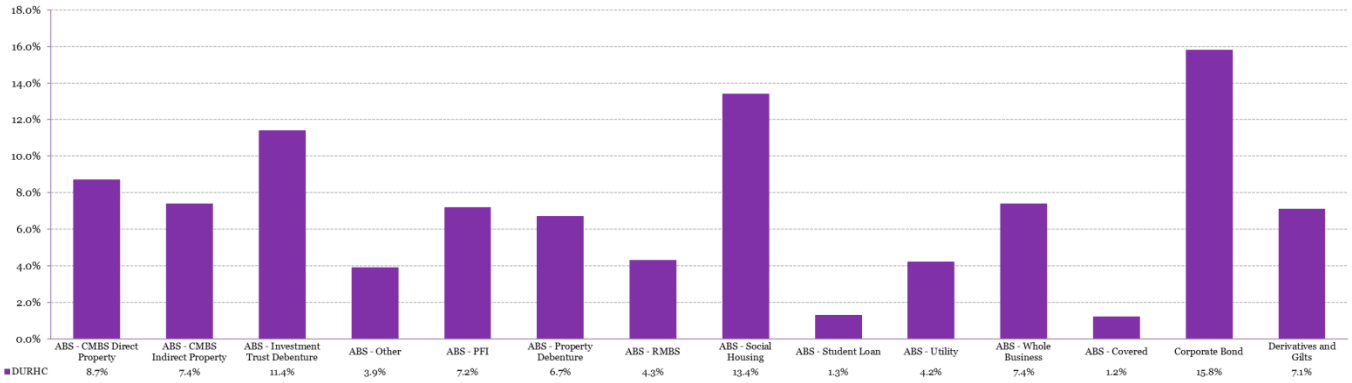
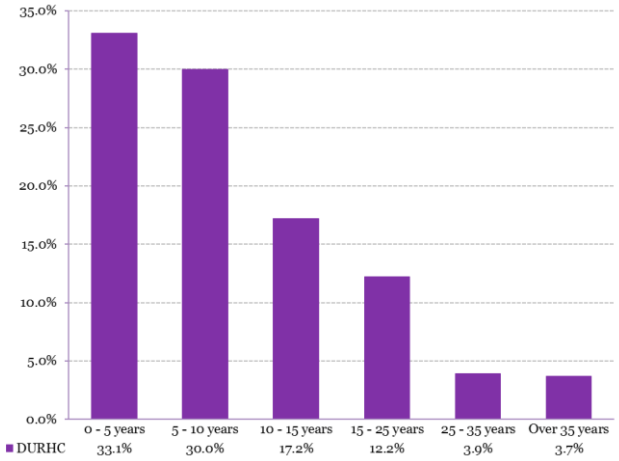
Sector breakdown

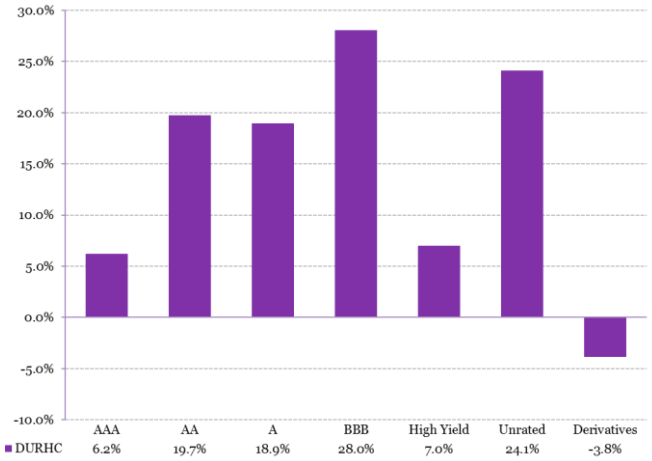


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Scottish Mortgage 6.875% 2023	2.0
British Land Co 5.264% 2035	1.7
Telereal Securitisation FRN 2033	1.6
Law Debenture 6.125% 2034	1.4
Edinburgh Investment Trust 7.75% 2022	1.3
Mercantile Investment Trust 6.125% 2030	1.2
Co-operative Bank 4.75% 2021	1.2
Grosvenor UK Finance 6.5% 2026	1.2
Trafford Centre 2038	1.2
Finance for Residential Social Housing 8.368% 2058	1.2
Total	**14.1**

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

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Changes to the fund

- *Please note:* changes were made to the fund from 21 December 2020 as detailed in the communication that was sent to fund holders in October.
- These include a change to the fund name (from 'Royal London Duration Hedged Credit Fund' to '**Royal London Diversified Asset-Backed Securities Fund**'); its objective ("The Fund's investment objective is to achieve a positive absolute return in all market conditions over rolling 3-year periods, by predominantly investing in asset-backed securities and other sterling-denominated corporate bonds. The Fund's performance target is to outperform, before the deduction of charges, the Bank of England Sterling Overnight Interbank Average (SONIA) plus 2% per annum over rolling 3 year periods."); its benchmark ("SONIA (target) with performance target as shown above"); and fee (Z class: B4K6P77), which will be reduced from 0.56% to 0.425%.
- These changes are for clarity and positioning, rather than any material alteration to how the portfolio is managed. Our definition of ABS reflects a wide range of bonds, including secured corporate bonds and securitisations. The exposure to this type of ABS is expected to remain in excess of 80% of the credit holdings in normal market conditions (i.e. excluding the impact of gilt collateral and swap hedges in place). We have a very diversified approach to lending in a secured bond format.

Fund activity and market commentary

- The fund performed strongly over the quarter, returning 2.90% against 0.07% for its SONIA benchmark. The outperformance against SONIA largely resulted from the ongoing recovery in credit markets following the Covid-19 impact in the first quarter. Beyond this, the strong performance primarily reflected three factors: the fund's limited exposure to lower-yielding unsecured bonds, the significant weighting to secured bonds, and positive security selection within the unsecured corporate bond allocation. The fund also outperformed over the 12-month period, returning 1.43% compared to 0.25% for the benchmark.
- Covid-19 cases generally increased over the fourth quarter and a more transmissible variant spread quickly in parts of the UK, South Africa and other countries, leading to tighter restrictions. However, strong efficacy data in early November and subsequent regulatory approval allowed vaccination programmes to start. As a result, investors looked through the short-term challenges to the possibility of a strong economic recovery in the second half of 2021. Political issues were also prominent. Financial markets responded positively to the expected combination of a Biden presidency with a Republican Senate, although two seats in Georgia required a runoff in early January. Congress finally agreed a $900bn (4% GDP) fiscal deal. The UK and EU also agreed a trade deal, although the market impact was limited, since it had been widely discounted.
- Sterling investment grade credit continued to outperform UK government debt over the quarter, reflecting a tightening of credit spreads. Gilts returned +0.63%, while sterling investment grade corporate debt returned +3.12%. The average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) narrowed 30bps from 1.29% to 0.99%. This is remarkable considering that the average spread was 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 fixed rate 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 bonds performed strongly with real estate and other asset-backed securities markedly beating the benchmark over the quarter.
- Within the fund's unsecured allocation, the exposure to the financials sectors was a boon to performance during the quarter. Banks have performed relatively well this year, helped by the unprecedented stimulus which the government has injected into the economy to prevent a rise in bad debts. While they will come, the combination of demanding regulations to ensure that capital positions remain healthy, alongside intervention earlier in the year to prevent dividend distributions, reduces the risk that we face as bond investors. Similarly, we think that reinsurers will be able to bear the brunt of Covid-19 claims and are encouraged by the rise in personal savings over the year.

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- The fund's secured and securitised bonds performed strongly in aggregate during the quarter, and so the fund's exposure to this area was positive. However, this exposure is highly diverse, and while a number of the fund's secured holdings and sectors did very well during the quarter, secured bonds generally lagged the liquidity-driven market rally experienced in the unsecured market. One secured sector that bucked this trend was social housing which, through a combination of long tenor, strong operational performance against the backdrop of Covid-19 and a clear and demonstrable social benefit suiting the growth in ESG requirements, performed very well over the period. More broadly, we nevertheless expect that secured bonds will continue to perform strongly as the rally transitions away from the most liquid assets and concern over economic pressure and specific corporate bond risk increases.
- Among the fund's best performing holdings during the quarter were Covid-impacted names e.g. **Heathrow**, **Gatwick** and pub chain **Mitchells & Butlers. Thames Water** and selective financial (insurance and banks) debt also performed strongly, including **Just Group** and **Aviva**; while our exposure to **GE** in the industrials sector showed a strong recovery. The weakest performers included shopping centre-related exposures e.g. **Meadowhall** and **Trafford Centre**, where despite the very low loan to values, sector challenges continued to weigh on relative performance.
- Sterling investment grade credit issuance was 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. Issuance dropped markedly in the second half. While issuance was still relatively high for the year overall (the third highest year in the past decade), there was no end-of-year surge, which used to be a feature of the market.
- Issuance of securitisations and secured bonds in 2020 has lagged, with the former in particular constrained by the availability of new BoE secured funding facilities for banks to finance assets as part of the UK's broader Covid-19 policy response. However, reflecting our extremely diversified approach to sourcing and investing in secured assets, despite this backdrop the fund was able to add high-quality and attractively-priced bonds across both primary and secondary markets. Most notably, after a period of due diligence, the fund participated in a new securitisation, **Sage AR Funding**. Our senior notes are secured against a portfolio of affordable housing in the UK. As well as funding critical social infrastructure, credit risks are materially underpinned through a loan to value of less than 30% and extremely healthy debt service cover from the underlying rents. The fund also added to senior positions in a recent residential mortgage backed (RMBS) securitisation, **CASTE 2020-1 A**, and a direct debit receivables vehicle, **PCLF 2017-2 A**. Despite all three of these bonds paying material premiums to SONIA, they are rated AAA and benefit from significant levels of over-collateralisation. In addition, we were also able to add strongly covenanted and secured positions across a diverse range of underlying economic sectors, including typically hard to source investment trust and infrastructure bonds. Following the strong performance of unsecured bonds, we took the opportunity to increase the overall fund's balance to secured assets through the disposal of a range of unsecured credits that had rallied particularly strongly, including **Danske Bank**, **Aviva** and **TSB Banking Group**.
- Throughout the year we have been engaging regularly 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, as well as dampening credit risk, has been highly valuable in enabling this, providing a natural justification for regular meetings. The meetings also allow us to express any 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. Typically, the holders of unsecured bonds do not get the same opportunities for interaction and control, particularly if the bonds have weak covenants, leaving them more exposed to the vicissitudes of the market.

Key views within the portfolio

- A bias towards senior asset backed securities, an area that we believe still offers the best risk/return characteristics.
- Very limited exposure to junior tranches of securitisations, where downgrade, loss and extension risks are heightened
- Selective exposure to unsecured debt (less than 20% of the corporate bond element), targeted at well-regulated financial debt and undervalued corporate debt
- Interest rate risk is reduced through derivative strategies.
- Zero exposure to supranational bonds, as we expect secured debt and corporate debt to outperform over the medium term.
- An exposure to credit risk with minimal exposure to interest rate risk (hedged with interest rate swaps).

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 consequently favour short duration strategies over the medium term.

- 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.
- The likelihood of further credit spread contraction is reduced compared to earlier in 2020, and so we think that income generation will become an increasingly important source of returns. This plays out as excess income is compounded over time, alongside some degree of re-pricing as investors become more attuned to risks. The fund is well positioned for this, since it has long maintained a yield advantage over the benchmark despite significant bias to senior secured bonds (the fund has very little exposure to junior tranches of securitisations), by investing in assets that we consider undervalued. A good example of this is the social housing sector, where our preferences have been in the higher yield parts of the sector in which we found more value.
- 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.

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