ROYAL LONDON GLOBAL BOND OPPORTUNITIES FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Executive summary

- The fund returned 4.44% over the fourth quarter, gross of tax and management fees of the Z share class.
- The fund's Z share income distribution for the fourth quarter, payable at the end of February, is 1.35p, above the 1.31p distributed in respect of the third quarter of 2020.
- It was an extraordinary quarter for risk assets, with global high yield and AT1 indices up in the region of 6.5%. Credit spreads contracted significantly as several key binary risks for the market subsided. The fund, supported by its high level of income generation, was able to deliver an exceptional return over the quarter, which brought its gross return for 2020 into positive territory. The fund ended the year up 3.54%, having completely recovered from the market crisis in the first quarter.
- Despite a second wave of Covid-19 infections sweeping across Europe and the US, the market outlook with regard to the virus improved after a multitude of Covid-19 vaccines were approved and rolled out in several countries. Joe Biden's victory in the US presidential election reduced the risk of trade wars, while the marginal outcome in the Senate race handed control to the moderates. And the UK and EU ended their trading negotiations on Christmas Eve as they agreed to a deal, thereby eliminating the risks associated with 'no deal' Brexit.

Performance

	Fund (%)
Q4 2020	**4.44**
Year-to-date	3.54
Rolling 12 months	3.54
3 years p.a	4.54
5 years p.a	6.41
Since inception p.a. 08.12.2015	6.24

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 Inc share class. Performance for the fund is calculated on a mid basis with income re-invested. The fund returns in the table above are gross of standard management fees.

Yields

	Fund
Gross redemption yield[1]	4.22%
Gross income yield[1]	5.33%

Source: RLAM and State Street. Based on the Z Inc share class.

[1]Net of standard management charges.

[2]Excluding cash

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.

Fund data

	Fund
Duration[2]	3.4 years
No. of stocks	203
Fund size	£220.3m
Launch date	08.12.2015

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Fund strategy

- The fund aims to achieve a high level of income with the opportunity for capital growth, 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 allocation can in isolation have an undue impact on overall performance.
- The fund's assets are held in securities denominated across a range of G10 currencies, with currency exposures substantially hedged back to sterling.
- The average duration of the fund's portfolio is relatively short, at 3.4 years, and the sensitivity of the fund's performance to changes in government bond yields is consequently modest.

Market Background

Index	Total return (%)	Spread movement (basis points)
HY non-financial emerging markets ICE BofA ML emerging markets high yield ex. subordinated financial index	6.71	-164
HY global non-financial corps ICE BofA ML global non-financial high yield index	6.63	-150
AT1 ICE BofA ML contingent capital index	6.41	-84
HY global non-financial hybrid corps ICE BofA ML global hybrid non-financial high yield index	4.91	-56
Sterling investment grade corporate bonds ICE BofA ML sterling corporate and collateralised index	3.87	-36
IG global non-financial hybrid corps ICE BofA ML global hybrid non-financial corporate index	3.58	-36
Dollar investment grade corporate bonds ICE BofA ML US corporate index	2.99	-41
Euro investment grade corporate bonds ICE BofA ML euro corporate and Pfandbriefe index	1.86	-24

Source: Bloomberg.

- Despite the still challenging economic background and uncertain outlook, financial markets generally performed well into the year end. Sub-investment grade markets performed strongly in November and December as investors repriced the risks in the market. The quarter featured breakthroughs in the development and rollout of Covid-19 vaccines, 'no deal' Brexit was avoided with a trade deal agreed between the UK and EU, and the US elections resulted in Biden being elected as President, alongside a marginal Senate race outcome. The resultant reduction in political risk and improved prospects for an eventual 'return to normality' improved market risk appetite.
- Covid-facing credits outperformed in the high yield markets, as did cyclicals, and the price of Brent crude oil surged from around $39 a barrel at the start of November to $52 a barrel at the end of December; important considering the high energy weighting in the global high yield index. For the year as a whole, the European and global sub-investment grade indices posted returns of 2.76% and 6.28%, in part reflecting the dominance of US dollar-denominated assets in the global high yield index and the higher level of US dollar interest rates over those denominated in euros, in turn contributing to higher income generation over the year as a whole.
- Reflecting the improved outlook for the market, risk assets outperformed over the quarter. There was considerable dispersion between the performance of high yield and AT1 assets compared with investment grade debt. Despite the strong outperformance of higher yielding debt, underlying government bonds generally declined as well; the US and Canada being prominent exceptions where yields rose. This simultaneous contraction of corporate bond spreads and decline in safe-haven government bond yields reflected the liquidity-driven nature of the market rally – that is, it was driven by an influx of money coming into the market.

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Fund commentary

- There were some very strong individual security performances over the quarter, with few notable detractors. Bonds in the banking sector did particularly well, despite giving up some of their gains in December. Subordinated debt of **Rabobank**, **Standard Chartered** and **Virgin Money** posted very strong performances over the quarter. The energy sector was boosted as oil prices rallied, helping holdings such as **DNO** and **ShaMaran Petroleum**. Likewise, the improvement in shipping rates after an extended period at subdued levels triggered uplift in the fund's holdings in the sector, with **Songa Container** a notably strong performer throughout the quarter. The pub sector struggled in October as it faced the prospect of a second wave of Covid-19, alongside the associated lockdown constraints. However, news of the Covid-19 vaccines reversed the fate of bonds in the sector, such that bonds from the pub chains **Mitchells & Butlers** and **Stonegate** surged in the latter half of the quarter. Other important bonds included those of **General Electric**, which significantly outperformed after the company reported better-than-expected earnings, secured major deals to supply wind turbines in the US and UK, and the Boeing 737 MAX (for which it supplies engines) was recertified. The fund also benefitted from participating in a US dollar-denominated new issue from **Aston Martin** with a coupon of 10.5%, at the same time as the company conducted an equity raise. Aston Martin had been badly hit by Covid-19 and had been mismanaged for a long time. Yet the bond was senior secured, offered significant compensation and had the additional safety net of the equity raise. The bond ended the year with a cash price of 110.
- Activity during the quarter included participation in new issues of US energy business **Talos**, Danish multinational power company **Ørsted** (a short-dated hybrid with a high reset), shopping centre owners **Metrocentre Partnership** (short-dated 'payment-in-kind' bonds, ranking by agreement ahead of the company's existing secured debt, with a 'super-senior' claim on the shopping centre in the North East), and **Rolls Royce** (BB rated, offering 5¾% income for seven years and contingent on the company's £2 billion equity raise). Other new issues came from **Thames Water** and offshore services group **Beerenberg**, which were aligned to repurchase offers for shorter-dated bonds of these two companies held within the fund. A number of bonds were called away from the portfolio during the quarter, such as from shipping company **Chembulk** (at a premium to their par value as the company exercised its option to repay early rather than hold cash within the pool of security for the bonds), Danish waste management company **DSV Miljoe**, exploration and production company **Aker** and international banking group **BNP Paribas**. The fund raised further liquidity by reducing its holding of **Lloyds** bonds, which has been issued in an attractive exchange offer for Lloyds bonds that had been rendered inefficient under present bank capital regulations for investment, at a 4% premium to exchange par value. Finally, activity in US treasuries was undertaken throughout the quarter for efficient liquidity management.

Investment outlook

- The biggest driver of the high yield markets is the default rate forecast, and we remain optimistic about it. We think that the market is still overly bearish, and that default rates will be benign over the next five years. There is less downside risk because the key negative catalysts for the market have been substantially eliminated. Additionally, the Democratic victory in the US election is likely to lead to greater fiscal stimulus, while the vaccine news accelerates the timeframe within which economies can bounce back.
- We also think that there will be greater recovery rates on the defaults, reflecting higher corporate valuations and the weight of money. We expect the biggest driver of returns in the year ahead to be the global economic recovery. This will be especially beneficial if it feeds into higher oil prices, helping the energy companies which constitute a large portion of the high yield market.
- 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. 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 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 owing to its high yield level from investing in sub-investment grade and unrated debt which we consider undervalued.
- We remain committed to ensuring that we are sufficiently compensated for all of the risks that we take, and consider that current credit spreads are still attractive on this basis. 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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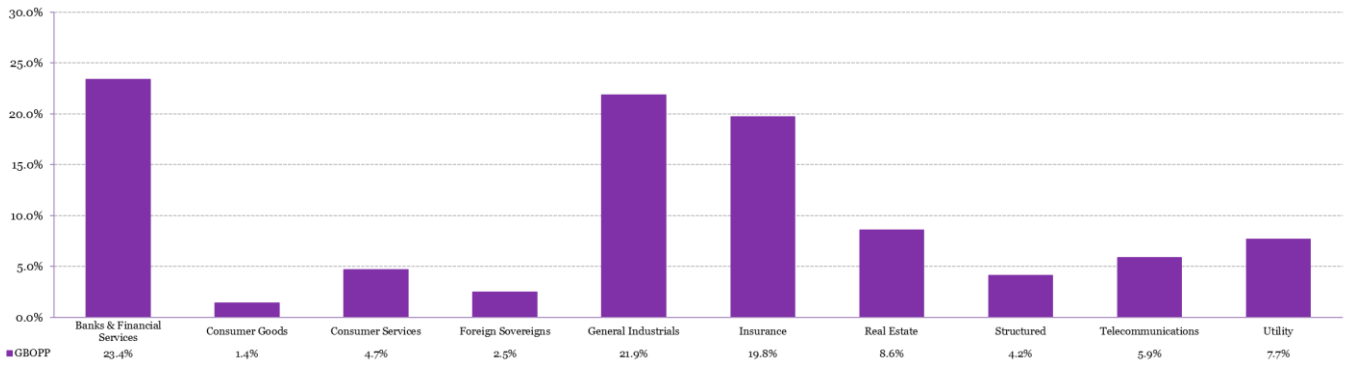
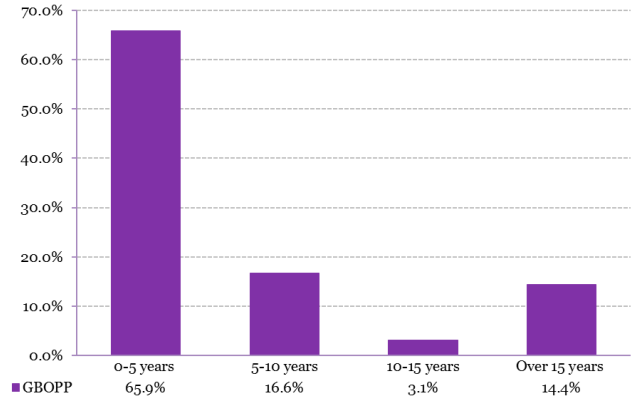
Sector breakdown



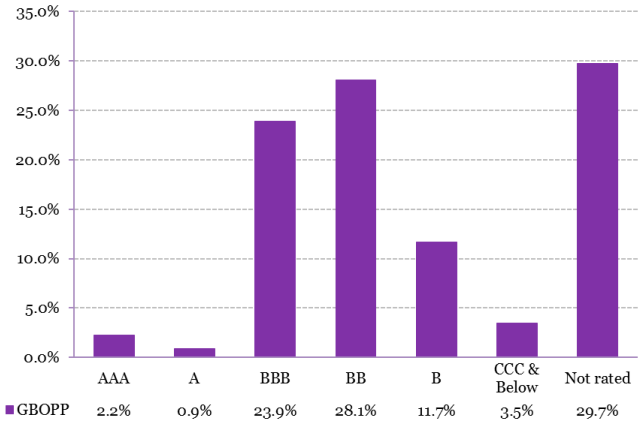
Source: RLAM. Figures include the impact of cash held.

Maturity profile



Source: RLAM. Figures include the impact of cash held.

Credit breakdown



Source: RLAM. Figures include the impact of cash held.

Ten largest bond holdings

	Weighting (%)
Lloyds Banking Group Plc 6.413% Perpetual	2.0
AXA SA 5.5% Perpetual	1.8
Coöperatieve Rabobank U.A. 6.5% Perpetual	1.7
M&G Plc 3.875% 2049	1.5
Heimstaden Perpetual	1.5
Digiplex Norway Holding 2 AS FRN 2024	1.5
Aggregated Micro Power Infrastructure 8% 2036	1.4
ML 33 Holding A.S. 5.5% 2021	1.4
Lamon 6.75% 2044	1.4
Storebrand Livsforsikring 6.875% 2043	1.3
Total	**15.4**

Source: RLAM. Figures include the impact of cash held, subject to rounding.

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ASSET MANAGEMENT