ROYAL LONDON INVESTMENT GRADE SHORT DATED CREDIT

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON INVESTMENT GRADE SHORT DATED CREDIT FUND **3**

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.1	99.6
Index linked credit bonds	0.9	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.4
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	2.7 years	2.8 years
Gross redemption yield[4]	0.98%	0.54%
No. of stocks	280	424
Fund size	£1,343.4m	-

Source: RLAM, based on the Z share class. Launch date: 07.12.2015.

[1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index

[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[1] (%)	Relative (%)
Q4 2020	**1.59**	**1.16**	**0.43**
Year-to-date	3.79	3.10	0.69
Rolling 12 months	3.79	3.10	0.69
3 years p.a	2.85	2.30	0.55
5 years p.a	3.12	2.57	0.54
Since inception p.a. 07.12.2015	3.04	2.51	0.53

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.

Source: RLAM, based on the Z share class.

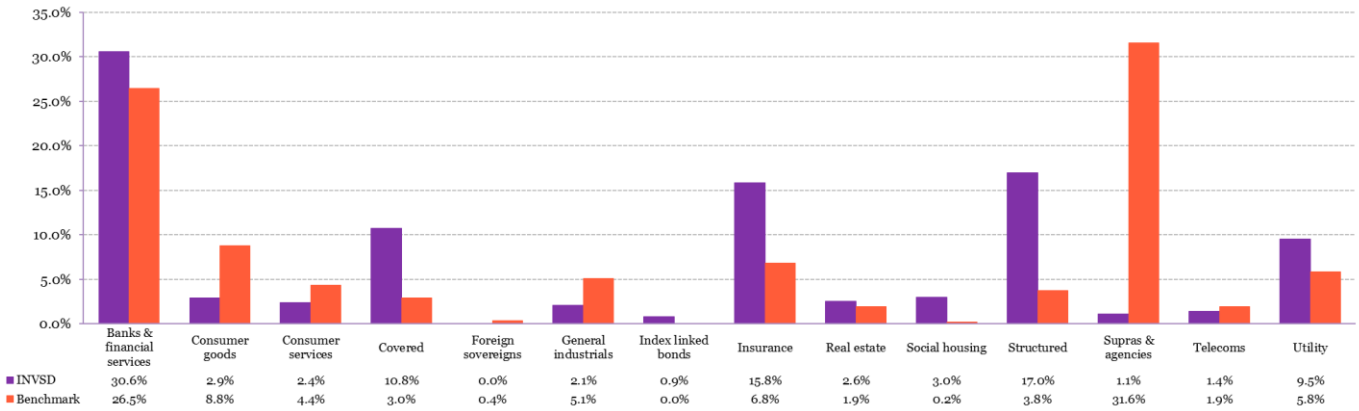
[1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index.

Performance for the Royal London Investment Grade Short Dated Credit fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over longer measurement periods.

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

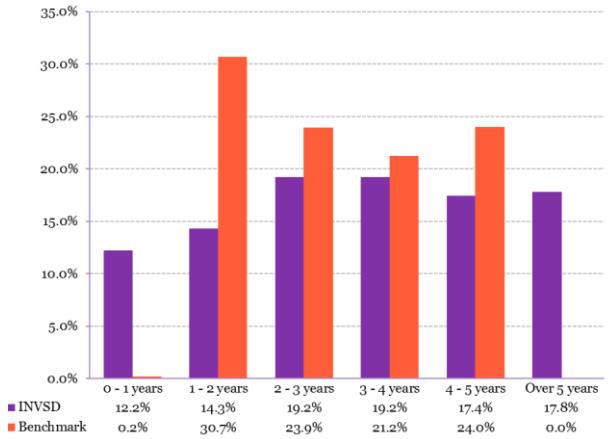
ROYAL LONDON INVESTMENT GRADE SHORT DATED CREDIT FUND

Sector breakdown

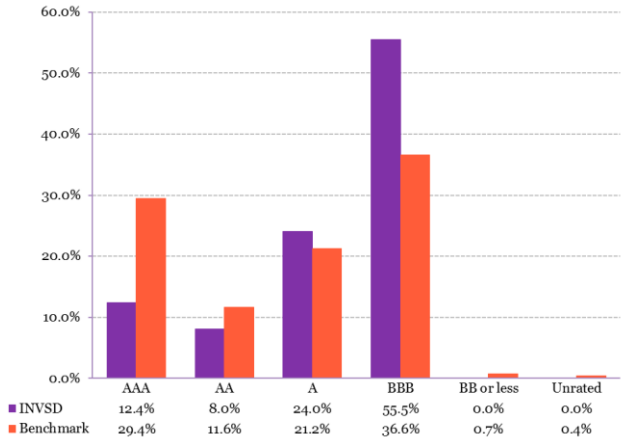


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Co-operative Bank 4.75% 2021	1.5
M&G Prudential Plc 3.875% 2049	1.1
Western Power Distribution Holding 3.875% 2024	1.1
HSBC Bank 5.37% 2030	1.1
Barclays Bank 10% 2021	1.0
Credit Suisse Group 2.125% 2025	1.0
Longstone Finance 4.791% 2036	0.9
Legal and General 10% 2041	0.9
Zurich Finance 6.625% VRN Perpetual	0.8
HSBC Bank 6.5% 2023	0.8
Scottish Widows Plc 5.5% 2023	0.8
Total	**10.3**

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

ROYAL LONDON INVESTMENT GRADE SHORT DATED CREDIT FUND

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.

Portfolio commentary

- The fund performed very strongly in the fourth quarter, achieving a positive absolute return and significantly outperforming the benchmark. This primarily reflected three factors: the substantial underweight exposure to low-yielding supranationals, the overweight allocations to bonds in the insurance and structured sectors, and security selection within the banking & financial services sector. The only significant detractor from performance was security selection within the structured sector. This offset the positive contribution from an asset allocation perspective, such that the structured sector had little overall impact on relative returns.
- The fund's overweight exposure to the financial sectors was a boon to performance during the quarter, and we have been adding to them over the year in light of attractive valuations. 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.
- Structured bonds performed strongly in aggregate during the quarter, and so the fund's exposure to the sector was positive. However, the sector is highly diverse, and while a number of the fund's holdings within the sector did very well during the quarter, it lacked some of the market's best performers. The less liquid bonds typically underperformed the sector given their lack of sensitivity to the liquidity-driven market rally. We nevertheless expect that these bonds will ultimately perform strongly as the rally eventually transitions away from the most liquid assets. Among the fund's best performing holdings during the quarter were **Heathrow**, pub chain **Mitchells & Butlers** and **Thames Water**.

ROYAL LONDON INVESTMENT GRADE SHORT DATED CREDIT FUND

- Other notable securities during the quarter included bonds 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. These factors improved the cashflow outlook for the company, to the benefit of bondholders and shareholders alike.
- New issue activity was limited during the quarter, although we participated in a new issue from **Incontinental Hotel Group** given our belief that the attractive spread more than compensated for the near term risk in the sector – the bonds subsequently tightening materially following positive vaccine news. Secondary market activity focused on managing cash flows and liquidity, examples including senior bonds of **Lloyds Banking Group** and **3i**; subordinated insurance bonds of **Aviva**, **Liverpool Victoria** and **PGH Capital**; and short-dated structured bonds of **Heathrow** and **Gatwick**.
- 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.

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 index 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 yields 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. 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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