ROYAL LONDON MULTI ASSET CREDIT FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Loans	25.0
Secured high yield	20.0
Short duration high yield	16.0
Conventional high yield	19.8
Asset backed securities	1.8
Investment grade corporate bonds	2.2
ROW	4.0
CLOs	11.4

Fund data

	Fund
Duration[1]	2.8 years
Yield to Expected	4.54%
Fund size	£1,065.0m

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

Launch date of the share class: 09 October 2017.

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

[1]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.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**5.16**	**0.01**	**5.15**
Year-to-date	4.79	0.30	4.49
Rolling 12 months	4.79	0.30	4.49
3 years p.a	4.44	0.61	3.83
Since inception p.a. 09.10.2017	4.16	0.60	3.56

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.

[1]Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 15 December 2020, and is reflected in the returns shown above..

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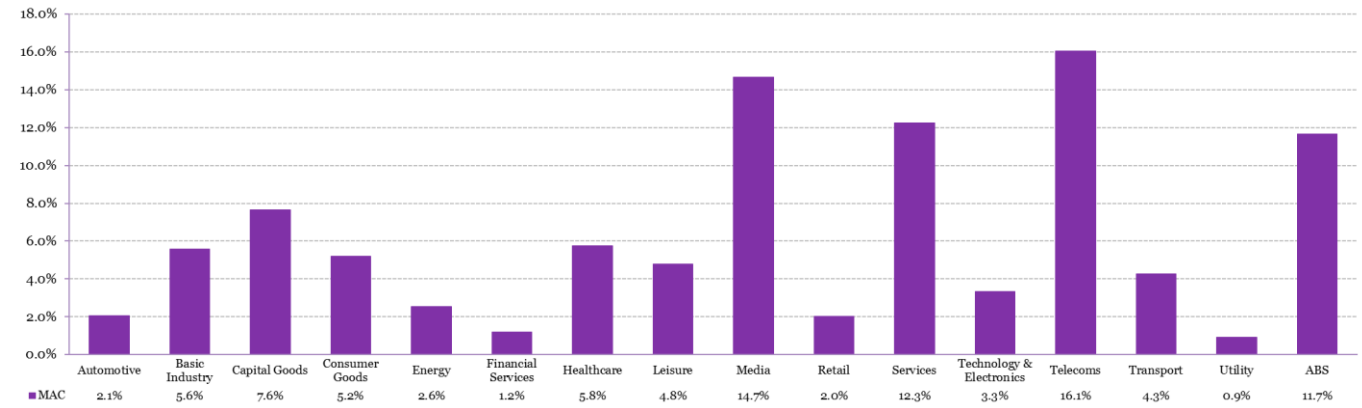
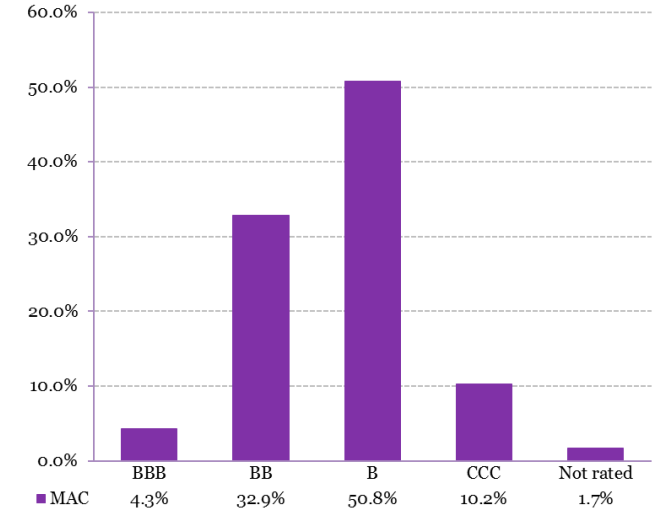
Sector breakdown

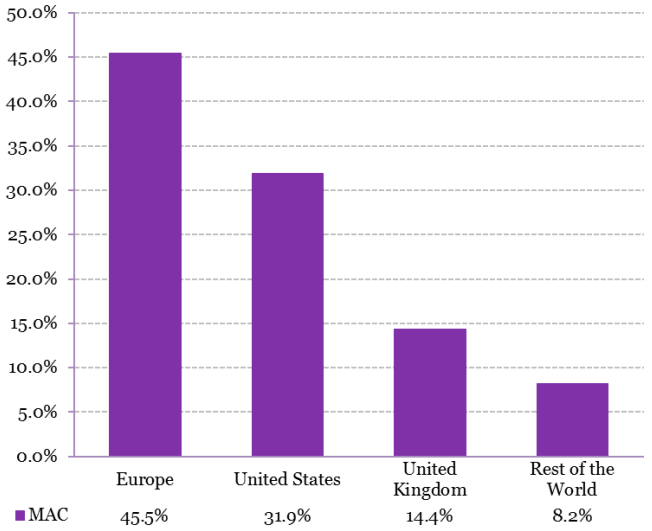


Source: RLAM. Figures exclude the impact of cash held.

Rating breakdown



Regional breakdown



Market overview

- When the quarter began, there was some nervousness in the high yield market. There had been a sell-off in the preceding month in which the high yield spread had widened by 45 basis points. It had, however, been driven by technical factors rather than by a deterioration in the market outlook, creating opportunities to add credit at discounted prices. There were three potential areas of concern for the market at the start of the quarter: the upcoming US elections, a second wave of Covid-19 and 'no-deal' Brexit. Of the three, the market was least concerned about Brexit, with there being a consensus that a last-minute deal would be agreed.
- The market consensus ahead of the US elections was that there would be a 'blue sweep', with Biden winning the presidency and the Democrats taking control of the Senate. There were thought to be two risks around this: that President Trump would cause a highly turbulent situation by refusing to accept the result, and that the Democrats would pass economically-damaging policies. We were less concerned by these risks than the market, believing that neither candidate would risk endangering the economy given its fragility. This has so far been borne out, with the market quickly looked through Biden's victory and the disruption that Trump caused as he unsuccessfully attempted to delegitimise and overturn the result.
- Our perspective on the likelihood of a second wave of Covid-19 was not unique given that we are not virologists. However, we thought that, were there to be a second wave, the impact would either be more localised or smaller than what had been experienced in March. Accordingly, we expected market liquidity to be sufficient in such a situation. There was, indeed, a

significant uptick in Covid-19 cases and deaths during the quarter across the UK, Europe and the US, with new strains of the virus emerging. While the situation has been just as serious as the first wave in the UK, it has generally been less severe in the rest of the world, so market liquidity has been fine.

- There were also significant breakthroughs in the development of vaccines to combat Covid-19. Several companies reported successful vaccine trials in November, which enabled the initial rollout of some of the vaccines before the end of the year in a few countries. That lifted market sentiment as it heralded an eventual return to normality for societies, much faster than had been expected. The high yield market consequently performed strongly in November and December as investors began to reprice the risks in the market. Covid-facing credits outperformed, 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.
- Overall, the fourth quarter was extremely positive for the high yield market, with all of the key negative risks getting diminished. Trump's defeat severely reduced the risk of trade wars, while the marginal outcome in the Senate race hands control to the moderates. The multitude of approved Covid-19 vaccines moves us into the endgame for living with the virus, while a Brexit deal was agreed as expected at the end of the year. The market has factored these improvements by reducing default rate expectations; though we think that high yield credit spreads continue to overcompensate for the risks.

Portfolio commentary

- The fund continued to perform very strongly over the quarter. Despite underperforming during the unprecedented market selloff in March, the fund finished the year up in both absolute and relative terms. The fund benefitted from our decision to top up in BB rated collateralised loan obligation tranches. This is an area that we think has a lot of value and is the purest way to take a view on the market's overestimation of default rates. We also took advantage of the healthy level of issuance in the market by purchasing Covid-facing credits during the third quarter and the start of the fourth. We thought that their likelihood of default was being excessively priced and that their spreads were attractive.
- One example is a bond from **Rolls-Royce** which we purchased in October. The company was Covid-facing and highly levered because its revenues had disappeared. Ideally for us as bond investors, the company equity capital at the same time as its bond issuance, giving us an additional safety net. We purchased the bond as a play on when people would start flying again, and it is a good example of the type of credit we like. It has roughly £11bn liquidity, meaning it should be able to survive another year of lockdown, and its leverage and high yield means that anything positive will enable it to appreciate significantly. Indeed, the bond benefitted hugely from the vaccine rally, appreciating to a cash price of 110.
- Another purchase, which was quite similar, was of a US dollar-denominated bond from **Aston Martin** with a coupon of 10.5%. Like the Rolls-Royce issue, the company had an equity raise at the same time. The difference was that the problems with Aston Martin were more long term and consistent than those of Rolls-Royce. While Aston Martin had been badly hit by Covid-19, it had been mismanaged for a long time. We nevertheless felt very comfortable because the bond was senior secured and there was fresh equity beneath us. We thought that it would benefit from a cyclical recovery and that it offered significant compensation if were wrong on such a recovery being likely. The bond ended the year with a cash price of 109.
- A third example of a very interesting credit was our purchase from **Jaguar Land Rover**, which was also a play on Brexit and the US election. We had thought that Trump would play down his rhetoric on tariffs for the auto sector. The bond was US dollar-denominated and senior unsecured with a 7.75% coupon. It had unusually strong covenants, with one feature being that if the company were to issue any secured debt, then the issue would also become secured. We consequently felt highly protected despite it being a nominally unsecured bond. The company benefitted from the reduction in each of the aforementioned key risks for the high yield market, causing the cash price to appreciate to 108.
- Despite the strong performance of each of these three bonds in a short space of time, we have not changed our views on them. One of the things that we liked about the Rolls-Royce and Aston Martin bonds was that their calls were pushed so far back, giving us more upside for the risk that we were taking in investing in them. Although the spreads have come in markedly as the key market risks have been muted, we still think that each of the three trades has a lot of value left and so have not been tempted to take profits yet.

Outlook

- The biggest driver of the high yield market 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. Our outlook is largely unchanged from the last quarter, with the only change being that we think there is less downside risk as a result of 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. This reduction in downside risk means that there is a narrow range in our forecast spreads.

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- We also think that there will be greater recovery rates on the defaults, reflecting higher corporate valuations and the weight of money. One of the things that have surprised us over the last 12 months is how high recoveries have been in some situations. This is because there have been more consensual restructurings, with more senior capital, to accelerate exits from bankruptcy. It has partially driven by the amount of capital that has been available in the distressed parts of the market. Additionally, equity markets have done very well, with enterprise values higher than people might have expected in most sectors.
- We expect the biggest driver of high yield 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. We think there will be more spread compression, particularly in the weaker parts of the market, as default risks are repriced. And we think that this spread compression will more than compensate for the impact of any increase in underlying government bonds yields; which are relatively unimportant in the high yield market.
- We may be starting 2021 with the lowest yield ever in the high yield market, yet we still feel extremely bullish. The excess spread in the market still offers significant compensation for default and other risks, especially considering the great improvements to the economic outlook over the past quarter. There is simply no alternative to the high yield market in its risk-return prospects. You can find out more about our thoughts on the risks and opportunities for the year ahead in our RLAM Outlook 2021 document.

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