ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Executive summary

- The fund recorded a return, gross of tax and management fees of the A share class, of 6.19% during the fourth quarter, bringing the gross return for 2020 as a whole to 1.62%. While the return for the year was modest, it is remarkable given the extraordinarily challenging market conditions that were prevalent in March and April. This marks the 12th successive year of positive annual returns, with this track record being strongly supported by the income generation of the fund.
- Sterling investment grade credit starkly outperformed gilts during the quarter; respective all-maturities returns were 3.12% and 0.63%. Credit spreads on the ML Sterling Non-Gilt index tightened from 1.29% to 0.99% over gilts, with the iBoxx sterling non-gilt index seeing a similar move. That is below the average spread at the end of 2019, which was 1.14%; a remarkable turnaround considering that the spread had been as wide as 2.25% during the market sell-off in March.
- Distributions in respect of the fourth quarter, payable at the end of February, are 1.51p, 1.35p, 1.43p and 1.41p respectively for the A, B, Y and Z class income shares, little changed from the amounts of 1.54p, 1.38p, 1.46p and 1.44p distributed in respect of the third quarter.

Performance

	Fund (Class A) %	Fund (Class Z) %
Q4 2020	**6.19**	**6.19**
Year-to-date	1.62	1.63
Rolling 12 months	1.62	1.63
3 years p.a.	4.36	4.36
5 years p.a.	7.81	7.81
10 years p.a.	9.13	-
Since inception p.a. 13.12.2013	-	7.30
Since inception p.a. 14.04.2003	8.18	-

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.

Source: RLAM. Based on the A and Z Income share classes. 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.

Fund price and yields

	Gross redemption yield[1]	Gross income yield[1]
Fund (Class A)	4.77%	5.29%
Fund (Class Z)	5.03%	5.56%

Source: RLAM and State Street. Based on the A and Z 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]	4.8 years
No. of stocks	218
Fund size	£1,818.4m
Launch date	11.04.2003

Fund strategy

- The fund's objective is to achieve a high level of income 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 investment can in isolation have an undue impact on overall performance. In addition, where possible within the yield objective of the fund, investments are focused on bonds where risk is mitigated by structure or a claim on assets or cashflows.
- The fund maintains at least three-quarters of its total assets in sterling-denominated bonds. Currency risk associated with holdings of bonds denominated in other currencies is substantially hedged by forward currency transactions.

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- The average duration of the fund's portfolio is relatively short, presently 4.8 years. The sensitivity of the performance of the fund to changes in gilt yields is therefore relatively modest.

Fund commentary

- Despite the still challenging economic background and uncertain outlook, financial markets generally performed well into the year end, with gilts posting a 1.62% return in December, more than offsetting the negative returns in October and November. 2020 index returns for the asset class ended up at 8.27%, primarily reflecting the fall in yields over the course of the year rather than income generation, with the benchmark 10-year gilt yield down from 0.82% at the start of the year to just 0.20% at the end. Sterling investment grade corporate bonds returned 3.12% in the fourth quarter and 7.80% for 2020. This slight underperformance relative to gilts reflected their shorter average duration and therefore lower price sensitivity to lower yields. The average yield differential of sterling investment grade corporate bonds over reference gilts declined from 1.29% to 0.99% over the year as a whole. The relative pricing of these assets has been extraordinarily volatile owing to the significant stress in corporate bonds at the depths of the market crisis in March, before the Bank of England's corporate bond asset purchase programme, monetary policy and direct government economic actions supported a progressive recovery from that point.
- 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 market, 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.
- There were some very strong individual security performances over the quarter. Financials performed particularly well, and among the more notable performers, **Lloyds** offered a new BBB rated bond with 10 years to call, priced at 2.4% over the 10-year reference gilt, in exchange for some 'old-style', sub-investment grade bonds. This exchange was very beneficial, providing a near 8% return on the three holdings of Lloyds bonds subject to the tender. The level of the tender was at a moderate premium to the market prices of the three bonds and the new bond, with an issue size of £1.3 billion, traded at a margin under 2% over gilts, triggering a 3% premium to issue price. Bonds in the energy sector did well as oil prices rallied, with examples being **DNO**, **OKEA** and **Tullow Oil**. 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** an exceptionally strong performer throughout the quarter. Elsewhere, pub chain **Stonegate**'s £1bn B rated bond, issued earlier to refinance the acquisition of Enterprise Inns, surged in response to news of the Covid-19 vaccines.
- Activity during the quarter included participation in new issues of **Aggregated Micro Power**, which were unrated and funded expansion of the company's renewable energy and UK electricity grid integrity assets; **Rolls Royce**, which were BB rated and offered 5¾% income for seven years and were contingent on the company's £2bn equity raise; **Wind Enterprise**, unrated and secured on a new vessel on a long-term lease to engineering giant Siemens and providing servicing capacity for offshore wind turbines; and an unrated bond of **Greensleeves** care home business, whose origins lie in the Women's Royal Voluntary Service. Issued in December under the Retail Charity Bond and offering a 5% yield for their 10-year term, the bonds were up over 3% in price by month end. This investment was financed by repayments of bonds 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), from Danish waste management company **DSV Miljoe** and from energy services business **Beerenberg** (which had financed the repayment by a new bond issue in October in which the fund participated). The fund raised further liquidity by reducing its holdings of the aforementioned **Lloyds** bonds in December. Activity in short-dated gilts was undertaken throughout the quarter for efficient liquidity management purposes.

Investment outlook

- We expect a further extension of quantitative easing in 2021 because the government and Bank of England will wish to avoid the increase in government bond yields that would result from a substantial increase in net supply. Nevertheless, the amount of quantitative easing 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 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. 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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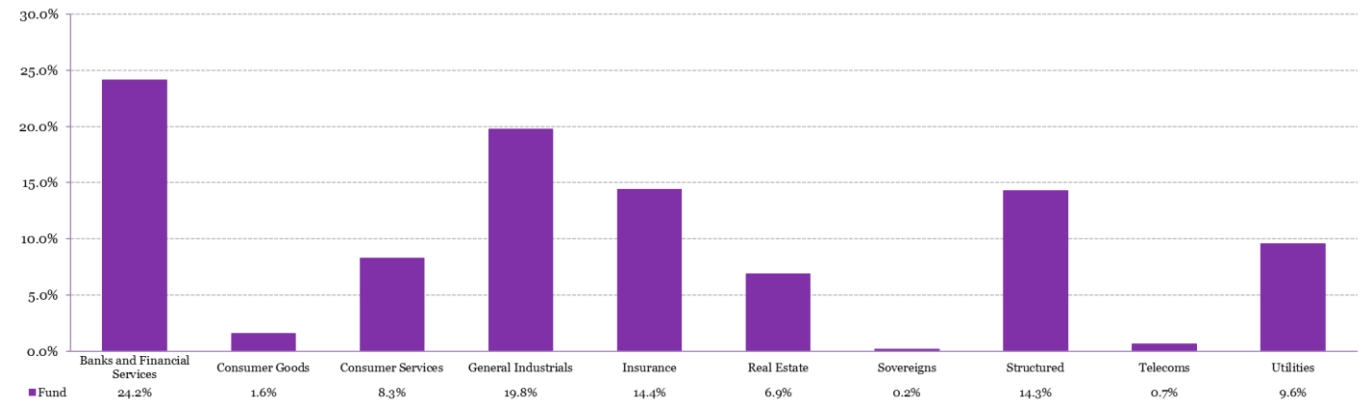
Sector breakdown

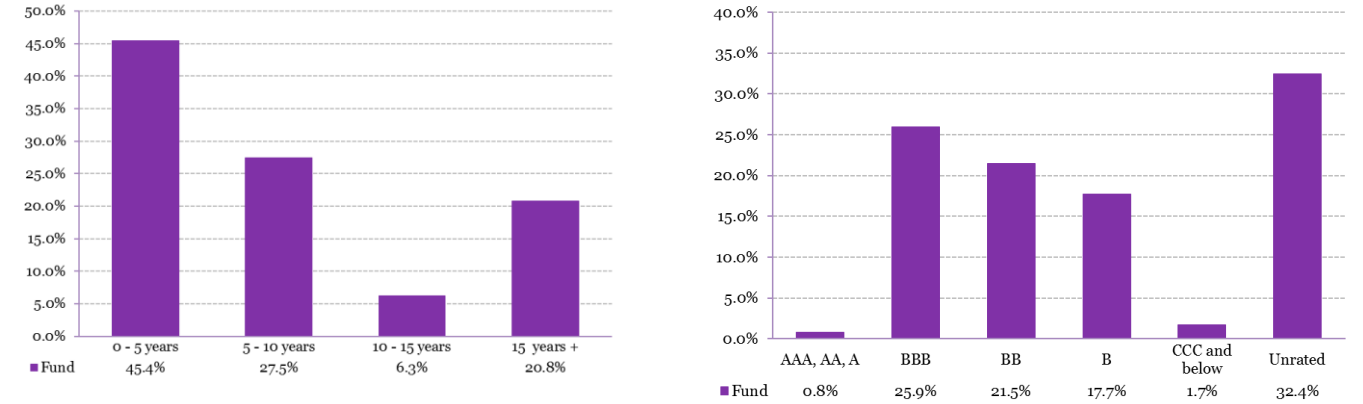


Source: RLAM. Figures exclude the impact of cash held.

Maturity profile

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

Credit breakdown



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

Ten largest bond holdings

	Weighting (%)
Co-op Group 6.25% 2026	2.8
Électricité De France 5.875% 2029	2.4
M&G 6.34% 2043/63	2.3
Centrica 5.25% 2025/75	2.3
Santander UK 10.0625%	2.1
Anglian Water Osprey 4% 2026	1.8
Phoenix Group 5.75% 2028	1.8
Santander UK 10.375%	1.7
Scottish Widows 7% 2043	1.7
Heathrow Finance 3.875% 2027	1.6
Total	**20.5**

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

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