ROYAL LONDON ENHANCED CASH PLUS FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

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Fund data

	Fund
Gross redemption yield[1]	0.59%
No. of issuers	186
Fund size	£2,292.6m
Weighted average maturity	0.5 years
Weighted average life	1.8 years

Source: RLAM, based on the Z Acc share class. Launch date: 15.08.2015.
[1]The gross redemption yield is calculated on a weighted average basis.
[2]The underlying yield aligns closely with the gross redemption yield of the fund taking in account expenses. Please see glossary for more detail. 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(%)
Q3 2020	0.58	0.01	0.56
Year-to-date	1.00	0.18	0.83
Rolling 12 months	1.39	0.36	1.03
3 years p.a	1.42	0.45	0.97
5 years p.a	1.29	0.35	0.94
Since inception p.a. 18.05.2015	1.22	0.35	0.87

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.

[1]Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 20 May 2019, and is reflected in the returns shown above.

[2]All commentary within this report is based on comparison Y Acc share class.

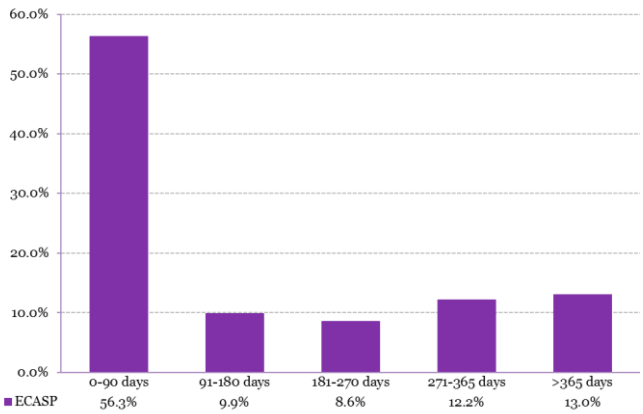
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Top ten issuers

	Weighting (%)
UK Government	5.0
Barclays Bank	3.8
Royal Bank of Canada	3.4
National Westminster Bank	3.3
Income Contingent Student Loans	2.8
Santander UK Plc	2.6
Standard Chartered Bank	2.4
Toronto Dominion Bank	2.4
Wells Fargo	2.4
TSB Bank Plc	2.3
Total	**30.2**

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

Duration profile



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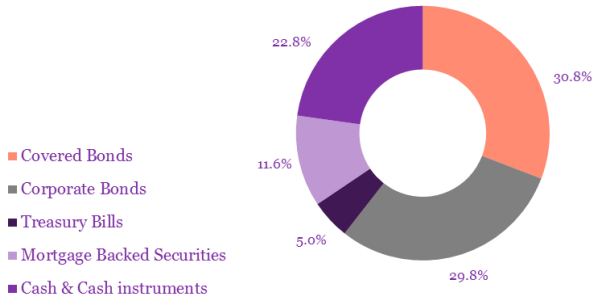
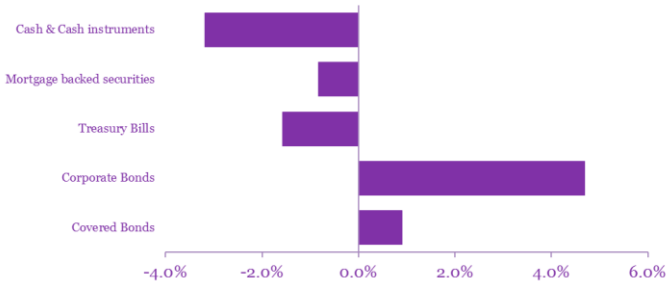
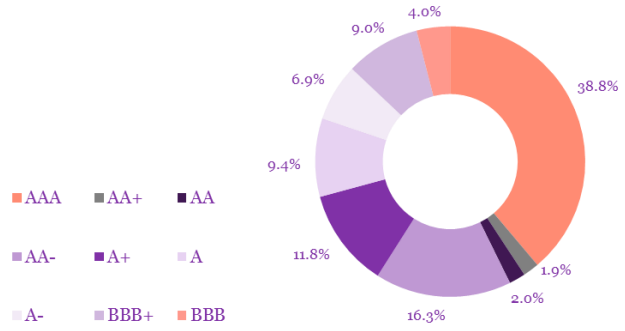
Asset allocation profile Q3 2020



Change since last quarter

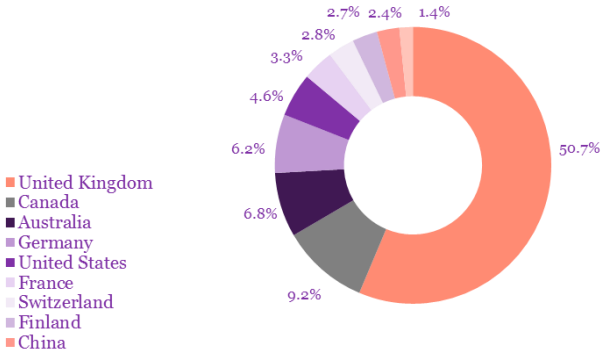


Credit rating profile Q3 2020

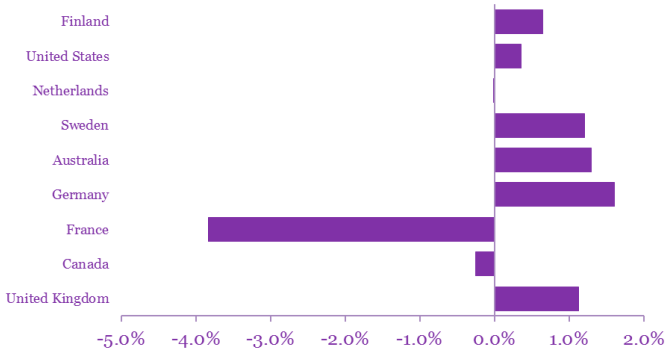


Change since last quarter

Top ten geographic allocation (ex gilts) Q3 2020



Change since last quarter



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Market overview

- The UK government continued to provide support for the economy through its Coronavirus Job Retention Scheme ("furlough"), tax deferrals, business grants and loan guarantees. In late September the Chancellor of the Exchequer announced that the furlough scheme would be replaced, from the 1st November, by a new Job Support Programme. Employees must work a minimum of 33% of their hours with the government and employer contributing to pay; larger businesses must show their turnover has fallen. GDP recovered in the quarter but remains significantly below pre-Covid 19 levels.
- The scale of the impact on Government finances became clearer in the quarter. At the last report we noted that UK government borrowing in the current year would exceed £300bn; it is now estimated to be £470bn or approximately 23% of GDP. The BoE has continued to neutralise the impact of government bond issuance through the buying of bonds; this is due to be complete in November although a further extension of Quantitative Easing is expected. The yield on 10-year gilts at the end of September was just 0.23%, compared to 0.17% at the end of June. Short dated government bond yields remained negative at maturities of less than seven years although the BoE has played down the imminent likelihood of negative base rates.
- Cash markets, having seen rates fall primarily at the shorter end in the initial reaction to the Covid outbreak, saw larger moves in longer rates. SONIA, the benchmark overnight rate, started the quarter at just 6 basis points (bps), and edged lower to 5bps over the period. Three month LIBOR, fell from 15bps to 6bps, and 12 month LIBOR fell from 43bps to 15bps. The collapse in rates reflected the move by investors to look for longer-dated exposure in their search for yield, as well as economic data and central bank guidance confirming that interest rates will remain very low for an extended period of time.

Performance

- Performance for RLAM funds was driven by the nature of the investment objective and the subsequent portfolio mix. The Enhanced Cash Plus fund looks to provide cash investors with returns over and above those on more traditional liquidity funds, by adding targeted exposure to non-money market instruments. We use covered floating rate notes as part of this strategy, as well as limited exposure to very short dated investment grade credit and secured bonds such as mortgage backed securities. These all contain limited credit risk, and saw spreads widen in the initial panic.
- The roll-out of huge government and central bank support and stimulus packages have convinced the market that the banking system is secure – helped by the fact that the banking sector was much more robust anyway following changes pushed through after the Global Financial Crisis a little over a decade ago. This led to an unwinding of the initial spread weakness we saw in credit, but also has pushed yields lower everywhere. This has been a positive trend for our funds, and this continued in the third quarter.
- For the Enhanced Cash Fund, performance has been strong across the range of assets held. Our relatively small exposure to money market instruments was helpful given the additional yield we locked in against a SONIA rate that fell further. Our covered bonds exposure also benefited from the yield premium these provide and slightly tighter spreads, with these having hit a peak of around 150bps over SONIA in the early stages of the crisis, but now recovering back to nearer 20bps. In addition, we have around a third of the fund's assets in short-dated corporate bonds and mortgage backed securities. Short-dated credit performed well, helped by increased demand and the general risk-on sentiment, which pushed spreads tighter. High quality RMBS also saw spreads tighten, helped by the fact that these are now classed as eligible collateral.

Activity

- Liquidity has remained a focus throughout the crisis. At its peak, we recognised that clients may need additional cash to meet margin calls or to take advantage of investment opportunities created by the sell-off. Although this need has abated slightly as investors become more comfortable with the changed situation that everyone is working in, we are aware that uncertainty is still high – particularly with the US presidential election and Brexit negotiations adding to the ongoing coronavirus issue – and therefore retain higher than normal levels of liquidity.
- The overall fund yield is still in excess of our target benchmark. As we pointed out at the end of the second quarter, we would expect the portfolio yield to naturally drift lower as holdings mature because replacement instruments in the market are yielding less. The fund is still well positioned to deliver their targets to investors, and hence we can be selective in where we add maturity or credit risk.
- Activity in money market instruments was relatively straightforward. Within our exposure to CDs, the collapse in rates has meant that the premium for buying longer paper has been eroded. Given our view that interest rates are a long way from seeing increases, that lack of premium means that we have generally preferred to focus on shorter dated maturities – with a selective longer dated exposure such as 12 month CDs from **UBS** and **Korea Development Bank.** We were able to pick

up a three year new issue from **Deutsche Pfandbriefbank** and five year issues from **National Australia Bank** and **TSB** at a decent premium over SONIA, but opportunities to add to covereds have been limited during the quarter, as the BoE Term Financing scheme means that institutions can get funding more cheaply from the BoE than the market, reducing the incentive to issue covereds and RMBS.

- We were more active on short-dated corporate bonds on the basis that in this environment, picking up 70-100bps of yield for high quality credit and less than 12 months' maturity is a considered way to enhance returns. Examples during the quarter included senior bonds issued by the likes of **Svenska** and **Fidelity**, but also selected utilities such as **Innogy**, **ENW** and **SSE**, all of which pay attractive rates over SONIA.

Outlook

- It is not controversial to point out that government and central bank support will remain in place in various forms for an extended period of time – both in the UK and beyond. Despite this, the scale of disruption caused by the virus means that it is inevitable that there will be further business failures, which will feed into downgrades and defaults in fixed income markets. While the banking system is significantly more robust than it was going into the crisis in 2007, the scale of the issue is much greater on both a human and financial level, and so this will not be immune.
- Negative interest rates remain a topic of speculation, with the market pricing in base rates at -0.10% by around this time next year. Recent comments from the Bank of England suggest, in our view, that negative rates are definitely part of the Bank's toolkit. The Bank is looking at the banking system and how it would cope operationally with negative rates, and will want to ensure that the benefits of such a move would reasonably be expected to outweigh the costs. The experience of negative rates in Japan and the Eurozone show that this is not a magic bullet, and we therefore expect the Bank to focus on further quantitative easing before considering negative rates.
- Even if the Bank does not go negative, we believe that yields will remain under pressure. The gilt curve is already negative to beyond five years, and longer dated cash rates have also fallen dramatically. This will impact return potential for money market funds, particularly those that have less flexibility to add credit risk.
- For money market exposure in our funds, we will manage these to achieve what we feel is the best combination of yield and liquidity, accepting that the former will be depressed. For exposure outside of these areas, our approach has always placed an emphasis on security and credit quality, both in the nature of assets we buy (such as covered bonds) but also in the way we assess credit quality, with our preference for bonds with security or covenants that we feel offer a degree of protection to investors. A high proportion of the assets in our funds are exempt from bail-in, and we will continue to favour such assets given these provide our clients with greater security. This approach mitigated the initial impact of the crisis on our funds, and with no immediate end in sight, we believe that this remains the most appropriate way to manage these funds.
- One change during the quarter was the inclusion of a fossil fuel screen into our research process. This has not had a material impact on the nature of credits we will buy for the funds given our long-term emphasis on incorporating ESG into our research, but this is now an explicit requirement for the fund.
- At the time of writing, liquidity is virtually back to normal in money markets: at the height of the crisis, buying in secondary markets was possible but for a short period, there was little demand to buy anything beyond highest quality, very short-dated instruments.

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ASSET MANAGEMENT