RLPPC ENHANCED BUY AND MAINTAIN CREDIT FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Conventional credit bonds[1]	99.9
Index linked credit bonds	0.0
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.1
Foreign index linked sovereign	0.0
Derivatives	0.0

Fund data

	Fund
Duration[2]	8.8 years
Gross redemption yield[3]	2.12%
No. of stocks	394
Fund size	£440.5m
Spread	1.84%

Source: RLAM. Launch date: 16.01.2017.

[1]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[2]Excluding cash

[3]The gross redemption yield is calculated on a weighted average basis.

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

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 (%) (Income)	Reference index[1] (%)
Q3 2020	**1.25**	**1.16**
Year-to-date	4.18	4.54
Rolling 12 months	3.35	3.82
3 years p.a	5.09	4.64
Since inception p.a. 16.01.2017	5.17	4.54

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, gross of standard management fees.

[1]There is no benchmark for the fund. The index data presented in this report is that of the iBoxx Sterling Non-Gilts All Maturities Index and is for reference purposes only. This index is a broad universe of investment grade sterling credit bonds and is therefore a representative comparison.

Downgrades

Representative portfolio	% downgraded to sub-investment grade
RLPPC Enhanced Buy & Maintain	2.22%
iBoxx Sterling Non-Gilt All Maturities Index	2.45%

Source: RLAM, showing downgrades since fund inception. Portfolio and benchmark percentages are based on weight prior to downgrade. Worst of Moodys, S&P and Fitch ratings are considered. RLAM internal ratings used in absence of any public ratings. Only first downgrades are included in the table.

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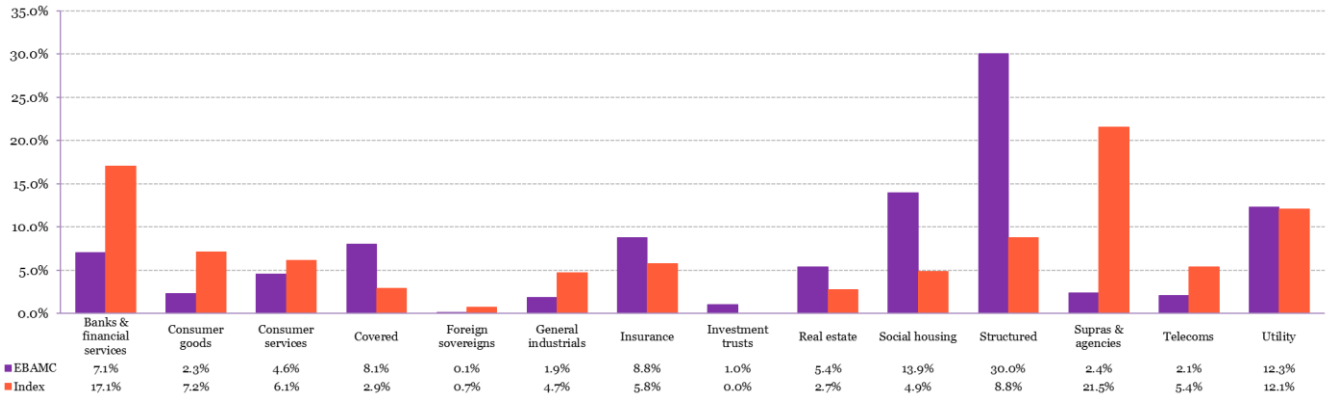
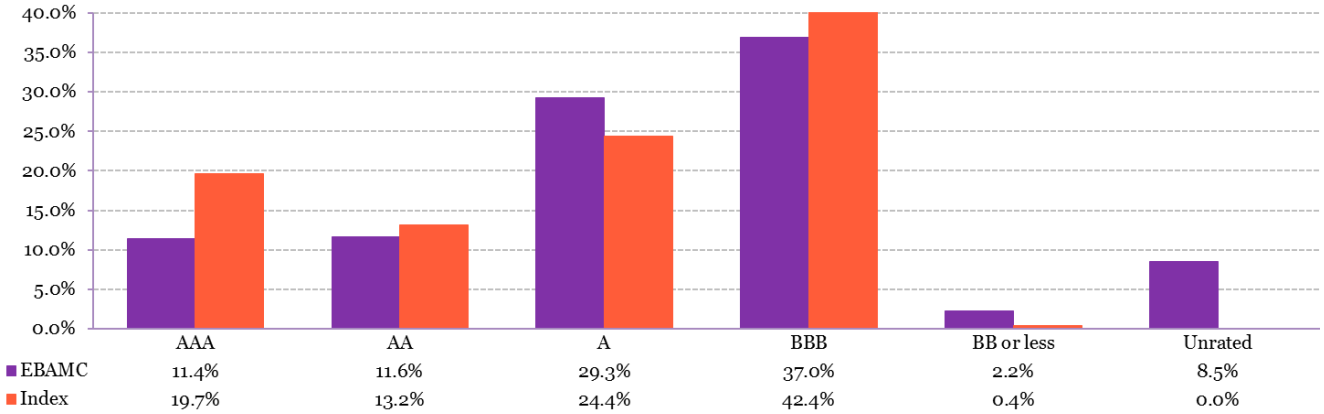
Sector breakdown



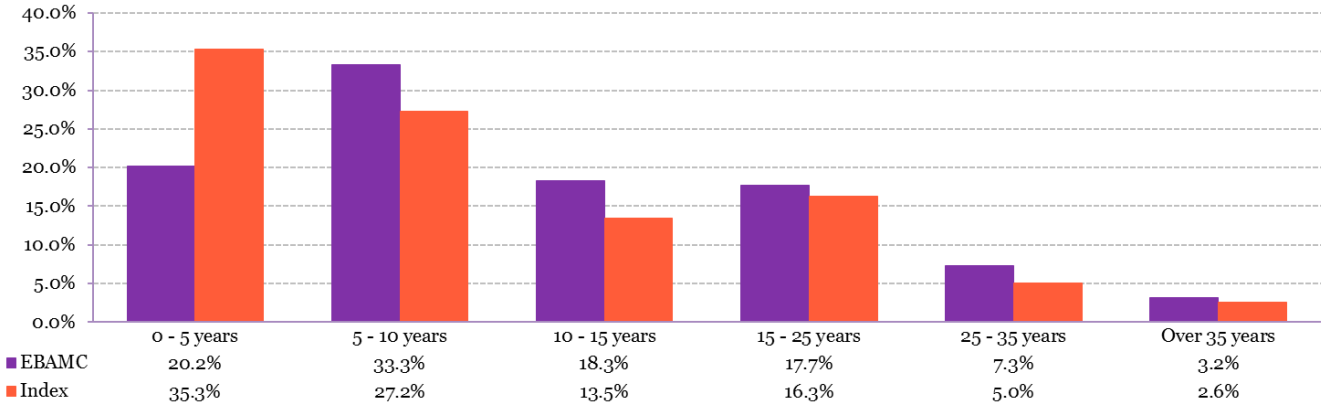
Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Rating breakdown



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

Maturity profile



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

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Ten largest holdings

	Weighting (%)
Clydesdale Bank Plc 4.625% 2026	1.4
Lloyds Bank Plc 6% 2029	1.1
The Housing Finance Corporation 5.20% 2043	1.1
High Speed Rail Finance 4.375% 2038	1.1
Co-operative Bank 4.75% 2021	1.0
Aviva 6.875% 2058	0.9
Électricité De France 6% 2114	0.9
University of Oxford 2.544% 2117	0.8
Equity Release Funding 5.05% 2033	0.8
Thames Water Utilities 7.738% 2058	0.8
Total	**9.9**

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

Market overview

- The Corporate Bond Purchase Scheme from the Bank of England (BoE) has played a major role in the recovery of the sterling credit market since March. The Scheme dates back to August 2016, when the BoE announced £10bn of investment grade corporate bond purchases to deal with the aftermath of the Brexit vote. In the wake of the Covid-19 crisis, the BoE pledged an additional £10bn of purchases under the Scheme. This helped improve market liquidity considerably, with bid-offer spreads on many of the more liquid issues returning to their pre-Covid levels during the third quarter. The programme was completed on 1 October and no further purchases have been announced.
- The Scheme, which excludes many asset-backed securities (ABS) and all financial bonds, has distorted market valuations. The eligible bonds (which represent approximately 28% of typical credit indices) have strongly outperformed the wider market. In *Bank of England buybacks: the show cannot go on* you can read our analysis of the programme, in which we consider what happened in the months after the Scheme was started in 2016, attempting to answer the question of how long-term investors ought to act in the face of inevitable market distortions.
- The UK government continued to support the economy over the quarter through its Coronavirus Job Retention Scheme ("furlough"), tax deferrals, business grants and loan guarantees. In late September, Chancellor Rishi Sunak announced that the furlough scheme would be replaced on 1 November by a new Job Support Programme. The programme requires an employee to work a minimum of 33% of their regular hours, with the government and employer each paying one third of the employee's salary for the remaining hours in which they do not work. Additionally, larger businesses must show that their turnover has fallen to remain eligible for the support.
- The scale of the impact of these programmes on the UK government's finances became clearer during the quarter. In our last quarterly report, we noted that UK government borrowing in the current year would exceed £300bn. It is now estimated to be £470bn; approximately 23% of GDP. The BoE has neutralised the impact of the heavy government bond issuance this implies by buying many of the bonds. This is due to end in November, although a further extension of quantitative easing is expected. The yield on 10-year gilts was just 0.23% at the end of September, little changed from 0.17% at the end of June. Short-dated government bond yields remained negative for maturities of less than seven years, although the BoE has played down the likelihood that it will implement negative base rates imminently.
- Against this background, credit outperformed gilts during the third quarter, reflecting a tightening of credit spreads. The broad gilt market returned -1.23% over the quarter, while sterling investment grade corporate debt returned 1.16%. 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 1.47% to 1.29%, as measured by the ML Sterling Non-Gilt index. The iBoxx Sterling Non-Gilt index experienced a similar move.
- All sterling credit sectors outperformed gilts and achieved positive absolute returns during the quarter. The strongest performances came from the subordinated financial sectors (banks and insurance). Investors were attracted to the higher yields on bonds in these sectors, compensating for the fact that they are considered more risky due to their lower positioning in capital structures. At the other end of the spectrum, the weakest returns came from supranational bonds, covered bonds and asset-backed securities. These types of debt are considered to be less risky, and so lagged the wider market given the

evident appetite for risk among investors. Reflecting this same dynamic, lower-rated debt significantly outperformed higher-rated issues. Medium-dated bonds outperformed both short- and long-dated issues.

- Sterling valuations have lagged those seen in the euro and US dollar markets, with credit spreads generally wider. This has been most evident in the financial sectors, despite their relatively strong performance during the quarter. It is likely that the "Brexit" credit spread premium, which has been a feature of sterling assets since 2016, will continue until there is greater clarity on the UK's eventual trading arrangements with the EU. The relatively wide credit spreads available in the sterling market meant that issuance fell short of expectations in the latter part of the quarter as companies sought cheaper debt funding in other markets. Sterling issuance amounted to £7.8bn over the quarter, and despite the fact that it was mostly concentrated in September, that month's issuance was only half the level seen in September 2019.

Performance

- Performance for the third quarter was positive in absolute terms, and broadly in line with the broader sterling credit market. Looking at performance relative to the wider market, it was two relatively small positions that had the largest impacts: supranationals lagged the market and these are a longstanding underweight given our overall positive view on the capacity for credit to outperform government bonds and the low yield spreads these provide; the relatively low exposure to financials was a drag compared to the market, as banks and insurance bonds, particularly subordinated bonds, performed well as these rebounded after the weakness shown during the initial market shock. Given that a buy & maintain approach is more conservative, we remain comfortable with our exposure to banks, which remains targeted at selective names within the senior and subordinated space within risk-controlled limits.
- The Bank of England corporate bond purchase programme has been a factor in sector performance during recent months. This continued during the quarter, but the effect did start to unwind as the programme wound down, making the overall effect less obvious than we had seen earlier in the summer.
- We retain a high exposure to structured bonds. These continued to make gains in aggregate, albeit slightly less than the wider market given these were not included in the BoE programme. Individual issuers such as Heathrow, the UK's regulated hub airport, and pub business Mitchells & Butler, remained under pressure. However, the balance sheets of these companies retain significant liquidity and our exposure to these issuers is in bonds that have claims over assets that we feel adequately protects us and will ultimately be reflected in market pricing.
- Rating agency action was less pronounced in the third quarter than might have been expected given the scale of the economic impact arising from Covid-19. Nevertheless, nearly 20% of investment grade bonds have seen some credit rating downgrade in 2020. This was most evident in the second quarter with the rate materially lower this quarter. We expect that the rate of downgrades will pick up again as the economic impact on the corporate sector becomes clearer. Given the high weighting of BBB in credit market indices, it is likely that there will be further downgrades to sub-investment grade; at the present time, only 1% of bonds have transitioned from investment grade to sub-investment grade in 2020. Overall, downgrades in the portfolio remain significantly lower than the market average. We would expect this due to the more cautious nature of the strategies relative to the broad market; however it was pleasing to see that our focus on the integrity of the initial lending position has been paying off.
- Our sterling credit approach emphasises the attractions of strong covenants and the importance of security. One consequence of the strong creditor position that secured lending provides is the existence of restrictive operational and financial covenants to which issuers need to remain compliant. This is distinct from the vast majority of unsecured corporate bonds. While these credit enhancements are a key protection, they do mean that we continued to engage in a number of discussions over the quarter with the most immediately impacted issuers (largely encapsulating the airport, retail property and leisure sectors) regarding temporary waivers and amendments to bond terms in order to accommodate the specific impacts of the Covid-19 pandemic. As mentioned in our Q2 report, intu Properties entered administration and in September, one of its subsidiary secured bond issuers, intu debenture, announced that it had failed to make a scheduled interest payment on its 5.562% 2027 debt. This followed an active decision by bondholders to preserve cash in the issuer and ensure the underlying shopping centre assets would continue to trade despite the significant short-term disruption to rental income from Covid-19 (including government allowance for tenants to remain in situ even if they are unable to pay rents), as well as an increase in temporary costs following the parent company entering administration. While disappointing, the relatively small impact on the portfolios emphasises the value of a diversified portfolio with a bias to bonds offering security and covenants. We continue to be involved in restructuring discussions as part of a unified bondholder group of institutional investors with a clear focus on maximising realisations. This applies also to other challenged intu-related secured bonds (SGS and Metrocentre, which were not in default in Q3), but where there are ongoing bondholder discussions that are focused on maintaining the shopping centres open and allowing for maximising potential recoveries should the situation deteriorate further. We will continue to monitor this situation closely and engage with stakeholders in order to

maximise recovery, and believe that market pricing is appropriate given the range of outcomes but reflecting our senior claim on the underlying assets.

- We approached all of these discussions with a common philosophy of balancing the need to be responsible lenders at a time of unprecedented social and economic disruption, while ensuring that we preserve our clients' economic interests. We have typically assented to the changes required, but in a number of cases we sought appropriate enhancements to maintain the correct balance between different stakeholders. While we expect these interactions to continue through the remainder of the year, this extraordinary event has underpinned our strong belief that security and effective covenants remain both undervalued by the market and underappreciated in terms of the tangible creditor control and protection they provide.

Activity

- Activity during the quarter was somewhat lower than normal. For our Buy & Maintain strategy, activity is driven by reducing holdings where we believe that there has been deterioration in the quality of the credit, or where new issues give us an opportunity to replace holdings with another that offers more attractive spread, lower risk, or both. New issues were somewhat quiet during the period, with the traditional August lull and September levels over half of the equivalent period last year.
- Social housing was one area where we saw activity, after several relatively quiet quarters. We have a structural bias towards this sector. Underlying cashflows are stable and most of the bonds issued are secured, while the sector is also delivering a wider social benefit. Examples during the last quarter included **Swan Housing**, which operates in Essex and East London with a focus on building homes that are environmentally, socially and economically sustainable, where we were able to buy secured 2048 bonds in the secondary market at more than 200bps over equivalent gilts. A new issue of note was **Hyde Group**, a not-for-profit housing association which focuses on the South-East of England, with more than 49,000 homes for over 100,00 people. Hyde issued 2055 bonds at a spread of 130bps. We also saw a tap of an existing 2049 issue from **Housing 21**, which provides properties for older people across the country, at a spread of around 150bps.
- We funded activity in social housing bonds by reducing exposure to gas utilities, through sales of bonds issued by **Cadent Finance**. Not only did this allow us to enhance spread, given that these both pay around 120bps over gilts, but we believe that this reduced longer-term risk, as we believe that gas distribution assets could face long-term pressures from the decarbonisation trend and 'net zero' Government objective.
- We prefer to focus utility exposure on electricity distribution, as these regulated companies have more stable cashflow and are less exposed to the decarbonisation trend. At the end of September we bought a new issue from **Western Power Distribution**, which operates in the Midlands, South West and Wales, at a spread of 125bps.
- Away from social housing, we looked for opportunities to add relative value. We purchased a new issue senior 2025 callable bonds from **Skipton Building Society**, selling investment bank **Goldman Sachs** 2029 maturity debt, thus increasing spread from around 130bps to 215bps, and doing this while reducing duration.
- We added a new issue from FTSE 250 real estate firm **Assura**. The company issued a 'social bond' with proceeds being used to fund acquisition, development and refurbishment of publicly accessible primary care and community healthcare centres. The bonds are unsecured, but underlying cashflows are therefore based on revenues from the NHS, and came at spread of 128bps. We also added a rare sterling issue from US REIT Realty Income, which came at a spread of 150bps, where a diversified portfolio of predominantly US commercial property assets provide us with some useful non-UK diversification.
- Rising downgrades and defaults remain a concern given the financial impact of the Covid crisis on many businesses. BBB is an obvious area to look at, as when bonds get downgraded from BBB into sub-investment grade, these can experience large price falls. At a glance, a material part of the portfolio is invested in BBB issues and could be seen as at-risk. However, our BBB exposure is very selective.. A large part of our BBB exposure falls into three categories, all of which we feel have lower downgrade risk than other parts of the BBB universe, particularly unsecured bonds in more cyclical areas:
  - Secured debt: a material proportion of our secured debt is BBB rated. These will be highly covenanted or have claims over specific cashflows or assets with a senior controlling creditor position
  - Utilities: we have a bias towards regulated utilities as these are required to maintain investment grade credit ratings as part of their licence to operate
  - Banks and insurance: the sector is regulated more strictly following the GFC, and is an area with high solvency ratios
- The sterling credit market is made up of over 80% in senior unsecured debt, while our portfolio has over half invested in secured debt, with a bias to senior bonds. We feel that this bias is particularly helpful in the current environment, where companies may be seeking extra cash. We have already seen several instances where new bondholders have looked for security over assets or seniority in the capital structure, which means they tend to subordinate the existing unsecured bond

holders. By investing in a senior secured bond format, we can avoid this subordination, thereby protecting our lending position.

Outlook

- The recent upturn in Covid-19 case numbers in the UK has forced the government to tighten its social distancing measures, including a 10pm curfew for pubs and restaurants, as well as encouraging everyone to work from home where possible. The current indications are that this policy will last the whole winter, and there is the potential for further restrictions if the measures fail to contain the spread of the virus. The economic recovery, which had already been slowing during the summer, may be jeopardised by these new lockdown measures and rising unemployment seems likely.
- Even if the measures succeed in curtailing the spread of Covid-19 and societies are able to return to more normal conditions, the economy is likely to be compromised over the medium term. The level of government debt has surged to levels not seen since the Second World War, while tax receipts will become increasingly challenged by rising unemployment. We expect the greater supply of government debt, which is presently being absorbed by the BoE, will eventually lead investors to seek higher yields, and thereby cause an upward trend in long-term interest rates.
- Over the next two or three years, however, interest rates look set to remain at very low levels, with yield curves heavily managed by governments. Central banks appear increasingly comfortable running inflation above their historic target levels, given their desires to avoid painful economic recessions. While we do not anticipate negative interest rates from the BoE in the near term, the BoE's analysis of the potential impact of negative rates suggests that they are a plausible possibility on the way out of an economic recession. As yet, there are few signs of higher inflation, but it remains a possibility that will need to be monitored.
- We expect that economic activity will gradually improve in 2021, particularly if a successful vaccine or treatment for the Covid-19 becomes widely available. There are, however, many threats to this expectation: the possibility of new waves of the virus, complications in the development and distribution of vaccines, subdued consumer confidence and business investment, corporate failures, and government and central bank policies. The UK also faces the additional uncertainty of new trading arrangements with the EU.
- Looking at our portfolio strategy, while we have seen a recovery in risk markets including sterling investment grade, there is no real change to our outlook since April – namely that the short-term outlook is highly uncertain. It is consequently essential that our portfolios are maintained in such a way that they will be resilient across a variety of market scenarios. Specific targeting within the BBB area, which is more prone to heavier price falls on downgrades to sub-investment grade, remains key in an environment of increasing ratings transition risk. Our emphasis on seniority within capital structures, proximity to the underlying assets and diversification across sectors and issuers remains necessary for controlling the risks that we may face.

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