ROYAL LONDON DURATION HEDGED 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[2]	86.7
Index linked credit bonds	0.1
Sterling conventional gilts	9.2
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.3
Foreign index linked sovereign	0.0
Derivatives	3.6
Other	0.0

Fund data

	Fund
Duration[3]	0.2 years
Gross redemption yield[4]	2.32%
No. of stocks	230
Fund size	£209.3m

Source: RLAM, based on the Z share class. Launch date: 24.09.2012.

[1]Benchmark: SONIA.

[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 (%)
Q3 2020	**2.03**	**0.01**	**2.01**
Year-to-date	-1.01	0.18	-1.19
Rolling 12 months	1.38	0.36	1.02
3 years p.a.	1.77	0.60	1.17
5 years p.a.	3.40	0.53	2.86
Since inception p.a. 24.09.2012	3.68	0.53	3.15

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 share class.

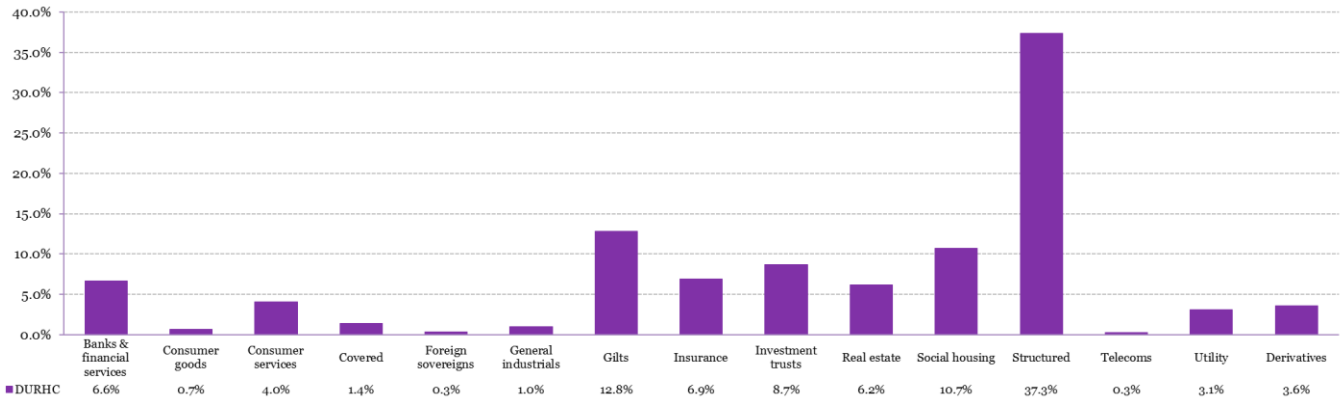
[1]Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 8th August 2019, and is reflected in the returns shown above.

Performance for the Royal London Duration Hedged Credit Fund is based on pricing at noon, while index performance is based on pricing at close of business, preventing direct performance comparison. The significance of this timing discrepancy is likely to be greater for shorter 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.

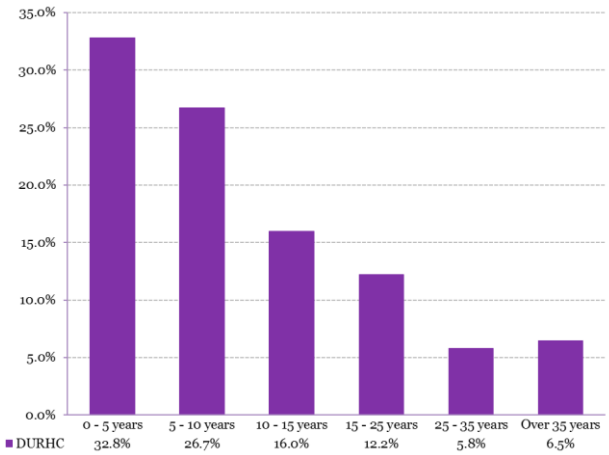
ROYAL LONDON DURATION HEDGED CREDIT FUND

Sector breakdown

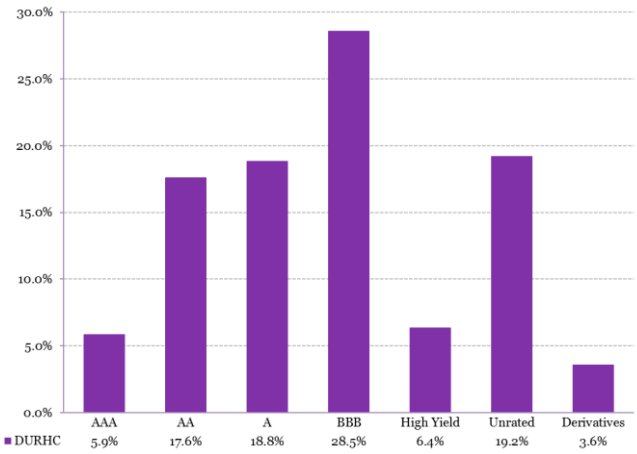


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Telereal Securitisation FRN 2033	1.5
British Land Co 5.264% 2035	1.5
Law Debenture 6.125% 2034	1.2
Edinburgh Investment Trust 7.75% 2022	1.2
Trafford Centre 2038	1.2
Mercantile Investment Trust 6.125% 2030	1.1
Grosvenor UK Finance 6.5% 2026	1.1
Finance for Residential Social Housing 8.368% 2058	1.1
Equity Release 5.7% 2031	1.1
Co-operative Bank 4.75% 2021	1.1
Total	**11.9**

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

ROYAL LONDON DURATION HEDGED CREDIT FUND

Fund activity and market commentary

- The fund performed well over the quarter, returning 1.89% against 0.01% for its benchmark. This was despite many of the bonds in the fund not being eligible for the Bank of England's (BoE) scheme, which meant our emphasis on secured and structured debt was unfavourable over the quarter (see below).
- This outperformance reflected two primary factors: the fund has a zero allocation to supranationals (the worst performing sterling credit sector) and selective holdings in subordinated financials (the best performing sectors). Supranational bonds have only a low yield advantage over government bonds, whereas the yields currently available on financial debt are highly attractive. Otherwise, the holdings in the social housing and structured sectors detracted slightly from performance. The fund also holds short-dated UK government debt, mainly as a requirement for collateral purposes for the interest rate swaps used to manage duration. This gilts exposure was detrimental for relative returns as short-dated gilts underperformed equivalent credit issues during the quarter.
- Economic activity continued to recover as social distancing requirements eased – however, this was tempered by fragile consumer confidence and renewed spikes in Covid-19 cases, leading to local lockdowns and travel restrictions. In addition, geopolitics re-emerged as an investment risk, with increasing concerns about the US presidential election in November and the possibility that negotiations between the UK and EU will fail to deliver a mutually-acceptable trade deal.
- The UK government continued to support the economy through its Coronavirus Job Retention (furlough) Scheme, tax deferrals, business grants and loan guarantees. In late September, the Chancellor of the Exchequer announced that the furlough scheme would be replaced from 1 November by a new Job Support Programme. The scale of the impact of the pandemic on government finances became clearer. UK government borrowing in the current year is now estimated to be £470bn (c. 23% of GDP). The BoE has continued to neutralise the impact of government bond issuance through asset purchases; this is due to be complete in November, although a further extension of quantitative easing is expected.
- With the economic recovery slowing and activity remaining below normal levels, and with so much monetary stimulus and government bond issuance, yields on benchmark 10-year government bonds fell over the quarter in nearly all major developed markets, apart from the UK, US and Canada. The yield on 10-year gilts increased 6 basis points (bps) to 0.23% and short-dated government bond yields remained negative at maturities of less than seven years, although the BoE played down the imminent likelihood of negative base rates.
- Sterling investment grade credit continued to outperform UK government debt over the quarter, reflecting a tightening of credit spreads. Gilts returned -1.23%, 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%.
- In new issues, social housing was an area where we saw renewed 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. We participated in longer-dated issues by **Hyde Group**, a not-for-profit housing association in the south-east of England, with more than 49,000 homes for over 100,000 people; and **Housing & Care 21**, which provides retirement homes and care. Otherwise, we bought structured bonds of **FOLIOR**, which is a subsidiary of the Notting Hill Genesis housing association, providing exposure to debt secured over privately rented homes. Other notable new issues included bonds of electricity distribution network operator **Electricity North West**; two AAA rated residential mortgage-backed securitisations (**CASTE 2020-1** and **PCLF 2020-1**); and 'social bonds' of **Assura**, a FTSE 250 healthcare-focused REIT, 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 based on revenues from the NHS, and came at spread of 140bps.
- Fixed and floating rate bonds of **Arsenal**, secured on the stadium, were redeemed early by the issuer at significant premia to existing valuations.
- 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 lower than the market average. We would expect this to be due to the 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.

- Intu Properties entered administration in the second quarter 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 portfolio 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 the third quarter), 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.
- The BoE's Corporate Bond Purchase Scheme reached its £20bn target for purchasing investment grade corporate bonds (i.e. an additional £10bn) on 1 October. This has distorted market valuations with many asset-backed securities and all financial bonds being excluded. This continued during the quarter, but its impact started to reduce as the programme wound down compared to earlier in the summer. As the scheme ends, we believe this will lead to an unwinding of the distorted market valuations of eligible corporate bonds, as occurred in 2016 and 2017 when the BoE previously bought corporate bonds as part of its asset purchase programme. It is difficult to predict a timeframe for this. The 2016 effect took several quarters to unwind and, while it may be reasonable to suggest a similar timeframe today, the crisis is still not over and so an extension of the scheme cannot be ruled out.

Key views within the portfolio

- Interest rate risk is reduced through derivative strategies.
- Zero exposure to supranational bonds, as we expect corporate debt to outperform over the medium term.
- An exposure to credit risk with minimal exposure to interest rate risk (hedged with interest rate swaps).
- A bias towards asset backed securities, an area that we believe still offers the best risk/return characteristics.
- A preference for subordinated financial debt, where we believe yields are attractive.

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 people to work from home where possible. The current indications are that these policies 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.
- 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 the portfolio is maintained in such a way that it 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 essential 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.
- Our investment philosophy underpins our confidence in the fund's ability to meet its objectives over the medium term despite the potential for further market volatility.

ROYAL LONDON
ASSET MANAGEMENT