ROYAL LONDON GLOBAL HIGH YIELD BOND FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

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Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2020	**3.79**	**3.53**	**0.26**
Year-to-date	-0.88	-0.67	-0.21
Rolling 12 months	1.12	1.65	-0.54
3 years p.a.	2.97	2.60	0.37
5 years p.a.	5.45	5.52	-0.07
Since inception p.a. 15.02.2013	4.83	4.45	0.38

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.

Source: RLAM. Based on the Z share class. 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.

[1]Benchmark: ICE BofAML BB-B Global Non-Financial High Yield Constrained,100% hedged to GBP.

Fund price and yields

	Distribution yield[1]
Fund	4.96%

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

[1]Net of standard management charges.

[2] Benchmark: ICE BofAML BB-B Global Non-Financial High Yield Constrained,100% hedged to GBP.

[3]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	Benchmark[2]
Duration[3]	4.2 years	3.6 years
No. of stocks	257	2,782
Fund size	£2,332.2m	-
Launch date	15.02.2013	-

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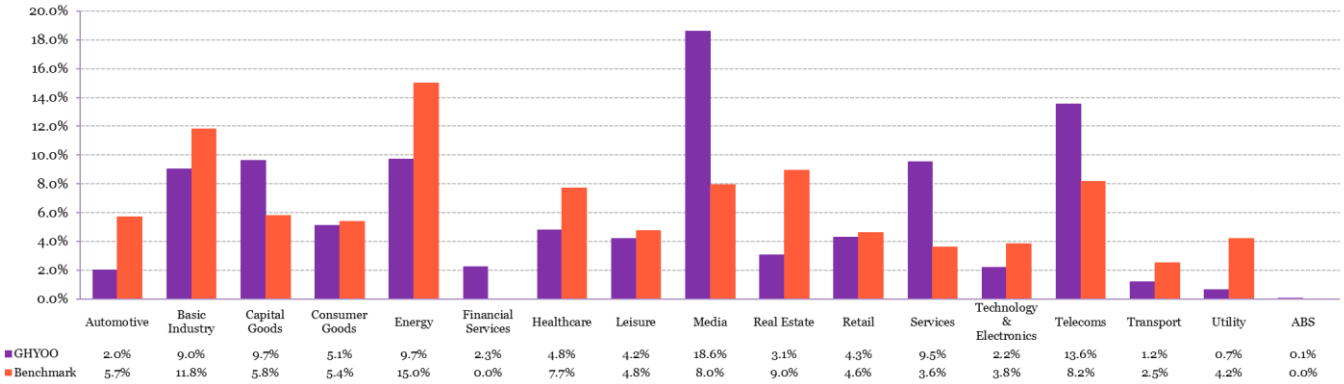
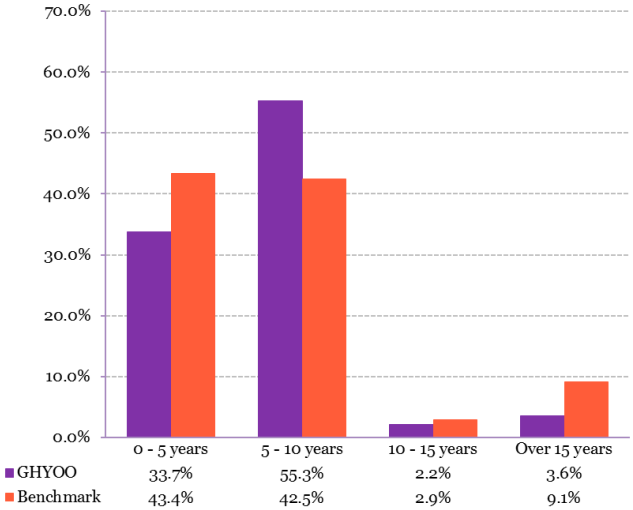
Sector breakdown



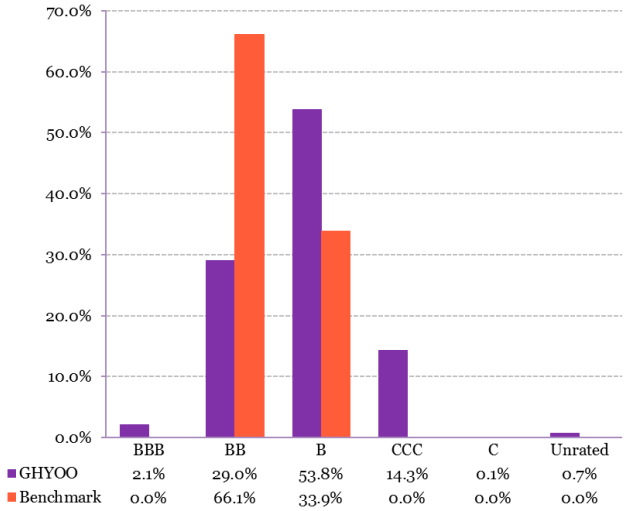
Source: RLAM.

Maturity profile



Source: RLAM. Maturity breakdown is the final maturity. Figures exclude the impact of cash held.

Credit breakdown



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

Ten largest bond holdings

	Weighting (%)
Stonegate Pub Co Financing 8.25% 2025	1.6
Wesco Distribution Inc 7.25% 2028	1.2
Delta Air Lines Inc Skymiles 4.75% 2028	1.1
TransDigm Inc 5.5% 2027	1.1
Univision Communications Inc 5.125% 2025	1.1
IHS Netherlands Holdco 9.5% 2021	1.0
Verisure 5.75% 2023	1.0
Petroleos Mexicanos 6.75% 2047	1.0
Ford Motor Credit Co 3.25% 2025	1.0
HTA Group Ltd 7% 2025	1.0
Total	**11.1**

Source: RLAM. Percent of fund is based on security's fund base value over total fund base value less cash and FX hedging.

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Market overview

- The global high yield market continued to perform strongly for much of the third quarter, though credit spreads widened in September. Overall, the high yield spread contracted by 64 basis points (bps) over the quarter, ending September at 496bps. This strong performance reflected a multitude of factors. There were signs of improvements in underlying economic data as many economies reopened amid falling Covid-19 case numbers. Corporate earnings were stronger than expected; often due to resilient revenues rather than mere cost cutting. There was also plenty of positive news on the development of vaccines and treatments for Covid-19. All of these factors encouraged greater risk taking from investors.
- This positive momentum was partially unwound in September, almost entirely as a result of outflows from high yield exchange-traded funds (ETFs). The high yield spread consequently widened by 45bps over the month. The assets under management (AUM) of high yield ETFs ballooned in the months after the market crisis as a result of policy support from the US Federal Reserve. The AUM of the largest high yield ETF (JNK) doubled, to a level more than 50% higher than it was before the crisis. The ETF had $5bn of outflows in September which, though trivial compared to the $1.2trn US high yield market, accounted for almost half of the monthly average trading volume in US high yield. This is because ETFs tend to have very lumpy cashflows, causing higher levels of market volatility.
- The experience of the extreme sell-off in the high yield market in March, followed by the dramatic recovery over the subsequent months, has highlighted to us the somewhat surprising relationship between liquidity and volatility. Despite the unprecedented market moves during the crisis period, we believe that liquidity remained widely accessible, enabling continuous price discovery and the consistent transfer of risk between market participants. In High yield liquidity: in at the deep end you can read our analysis of how the increase in liquidity in the high yield market has resulted in higher levels of volatility. Additionally, you can listen to senior fund manager Stephen Tapley presenting on this topic at our recent virtual investment conference here.
- It was the second busiest quarter for high yield issuance ever; the busiest having been the previous quarter. This reflected companies taking a proactive approach in managing their risks, conscious of the pressures they came under in March, with the replacement cost of capital being lower for almost all of them. The amount of issuance was almost double that seen in the third quarter of 2019, with the majority being BB or B rated and overwhelmingly coming from the US dollar market. The comparatively muted European issuance continued to reflect the fact that European companies were able to raise liquidity through public sector facilities, rather than relying on the primary market.
- Having rallied strongly in the second quarter, oil prices traded within a fairly narrow range during the third quarter, ending September close to the price at the end of June. Natural gas prices performed more strongly, rising from around $1.75 per million British Thermal Units (MMBtu) to approximately $2.5/MMBtu. Reflecting the backdrop of rising commodity prices over the second and third quarters, as well as factors like an increase in the quality of the sector due to fallen angels (credit downgrades from investment grade to high yield) energy was the best performing sector in July. However, it was the worst performer in September, possibly reflecting the fact that the rally in oil prices had ended.

Portfolio commentary

- The fund continued to perform strongly over the quarter, ahead of its benchmark. There was a strong rally in the market in July, which the fund kept up with. This was followed by a period of strong outperformance for the fund in August, before marginally lagging in September amid the market sell-off. The fund was able to hold onto its outperformance due to a number of individual stories playing out. While the fund is still down in absolute and relative terms for the year to date, it has significantly retraced its underperformance during the market recovery.
- Given the enormous support for the high yield market from central banks, we took a pragmatic view on risk during the quarter, adding a lot of new issues. We concentrated on the areas of the market that featured wider spreads, where we felt that the likelihood of default was excessively priced. These were generally the sectors with first- and second-derivative exposures to Covid-19. There were two main reasons for our interest in these areas: either the bonds featured very high yields, or we were confident that the sectors would recover. We felt that they were still being priced based upon the volatility in March, rather than factoring in the reduction in risk levels due to the intervention from the US Federal Reserve in April.
- At the sector level, we tried to close the fund's underweight exposure to the energy sector by putting on more idiosyncratic exposure to the index. Many of the companies in the sector have been downgraded from investment grade or feature large and complex capital structures, with strong liquidity and non-core assets. That gives them a multitude of options in terms of investment sales to ensure their survival through protracted periods of limited cashflows.
- We also sought to reduce the fund's underweight exposure to the autos sector, by adding names such as **Ford** and **Jaguar Land Rover**. Ford, whose bonds became fallen angels in April, is supported by the US government, while Jaguar Land Rover declined a UK debt facility in favour of a Chinese one, so both companies are protected by government backing. Elsewhere, we added debt of transportation companies such as **United Airlines** in September. The bonds of United

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Airlines were quite unusual, being secured on air miles, and provided a lot of downside protection. The airlines has turned down assistance from the US government, though the fact that such assistance was offered shows that there is likely to be a backstop in the event of more serious financial difficulties for the company.

- On the other hand, we sold out of some of the fund's debt which had done very well. An example would be the US gaming company **Boyd Gaming**, which had rallied from the mid-80s up to par in the space of two months. We took profits on the debt, rotating into the areas that we thought were more interesting. The portfolio also benefitted from a few refinancings. One was the US petroleum and natural gas exploration and production company **Continental Resources**. Another was the utility **Pacific Gas and Electric Company**, which had recently emerged from one of the largest and most complex bankruptcies in US history.

Outlook

- While Covid-19 has certainly not disappeared, countries appear to have learned to cope with it better. There is evidence that treatments for the virus have improved and vulnerable people are being more effectively shielded. As a consequence, the proportion of deaths from the virus compared to total cases has fallen. At the same time, government measures for combating the virus are now less draconian, as alternatives to blanket lockdowns like 'test and trace', the rule of six and localised lockdowns have become viable.
- The economic damage wrought by Covid-19 and the measures to contain its spread have been substantial. While most sectors have bounced back strongly, the second-order impacts remain evident. We expect that economies will recover slowly from here, with unemployment in the 7-9% range. Nevertheless, default rates are likely to peak in the high single digits (far lower than much of the market commentary imagined during the crisis) and be concentrated in the energy sector. There is still a high level of policy support in most economies, and this is likely to be increased in the US via the CARES Act.
- Over the next two or three years, 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. As yet, there are few signs of higher inflation, but it remains a possibility that will need to be monitored.
- There are risks surrounding the upcoming US elections, but we think that there is as much chance of a Biden landslide as there is of a contested race. We consider the main risk to be the Democrats gaining all three branches of US government, leading to a much more radical agenda that impacts the private equity industry and corporate taxation levels, ultimately lowering corporate valuations. Yet this outcome would be much worse for equity markets than for credit markets. Elsewhere, the risk of a hard Brexit has recently resurfaced, but we regard it as a lower probability outcome that would have a smaller impact on Europe than would have been the case a year ago.
- As credit investors, dealing with asymmetric pay-offs, we are natural pessimists. Yet the current environment appears extremely conducive for investing. The impact of the virus has become more predictable, growth is more muted, labour is cheaper and policy support is plentiful. While political risks still abound, they are lower than they were a year ago. We think that credit markets should be trading tighter now than they were at the beginning of the year, and yet they are 50% wider in spread terms. We are consequently bullish in all of our strategies, considering the current excess spread in the market to offer significant compensation for default and other risks given the extraordinary support from central banks.

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