



## **ROYAL LONDON STERLING EXTRA YIELD BOND FUND**

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### **Quarterly Report 30 September 2020**

For professional clients only, not suitable for retail investors

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## ROYAL LONDON STERLING EXTRA YIELD BOND FUND

### Executive summary

- The fund recorded a return, gross of tax and management fees of the A share class, of 2.85% during the third quarter.
- Sterling investment grade credit starkly outperformed gilts during the quarter; respective all-maturities returns were 1.16% and -1.23%. Credit spreads on the ML Sterling Non-Gilt index tightened from 1.47% to 1.29% over gilts, with the iBoxx sterling non-gilt index seeing a similar move.
- Distributions in respect of the third quarter, payable at the end of November, are 1.54p, 1.38p, 1.46p and 1.44p respectively for the A, B, Y and Z class income shares. These are markedly up from the second quarter distributions of 1.41p, 1.26p, 1.34p and 1.32p respectively for the A, B, Y and Z class income shares, but still well below the 1.81p, 1.64p, 1.71p and 1.69p respectively for the same period a year ago. The lower levels this year reflect the general lower level of yields prevailing, which influences the reinvestment yield of inflows from investments; the recent investment in short-dated government bonds to increase fund liquidity in volatile market conditions and to take advantage of attractive opportunities; and some deferral of income payments in the present, still challenging, economic environment.

### Performance

	Fund (Class A) %	Fund (Class Z) %
<b>Q3 2020</b>	<b>2.85</b>	<b>2.85</b>
Year-to-date	-4.30	-4.29
Rolling 12 months	-2.40	-2.39
3 years p.a.	3.18	3.19
5 years p.a.	6.63	6.63
10 years p.a.	8.70	-
Since inception p.a. 13.12.2013	-	6.64
Since inception p.a. 14.04.2003	7.93	-

**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 <sup>1</sup>	Gross income yield <sup>1</sup>
Fund (Class A)	5.43%	5.43%
Fund (Class Z)	5.69%	5.69%

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

<sup>1</sup>Net of standard management charges.

<sup>2</sup>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 <sup>2</sup>	4.9 years
No. of stocks	225
Fund size	£1,898.1m
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 4.9 years. The sensitivity of the performance of the fund to changes in gilt yields is therefore relatively modest.

### Fund commentary

- The trend for gilt yields for the year to July was distinctly downwards, reflecting the prospects of an extended period of low short-term interest rates and massive quantitative easing stimulus. This reversed in August, when the yield on the benchmark 10-year gilt, having declined over each prior month in 2020, rose from 0.10% to 0.31%. The yield on the all-maturity gilt index almost doubled, from 0.26% to 0.45%, resulting in the worst monthly return since the 2016 referendum and the third worst in over a decade. The selloff in gilts was partially retraced in September amid a marked pick-up in Covid-19 cases and political uncertainty ahead of the US presidential elections. 10-year gilt yields finished the quarter at 0.23%, having started it at 0.17%. Credit spreads tightened, with the ML Sterling Non-Gilt index contracting from 1.47% to 1.29% over gilts. Consequently, sterling investment grade credit markedly outperformed gilts, with all-maturities returns of 1.16% and -1.23%, respectively.
- A number of the fund's holdings within the financial sectors (banks and insurance) performed very strongly over the quarter. This reflected their sensitivity to the continued improvement in sentiment in corporate bonds, as well as their strong income generation. Among them, noteworthy contributions to returns came from the banks **Investec** and **Barclays**, the financial services company **Virgin Money**, and the insurance businesses of **M&G** and **Pension Insurance**. An exception to the generally strong performances from the fund's financial debt was the holding of **Metro Bank**. Covid-19 has compromised the profitability of the challenger bank, as it has been forced to increase loan provisions for bad debts. Elsewhere, 'hybrid' bonds of **Centrica**, were up significantly on news of a \$3.6bn sale of US assets in order to reduce the company's debt burden. Surprisingly, though, both Moody's and Standard & Poor's rating agencies reacted by putting the company on 'credit watch negative', citing reduced diversification within the business.
- Some of our holdings of secured and structured bonds, which are largely excluded from the Bank of England's Corporate Bond Purchase Scheme, underperformed. Among them, issuers **Heathrow** and pub business **Mitchells & Butlers** came under additional pressure in the context of the challenges to their business models from Covid-19. However, the balance sheets of these companies retain significant liquidity and our exposure to them is in bonds that have claims over assets that we feel adequately protect us, which should ultimately be reflected in market pricing. Unrated secured bonds of property group **Peel Holdings** weakened during the quarter on concerns over ongoing challenges in the retail sector – the security pool in the bonds being primarily out-of-town retail parks. Investments in shipping, typically secured and over-collateralised, with a first charge on assets, were generally strong following subdued recent performance – these included **Borealis Finance** and **MPC Containerships**.
- While the share price of **Amadeo Air Four Plus**, the aircraft leasing business, was little changed over the quarter, ending September at 33p, the company repaid one third of holdings at a price of 46p. This reflected the sale proceeds of two aircraft to Etihad earlier in spring this year. The company also announced its intention to resume dividend distributions, which had been suspended in April. Repayment proceeds from **Mutual Securitisation** and power generation firm **InterGen** were also received during the quarter. Both of these repayments have been reviewed in recent months' fund commentaries.
- Activity in the fund was fairly limited in July and August, reflecting the quieter holiday period, influential even in the context of the travel situation in the pandemic. With respect to new issues, purchases included B rated, secured, five-year bonds of **Stonegate**, refinancing part of the cost of its recent acquisition of Enterprise Inns in a deal worth nearly £1bn. A bond was added from shipping group **Navigator Gas**, issued to refinance a 2021 maturity bond in which the fund had a holding. Consequently, overall exposure to the company was little changed, while increasing coupon and extracting a modest price differential on the exchange. Activity picked up in September, with investment in new issues of **Virgin Money**, leisure business **Centre Parcs**, **European Energy**, **Brooge Petroleum and Gas**, property business **Scentre Group** and **Genel Energy**. New tranches of bonds of shipping business **Klaveness Combination Carriers** and data centre owner **Bulk Infrastructure** were also purchased. These investments were financed by the sale of short-dated gilts and bonds of **Fibo Group**, the Scandinavian bathroom fittings manufacturer, crystallising a capital profit from purchase in 2019, in addition to income generation of more than 8% per annum.

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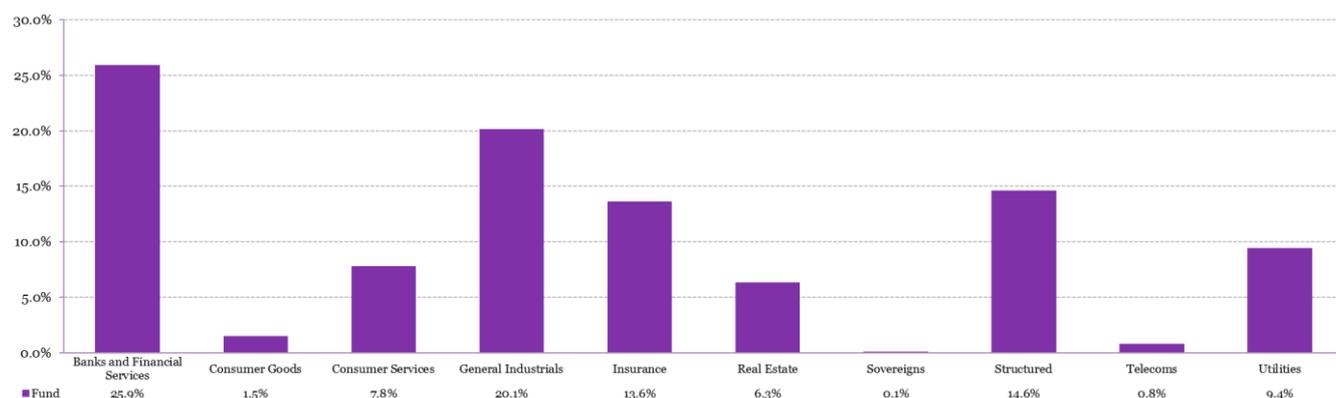
### Investment outlook

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- 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 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.

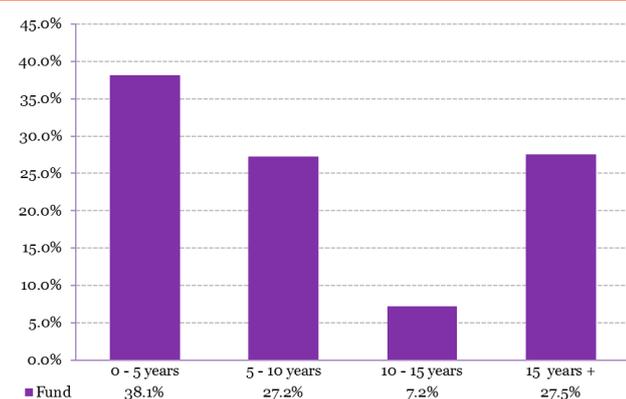
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### Sector breakdown



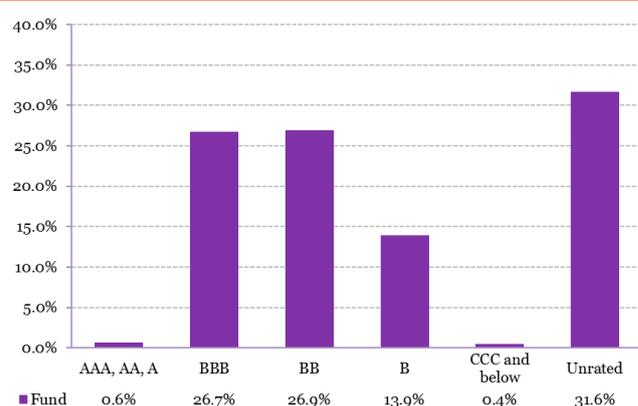
Source: RLAM. Figures exclude the impact of cash held.

### 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	2.7
Électricité De France 5.875% 2029	2.3
Centrica 5.25% 2025/75	2.3
Santander UK 10.0625%	2.3
M&G 6.34% 2043/63	2.2
Anglian Water Osprey 4% 2026	1.8
Phoenix Group 5.75% 2028	1.7
Scottish Widows 7% 2043	1.6
Santander UK 10.375%	1.6
Heathrow Finance 3.875% 2027	1.5
<b>Total</b>	<b>20.0</b>

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

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