



Royal London Short Duration Credit Bond Fund

Quarterly Report 31 December 2021



Asset split

	Fund (%)	Benchmark ¹ (%)
Conventional credit bonds ²	99.6	99.7
Index linked credit bonds	0.4	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.3
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

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 ¹
Duration ³	2.8 years	3.1 years
Gross redemption yield ⁴	2.35%	1.41%
No. of stocks	319	465
Fund size	£1,141.3m	-

Source: RLAM, based on the Z share class. Launch date: 08.11.2013.

¹Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index

²Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

³Excluding cash

⁴The gross redemption yield is calculated on a weighted average basis

Performance

	Fund (%)	Benchmark ¹ (%)	Relative (%)
Q4 2021	-0.30	-0.68	0.38
Year-to-date	1.55	-0.98	2.53
Rolling 12 months	1.55	-0.98	2.53
3 years p.a.	3.96	1.98	1.99
5 years p.a.	3.45	1.53	1.92
Since inception p.a. 08.11.2013	3.87	2.08	1.79

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.

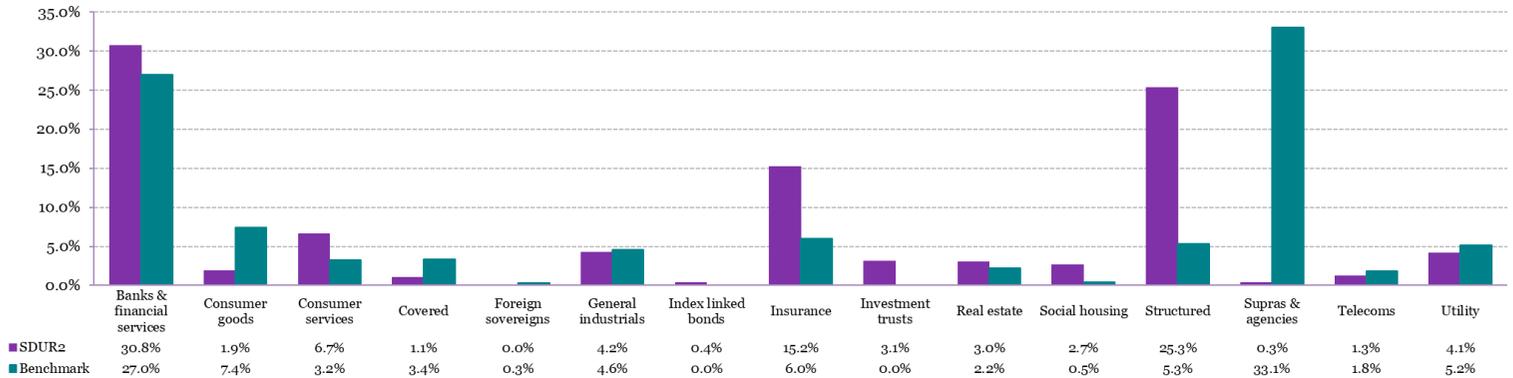
Source: RLAM, based on the Z share class.

¹Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index.

Performance for the Royal London Short Duration Credit Bond Fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over longer measurement periods.

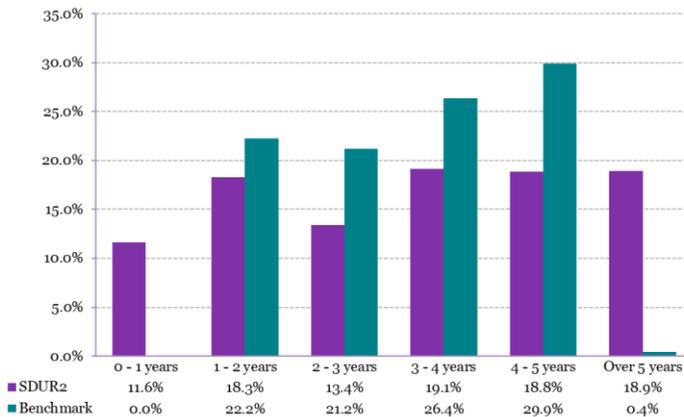
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Sector breakdown

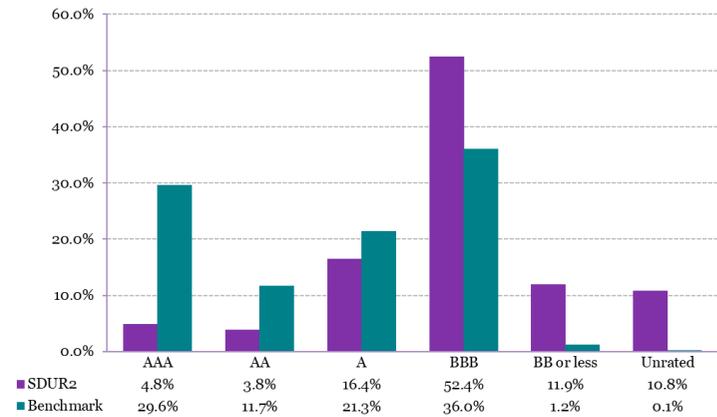


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Lloyds Bank Plc 7.625% 2025	1.2
Électricité de France 6% VRN Perpetual	1.1
M&G Plc 3.875% 2049	1.1
Delamare Finance 5.5457% 2029	1.0
AXA 6.6862% VRN Perpetual	1.0
Eversholt Funding Plc 6.697% 2035	1.0
BNP Paribas 2% 2031	0.9
Rothschild Continuation Finance 9% VRN Perpetual	0.9
Edinburgh Investment Trust Plc 7.75 2022	0.9
HSBC Bank 5.375% 2030	0.9
Total	10.2

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



Market overview

- The themes that influenced the market earlier in 2021 continued in the fourth quarter: periods of volatility – arising from new strains of Covid-19, renewed travel restrictions and lockdown measures, as well as concern about inflation and the implications for quantitative easing (QE) and interest rates – may have filled the headlines, yet the global economy continued to recover from the impact of Covid-19 and corporate earnings surprised on the upside.
- The travails of the Evergrande property company and the deflation of the Chinese real estate bubble continued, albeit without significant effects on global financial markets. Meanwhile, bottlenecks in supply chains and labour shortages caused by Covid disruption (and, in the UK, possibly exacerbated by Brexit) continued to result in price spikes. For the UK, using implied inflation at a 20-year horizon, 2021 started with a rate just above 3%, before moving higher to 4% during the course of the fourth quarter. Movement at the short end of the implied UK inflation curve was more extreme, mirroring the sharp rise in RPI. Other markets showed similar patterns, as their own inflation measures adjusted to higher energy costs, supply chain bottlenecks and labour shortages.
- Nonetheless, fears of inflation seemed to ease with a change in rhetoric and some action from central bankers. The Bank of England surprised investors in December by raising the UK base rate for the first time in three years – from 0.1% to 0.25% – as the Omicron variant hit the UK, having held steady in November; while the Federal Reserve (Fed) started to taper its QE programme and guide investors to earlier and faster rate rises in 2022. Investors appeared relatively sanguine about these policy changes as they had been trailed from September and, to an extent, taking moderate action on inflation was seen as less of a risk than no action.
- Whereas the third quarter started with the spread of the Delta variant of Covid-19, the fourth quarter began with some confidence about vaccine programmes and the rollout of booster jabs. There was concern about the rapid spread of the Omicron variant as the holiday season loomed; however, while there are ongoing fears about the ability of healthcare systems to cope with the huge numbers of new cases and the impact of staff shortages on key services, investors quickly took comfort from early data from South Africa that suggested that, while highly contagious, this variant is less deadly, and vaccines remain effective in mitigating its effects.
- Over the fourth quarter, the benchmark 10-year gilt yield fell from 1.02% to 0.97%, leading gilts to return 2.42% on an all-maturities basis (FTSE Actuaries). The apparent stability of the gilts market is misleading, however: having risen to 1.20% in late October, the 10-year gilt yield rallied to just 0.70% on 13 December (before the Bank of England raised the UK base rate), then ending the year at 0.97%. For the year as a whole, the rise in gilt yields (from 0.20% to 0.97% for the 10-year gilt) led gilts to return -5.16%. gyrations in the US treasury market were less extreme than for gilts: starting below 1%, the peak was recorded in March at 1.7% before falling back to 1.2% by August and ending the year above 1.5%. German 10-year bund yields remained negative throughout the year, ending at -0.2%.
- Credit market returns were more pedestrian than gilts for the fourth quarter – sterling investment grade credit returned 0.34%, as the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened from 0.87% to 0.98%. Sterling investment grade credit returned -3.09% for the year as a whole, outperforming gilts, with the credit spread tightening by one basis point to 0.98%.
- Sterling credit sector returns were mixed for the fourth quarter. Real estate, healthcare, capital goods and utilities were particularly strong, and asset-backed securities again delivered strong returns compared to the broad market. Supranational bonds underperformed as did the financial sectors – senior and subordinated banks were weak, as were the subordinated insurance and covered bonds subsectors. Longer-dated bonds strongly outperformed shorter-dated issues – only bonds with maturities greater than 10 years delivered significant positive returns. Otherwise, A and AA rated bonds outperformed BBB rated bonds, but AAA rated bonds delivered negative returns.

Portfolio commentary

- The stabilisation of the gilts market in the fourth quarter provided some welcome respite, but 2021 was nonetheless the worst year for global sovereign bonds since 1999. Despite positive returns in the final quarter, gilts returned -5.16% on an all-maturities basis for the year as a whole. Such large movements in government bonds meant that it was also a difficult year for sterling investment grade credit investors, with the iBoxx Sterling Non-Gilt All Maturities Index returning -3.09%. Short-dated credit, with its lower exposure to interest rate risk, returned -0.98% for the year.
- Nonetheless, we are pleased that our sterling credit strategies continued to outperform over the final quarter and delivered very strong relative performance for the full year. Despite the hostile environment, a number of our funds (whether all-maturities or short-dated) produced positive absolute returns and most delivered top-quartile relative returns compared to their Investment Association (IA) sector peer groups. Our funds' outperformance in 2021 (and, for most funds, also over three and five years) is the result of a clearly established investment philosophy and process. We emphasise the importance of well-diversified portfolios to mitigate the overall impact of defaults; and our active



investment approach seeks to identify high-quality bonds that offer good value, which aren't always found in the mainstream parts of the market covered by indices. At times our approach will be at odds with market moves, giving rise to periods of underperformance, but we firmly believe that in the long term our philosophy will deliver positive relative returns.

- Most summaries of the fourth quarter will refer to 'volatility', but what does it mean in practice? If we look at October, returns for the month were not abnormal. However, over the period, the one-year sterling money market rate was up from 0.38% to 0.82% while the yield of the five-year gilt rose from 0.54% to 0.74% (from -0.06% at the start of the year). Conversely, compared to the rising yields seen in money markets and short gilts, the yield of the 50-year gilt *fell* from 1.16% to 0.87% over the quarter, corresponding to a rise in price of over 11%, as the Budget delivered a £60bn reduction in gilt issuance
- The fund had another strong quarter, with outperformance driven by stock selection. **General Electric** was a notable example. We don't tend to favour the general industrials sector and GE wasn't a preferred issuer over many years, due to its low credit spread. However, as the company's bonds were downgraded by ratings agencies from AAA, we felt they increasingly offered value; and, when the bonds were downgraded to BBB in 2018, resulting in a material price fall, we added further to our positions. This paid off this quarter as GE tendered for some of its outstanding bonds following the announcement of its major restructuring. There was also a notable contribution from a 'legacy bond' of **NatWest Markets**, following a tender in November. We have added to legacy financial capital instruments over a number of years in a number of our funds. Many of these bonds will not count as capital in the medium term and we expect ongoing capital management, including further buybacks.
- For sterling credit, new issuance tailed off in December due to increased volatility and seasonal factors, but all three months of the quarter were stronger than in 2020, and issuance for 2021 as a whole was robust and exceeded expectations. The favourable conditions that were in place in October meant that some deals that looked attractive initially were tightened during the book building phase to levels where we passed; however, as the market became more turbulent, spreads widened to more attractive levels. Euro investment grade credit issuance was low in December and for 2021 as a whole both the euro and sterling markets lost share to the US dollar market.
- Notable new issues in which we participated included senior banks issues from **IG Group** and **ICAP**, subordinated issues from French bank **BPCE** and **abrdn** (formerly Standard Life Aberdeen), and a short-dated covered bond of **BayernLB**. In the structured sector, we bought a mortgage-backed securitisation from **Sage** (sterling tranche A), and in the secondary market, we added structured bonds of **Anglian Water Osprey**, **Thames Water**, **Mitchells & Butlers**, **Heathrow Finance** and **Center Parcs** – the last of these was a switch from a shorter-dated bond of the same issuer.
- There was further issuance of green and sustainable corporate bonds in the quarter. While we welcome the greater recognition of climate challenge and the higher focus on ESG, we do not believe that all 'labelled' bonds offer value or clarity of objective. We will continue to focus on integrating ESG risk and to add incremental value in overlooked areas of the market.

Outlook

- There is considerable uncertainty about the year ahead. The volatility that erupted at points in 2021 has already been evident this year as the minutes of the December FOMC meeting (published in early January) indicated that the Fed is prepared to increase rates earlier and faster than previously signalled. This has caused weakness in government bond markets and to a reappraisal of more highly rated equity sectors, such as technology. With the withdrawal of QE programmes and the expectations of strong global growth in 2022, markets are pricing in at least three Fed hikes this year and four more from the Bank of England.
- Despite the current spike, we are not convinced about the arguments for inflation returning in the long term. There are plenty of potential factors that may mitigate inflationary pressures, including higher taxes, the slowdown in growth in China (arising from the deflation of the Chinese property bubble and the government's zero-tolerance approach to Covid-19) and the possibility of lower energy costs in the latter part of the year. Overall, whilst central banks are raising interest rates sooner than anticipated a few months ago, we believe that inflation will ease considerably by the second half of this year and that we remain in a relatively low interest rate environment.
- Nonetheless, we remain cautious on government bonds. This reflects both the waning impact of QE and the bounce back in economic growth. There is scope for US treasuries to settle above 2%, with real yields moving higher and yield curves to steepen. However, on a secular basis we remain in a relatively low growth phase – despite technological advances. We cannot buck the long-term impact of ageing societies, nor the bills that will need to be paid for Covid and preparing for the next pandemic. In the UK this means more of our national spending going to the NHS – and more issuance of government debt.



- Credit generally outperforms government bonds – with the caveat that when it underperforms, the magnitude can be meaningful; for long-term investors the balance of outcomes sits firmly in favour of credit. However, credit risk is not something that should be taken unthinkingly, and it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.
- We will maintain our long-standing focus on risk management by seeking to identify companies with strong balance sheets; favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors and other factors. In addition, we expect to maintain an overweight position in subordinated financial bonds where credit spreads remain attractive.

Find out more

- A record number of current and prospective clients and consultants joined us online for the *2021 RLAM Investment Series* (our annual client conference) between 1 and 5 November 2021. Fund managers and other in-house specialists addressed the macroeconomic environment and prospects for different asset classes, and the issues that they consider in managing their funds. There were also sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. All the sessions are available to watch on demand – please visit the [RLAM Digital Insight Hub](#).
- You can find more of our thoughts on the opportunities and risks in the year ahead in our [RLAM Outlook 2022](#) document, and regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk. Head of Fixed Income Jonathan Platt writes a weekly blog each Monday on key issues in sterling credit and other fixed income markets.



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