



Royal London Short Duration Global High Yield Bond Fund

Quarterly Report 31 December 2021



Performance

	Fund (%)	Benchmark ¹ (%)	Relative (%)
Q4 2021	0.70	0.02	0.68
Year-to-date	3.55	0.06	3.50
Rolling 12 months	3.55	0.06	3.50
3 years p.a.	3.10	0.39	2.71
5 years p.a.	2.61	0.45	2.17
Since inception p.a. 15.02.2013	3.58	0.49	3.09

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 Inc share class. Performance for the fund is calculated on a mid basis with income re-invested.

¹Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 15 December 2020, and is reflected in the returns shown above.

Fund price and yields

Distribution yield	
Fund	4.61%

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

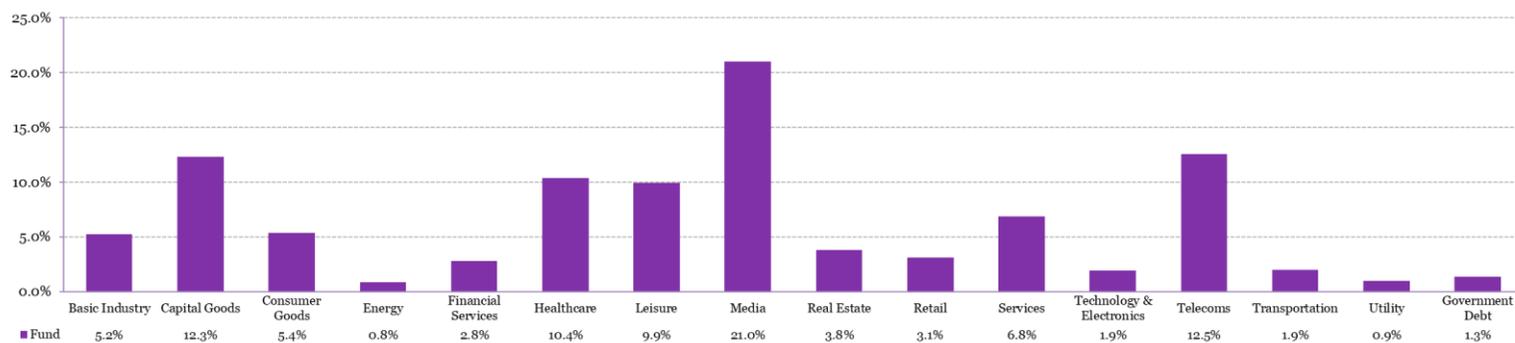
²Excluding cash

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

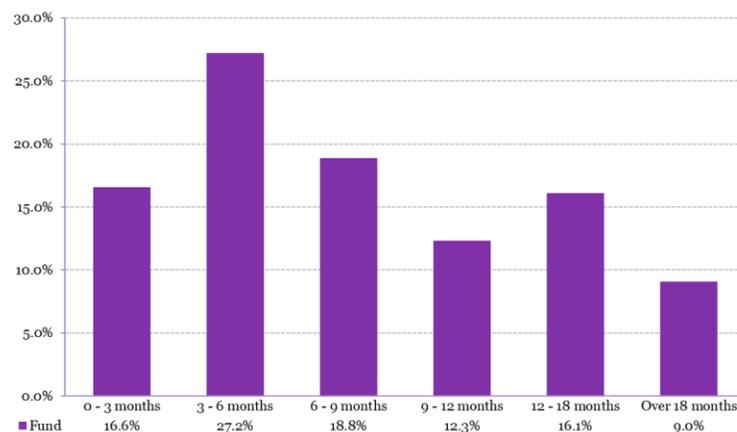
Fund	
Duration ²	0.7 years
No. of stocks	119
Fund size	£1,335.2m
Launch date	15.02.2013

Sector breakdown

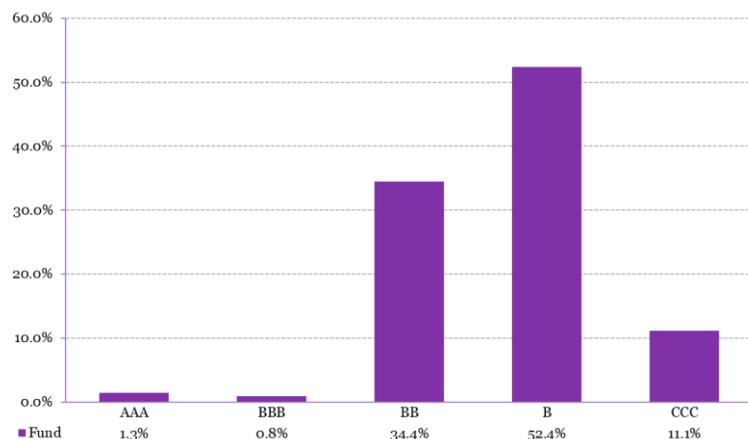


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Grifols 3.2% 2025	1.7
CSC Holdings Llc 7.5% 2028	1.6
Transdigm Inc 6.25% 2026	1.6
Telenet Finance Luxembourg 5.5% 2028	1.6
Ziggo Secured Finance 5.5% 2027	1.6
Silgan Holdings Inc 3.25% 2025	1.6
AMC Networks Inc 4.75% 2025	1.6
Virgin Media 5.0% 2027	1.5
CCO Holdings Llc 5.125% 2027	1.5
Wesco Distribution Inc 7.25% 2028	1.4
Total	15.8

Source: RLAM. Percent of fund is based on Security's fund Base Value over Total fund Base Value less Cash and FX Hedging, subject to rounding.



Market overview

- After three benign quarters of spread tightening and riding the occasional periods of volatility without too much trouble (including the effective failure of Evergrande in China), the fourth quarter proved more testing. However, the challenges were largely confined to the week or so around Thanksgiving, when the rapid emergence of the Omicron variant of Covid-19 (and more hawkish guidance from the Fed on inflation) unsettled government bond markets, and this spilled over into global high yield markets. It would be somewhat overdramatic to call this ‘The Thanksgiving Massacre’: it served more to clear out the pipes and reboot the market for a strong year end.
- At the start of 2021, we were particularly bullish on the outlook for global high yield. Despite some challenges with new variants of Covid-19 and supply-chain frictions, the global economy was recovering strongly and there was considerable optimism about the rollout of vaccines. With very low default rates and with many issuers having refinanced their debt at ultra-low interest rates, the high yield spread started the year at +360 basis points (bps) and had tightened to +345bps by the end of September, having reached +330bps in the summer. Global high yield markets escaped the volatility in government bonds in January and February as this was in the 10-year part of the market, whereas the duration of the high yield market is around four years.
- In the fourth quarter, the travails of the Evergrande property company and the deflation of the Chinese real estate bubble continued, albeit without significant effects on the global asset class. We were underweight China throughout the period and had no direct exposure to Evergrande; and with the company dropping out of the indices, China will be a less significant element of global high yield markets for some time to come. Pre-Thanksgiving, as evidence built up that inflation might not prove to be as transitory as hoped and policymakers started to talk about tapering and eventual interest rate rises, spreads started to widen and yields rose gently – yields reached around 4.3% in absolute terms, with the high yield spread ending October at +360bps (where it had started the year). However, the coming together in November of fears about the Federal Reserve’s (Fed’s) policy response to rising inflation and the emergence of the Omicron variant in South Africa caused financial markets to wobble and high yield was no exception – the spread widened to c. 400-410bps and the market’s yield reached its highpoint for the year at c. 4.8%.
- The storm was over almost as soon as it had started, and December saw high yield markets recover strongly. While there are ongoing concerns about the ability of healthcare systems to cope with the huge numbers of new Omicron 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. Likewise, the Fed generated more confidence that it appreciated the risks of inflation and policy overreaction, calming investors’ fears. The year ended with spreads back down to +350bps and an overall yield of 4.2%. The areas of volatility remain in energy (oil prices rose over 50% in 2021 as a whole, but had a difficult November and ended the year off their highs) and in ‘Covid reopening’ sectors such as travel and leisure, where valuations have recovered but revenues are still weak.
- Over the fourth quarter, the benchmark 10-year treasury yield increased slightly from 1.49% to 1.51%. The apparent stability of the market is misleading, however: having risen to 1.70% in late October, the yield on the 10-year treasury rallied to just 1.34% in early December. It had started 2021 at just 0.91%. Fears of inflation seemed to ease with a change in rhetoric and some action from central bankers. The Fed started to taper its QE programme and guide investors to earlier and faster rate rises in 2022; while the Bank of England (BoE) surprised investors in December by raising the UK base rate for the first time in three years – from 0.10% to 0.25% – as the Omicron variant hit the UK, having held steady in November. Investors appeared relatively sanguine about these policy moves 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.
- While new issuance slowed in the third quarter and more-or-less stopped after the market’s travails in November, 2021 was still a record year for new issuance. After c. \$300-400m in the nine months of 2020 and c. \$500m in 2021, half the market has been extended and this will be positive for default rates in the year ahead. Refinancings should be quieter in the year ahead, but there is a lot of leveraged buy-out (LBO) activity in the pipelines, so M&A issuance will likely take up the baton.
- The US default rate fell to just 0.5% during the fourth quarter, its lowest ever level since the markets became a reasonable size i.e., the last two decades. The default rate for the energy sector (the worst sector for defaults over recent times) fell from 23% in January to just 1% at the end of December. High yield defaults remain considerably lower than before the Covid outbreak (we had a 3% default rate at the end of 2019) and yet valuations are similar. As a result, the market environment for high yield is still extremely positive, Recovery rates on defaults also remain stronger than we could have anticipated at the start of the year.
- With the outlook for defaults remaining so positive and yields higher than at the start of 2021, the year ahead is likely to be encouraging. Although there may be periods of volatility around policy moves, spreads are wide enough to act as a buffer.



Portfolio commentary

- While issuance slowed noticeably during the summer months, it recovered in October and early November. While seasonal factors and weak markets in late November reduced issuance to a trickle, 2021 was still a record-breaking year. We continued to be very selective, passing on companies with weak business models or poor fundamentals, and building up a cash buffer in the expectation of better-quality new issues at the end of the period.
- While these new issues were delayed into 2022, these cash reserves proved beneficial away from the primary market: in the market weakness in late November, we were able to deploy all our resources buying good quality credits at temporarily reduced levels, boosting performance in the bounce back in December.
- The fund performed strongly against its Sterling Overnight Index Average Rate (SONIA) benchmark over the quarter and delivered strong returns for the full year. We took a cautious approach for the quarter, keeping cash balances tight once the volatility subsided.
- While refinancings continued in the market and we participated in this, new issuance dried up with the market volatility in November. As well as the seasonal slowdown, this isn't particularly surprising given refinancing levels over the previous 12 months – the resulting financial health of many issuers is one of the reasons that we remain bullish on high yield.
- We still find the global high yield curve technically very interesting and the front end very cheap, providing us opportunities due to the global high yield market not being able to digest the number of new issues. As a result, we found it relatively easy to replace the issues lost to refinancings with new names. Notable new names were **Royal Caribbean Cruises**, **Community Health Systems** and **Kraton Polymers**.

Outlook

- The biggest driver of the high yield market is the default rate forecast and, given the unprecedented levels of liquidity in the global financial system since March 2021, we expect default rates to remain benign for some time to come. While the average yield may still be low by historical standards, the improved economic prospects and policy supply continue to bode well for the asset class for the next few quarters at least. Arguably, the biggest concern for high yield markets is the tail risk of recession. However, the Fed remains acutely aware of the risks of premature tightening and choking off the nascent recovery, so this seems more of a risk for the end of 2023 at the earliest. Given this, high yield looks set fair for the next three quarters at least, and possibly longer if policymakers can navigate the challenges posed by inflation.
- 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 caused weakness in government bond markets and to a reappraisal of more highly rated equity sectors, such as technology. The Fed is expected to increase rates at least three times this year and the BoE is expected to make four further increases (just two will take the UK base rate back to the highest level since early 2009), so we still expect occasional bouts of market volatility due to monetary policy concerns. As such, we believe bonds with near-term catalysts, which mitigate market risk, will continue to be an important attribute underpinning investment performance over the medium term.
- Inflation remains a greater concern than it was a year ago, and we expect greater differentiation in the market as it becomes apparent who can adjust prices to compensate for higher short-term inflation. However, we feel that current inflation is mostly transitory, with much of the increase due to technical year-on-year comparisons. There are also plenty of drags on growth that will mitigate inflationary pressures, including higher taxes, the slowdown in growth in China (arising from both the deflation of the property bubble and the government's zero-tolerance approach to Covid-19) and the drag of any further variants of the virus. While 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 low interest rate environment.
- We began 2021 believing that the risk-return prospects for high yield were better than for investment grade and government debt, and subsequent returns confirmed this. Our outlook for 2022 is broadly the same, although our bullishness has been somewhat tempered by the performance of the asset class over 2021 and the scale of the recovery in December in particular. Nonetheless, the macroeconomic environment is very encouraging, and record low default rates and the high yield spread over US treasuries provide a useful cushion. Furthermore, the short duration of the high yield market should protect it from some of the volatility that may impact government bond markets.
- While our overall position is clear, it's harder to anticipate which areas of the market will outperform. With less economic stress, sector dispersion is lower than it was 12 months ago – energy roared back over 2021 as oil prices recovered, and Covid reopening trades have materially played out. Instead, the dispersion in returns may be driven by regional factors. In particular, we would highlight emerging market



debt (EMD) as an area of weakness: US dollar strength tends to be negative for EMD; the economic slowdown in China is likely to have a greater effect on the region than is currently suggested by consensus – it will take time to adjust to growth of 3-4%, rather than 7%; and contrary to many people's belief, EMD is higher quality with a greater share in the BB rated band, so will be more sensitive to interest rates.

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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