ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

Quarterly Report 30 June 2021

For professional clients only, not suitable for retail investors

CONTENTS

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Asset split

	Fund (%)
Conventional credit bonds[2]	93.9
Index linked credit bonds	0.2
Sterling conventional gilts	6.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.4
Foreign index linked sovereign	0.0
Derivatives	-0.4
Other	0.0

Fund data

	Fund
Duration[3]	0.2 years
Gross redemption yield[4]	2.34%
No. of stocks	199
Fund size	£193.2m

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 (%)	Relative (%)
Q2 2021	**1.60**	**0.01**	**1.58**
Year-to-date	3.81	0.02	3.78
Rolling 12 months	9.13	0.05	9.08
3 years p.a.	3.43	0.47	2.97
5 years p.a.	4.93	0.45	4.48
Since inception p.a. 24.09.2012	4.16	0.49	3.67

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.

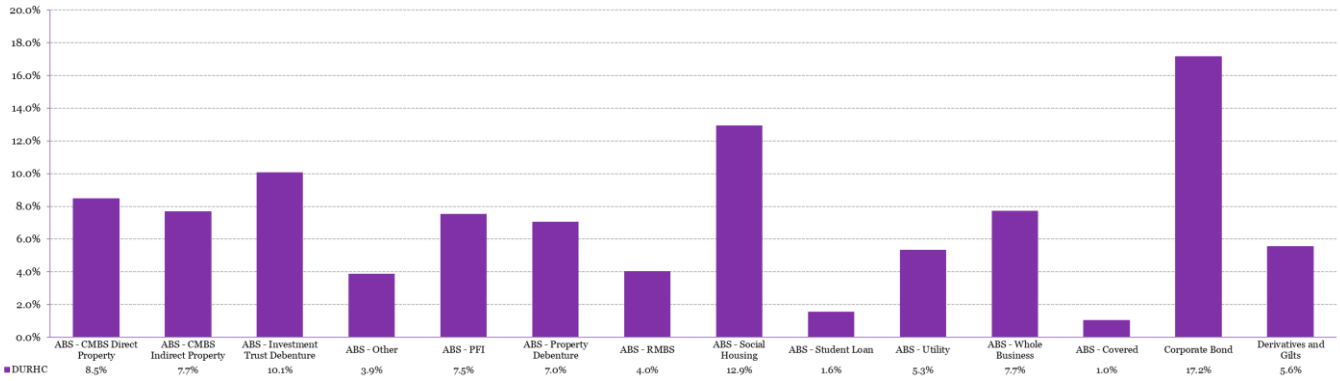
Source: RLAM, based on the Z share class.

Please note that fund name was changed from RL Duration Hedged Credit Fund on 21 December 2020, and the objective amended, while the benchmark of that fund changed from 3-month LIBOR to SONIA, effective 8 August 2019. Both changes are reflected in the returns shown above.

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

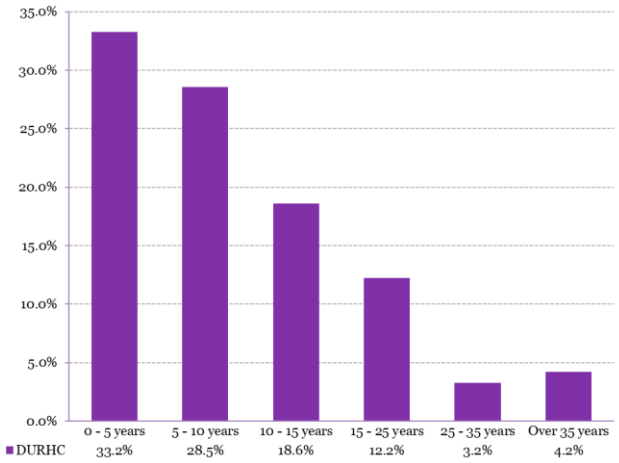
ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

Sector breakdown

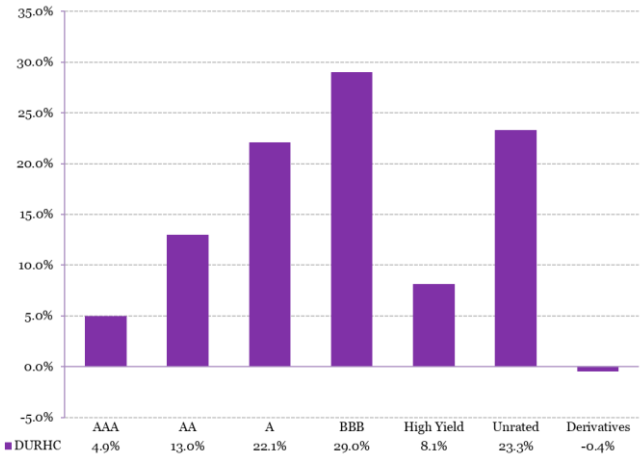


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Scottish Mortgage 6.875% 2023	2.0
Telereal Securitisation FRN 2033	1.7
British Land Co 5.264% 2035	1.7
Law Debenture 6.125% 2034	1.4
Equity Release 5.7% 2031	1.4
Trafford Centre 2038	1.3
Edinburgh Investment Trust 7.75% 2022	1.3
Grosvenor UK Finance 6.5% 2026	1.3
Mercantile Investment Trust 6.125% 2030	1.3
Finance for Residential Social Housing 8.368% 2058	1.2
Total	**14.5**

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

ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

Changes to the fund in December 2020

- *Please note:* changes were made to the fund from 21 December 2020 as detailed in the communication that was sent to fund holders in October.
- These include a change to the fund name (from 'Royal London Duration Hedged Credit Fund' to '**Royal London Diversified Asset-Backed Securities Fund**'); its objective ("The Fund's investment objective is to achieve a positive absolute return in all market conditions over rolling 3-year periods, by predominantly investing in asset-backed securities and other sterling-denominated corporate bonds. The Fund's performance target is to outperform, before the deduction of charges, the Bank of England Sterling Overnight Interbank Average (SONIA) plus 2% per annum over rolling 3 year periods."); its benchmark ("SONIA (target) with performance target as shown above"); and fee (Z class: B4K6P77), which will be reduced from 0.56% to 0.425%.
- These changes are for clarity and positioning, rather than any material alteration to how the portfolio is managed. Our definition of ABS reflects a wide range of bonds, including secured corporate bonds and securitisations. The exposure to this type of ABS is expected to remain in excess of 80% of the credit holdings in normal market conditions (i.e. excluding the impact of gilt collateral and swap hedges in place). We have a very diversified approach to lending in a secured bond format.

Market overview

- The quarter began with further progress being made in reducing the spread of Covid-19, with the number of new cases falling and vaccine rollout programmes accelerating in most parts of the world, particularly in the US and Europe. However, as lockdown restrictions started to ease, a sharp rise in deaths in India and fears over new viral strains, particularly the 'Delta' variant, became a significant cause for concern. In the UK, while hospitalisations remained low, new cases rose sharply.
- In the US, the Biden administration followed up the $1.9tn economic relief bill of the first quarter with proposals for a $579bn infrastructure package promising investment in roads, water, clean transportation, and the electric grid. While the spending package, to be funded through stronger tax collection enforcement rather than formal tax increases, appeared to have bipartisan backing, it remained to be seen whether it would gain enough support in the Senate.
- Inflation discussions were increasingly prevalent, with opinion divided as to whether rising prices were an indicator of nothing more than 'transitory' inflation, particularly given the lack of higher wage inflation, or a sign of more deep-rooted issues. US Federal Reserve (Fed) Chair Jerome Powell was keen to reiterate that price pressures were indeed transitory, but cautioned that effects on inflation "have been larger than we expected and they may turn out to be more persistent than we expected". However, central banks appeared firmly committed to maintaining accommodative monetary policies.
- In the UK, after a first quarter focused on rising inflation expectations and a corresponding increase in government bond yields, the benchmark 10-year gilt yield fell from 0.85% to 0.72% over the quarter: the gilt market returned 1.70% on an all maturities basis (FTSE Actuaries). In sterling investment grade credit, the market returned 1.71%. The average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) tightened from 0.96% to 0.91%.
- All sterling credit sectors produced positive returns during the quarter. Lower risk areas such as supranationals and covered bonds lagged the wider market, while sectors such as real estate and telecoms performed relatively well. Financials performed broadly in line with the market, but subordinated debt again outperformed. With gilt yields falling slightly, longer maturity bonds outperformed shorter dated, while BBB and A rated bonds outperformed AAA and AA issues.

Fund activity and market commentary

- The portfolio performed well over the quarter, producing positive absolute returns and higher returns than broad sterling credit market indices. Our allocation and stock selection in social housing and structured bonds were the main drivers of returns.
- When looking at the broader market, the portfolio's relatively small weighting to supranationals was positive. The relatively low credit spread on these bonds means we prefer to focus on other areas, particularly given our view that market inefficiencies allow us to pick up materially higher spread in other sectors without a corresponding increase in credit risk.
- Our exposure to structured bonds was also positive. The sector outperformed, but we also benefited from holdings such as **Thames Water** and **Dignity Finance**. We particularly like the longest dated Thames bond which is often overlooked by investors. Our view remains that the bond's yield premium relative to shorter-dated Thames bonds, and senior position in the capital structure, offer our clients attractive exposure to longer cash utility cashflows. Dignity Finance, one of the UK's largest funeral services providers, has experienced a period of weak operating performance as greater competition and the limitations on the size of funeral limits has hit profitability. We see signs for encouragement, with management focused on reducing leverage, and strong asset backing given the senior position of the Class A bonds. **Finance For Residential Social**

ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

Housing was another strong performer over the quarter. The bond, while not easily modelled on Bloomberg and relatively illiquid, offers strong collateral and an attractive yield - above that of many unsecured BBB bonds despite its AA rating.

- Holdings are focused on sectors that benefit from strong covenants (legal restrictions on what an issuer can do) and often offer enhanced security (offering assets as collateral). A takeover offer for Morrisons (not held in the fund) illustrates why we like strong covenants and security. It is not just at times of economic distress that security is beneficial. When financing costs are low and private equity businesses are awash with cash we can expect to see balance sheets being utilised to increase leverage. This will eventually lead to higher default risk in those more leveraged business models. Secured bonds also offer upside when issuers want to access assets that part of a secured issue. During the quarter, **Broadgate** announced that they were removing 100 Liverpool from their security pool, and as a result, have had to prepay a number of bonds (at a premium to the market price) to ensure that the underlying LTV is maintained. This latest news forms part of a continuing trend of Broadgate repaying parts of structure (we saw similar prepayments in 2018 and 2019), and represent a positive dynamic for us of being in a structure that issuer is looking to unwind over time.
- There was further issuance of Green, Social and Sustainability bonds in the quarter. Whilst we welcome the greater recognition of the 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.
- Structured bonds are a major part of the portfolio and remain an area where market efficiency presents us with opportunities to add above market spread at what we see as below market risk. **Yorkshire Water (Kelda)** issued secured bonds at a spread of 97bps. We continue to favour the water sector given its low carbon footprint and the regulated nature of the business. We also picked up a number of attractive bonds in the secondary market, including Freshwater Finance, a bond secured on debt issued by Anglian Water, and **Lunar Funding**, which is secured on debt issued by Wessex and Northumbrian Water. Both of these bonds benefit from the same sector dynamics, but offer a significant spread premium due to their perceived complexity.
- In the financial sectors a number of reasonably priced issues came to market in the quarter, including **Goldman Sachs**. We did take advantage of secondary market availability to pick up subordinated bonds from **HSBC** – these being legacy bonds that mean they will not count against capital requirements after 2021 and hence may be bought back, but offer an attractive spread premium. In covered bonds, issuance remains very subdued in a historical context as the traditional issuers of these bonds continue to access the Bank of England Term Financing scheme instead given the lower borrowing costs. However, there are still some issues coming to market, and we participated in a new issue from **TSB**. The spread is lower compared to some sectors, but the bonds are floating rate, and hence provide some insulation from the risk of rising rates.
- Social housing remains a key area of interest for us. During the quarter we added a new issue from **Beyond**, which provides 15,000 homes, predominantly in the Tees Valley and North Yorkshire, and in the secondary market added to **Harbour Funding** and **Haven**, which benefit from stronger covenants than typical new issuance in the sector.
- There were no defaults in our portfolios during the quarter and across the corporate sector failures remain at low levels. While defaults are likely to increase from the current very low levels as we transition back to more normal economic conditions, we believe that our strategies are well positioned to navigate this, as shown in a historical downgrade rate that is lower than the broad sterling credit market.

Key views within the portfolio

- A bias towards senior asset backed securities, an area that we believe still offers the best risk/return characteristics.
- Very limited exposure to junior tranches of securitisations, where downgrade, loss and extension risks are heightened
- Selective exposure to unsecured debt (less than 20% of the corporate bond element), targeted at well-regulated financial debt and undervalued corporate debt
- Zero exposure to supranational bonds, as we expect secured debt and 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).

Outlook

- There remain three key questions that will determine the path of global economic activity: the efficacy of a global vaccination programme, the reaction of businesses and consumers to news flow and the response of governments and central banks. Our view remains that the current inflation spike will not become embedded in consumers' expectations.
- For markets, government and central bank support has been a major factor; this has helped keep yields low across yields curves. We know that this support will be reduced over time and believe that it will eventually feed through into higher yields. While we are not expecting to see this imminently, as fixed income investors, this will present a headwind.

ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

- For credit specifically, we do feel that the additional yield available more than compensates for the risk of default and hence believe that credit will outperform government bonds over the medium term. However, we recognise that idiosyncratic risk – such as increased merger and acquisition activity – cannot be ignored.
- Our portfolios have a material exposure to BBB bonds, reflecting our sector and security preferences. We continue to believe that at current valuations we are compensated for risk: on a longer-term perspective investors require less than 50 bps of excess return to compensate for BBB risk, compared with a current spread of 130 bps. Credit risk is not something that should be taken unthinkingly but it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.
- The recovery in credit spreads since the pandemic has been remarkable and they are now towards the lower end of their normal range, so the potential for further contraction is limited for the wider market. However, there are pockets of value in some sectors and securities that will reward diligent active managers. Our strategies are well positioned for this, since we have long maintained a spread advantage over the index by investing in assets that we consider undervalued. A good example of this is social housing, where our preferences have been in the higher spread parts of the sector and where this advantage can be realised without compromising security.
- You can find more of our thoughts on the opportunities and risks in the sterling credit sector at www.rlam.co.uk

ROYAL LONDON
ASSET MANAGEMENT