ROYAL LONDON ETHICAL BOND FUND

Quarterly Report 30 June 2021

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.8	99.3
Index linked credit bonds	0.2	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.7
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	7.6 years	7.8 years
Gross redemption yield[4]	2.32%	1.46%
No. of stocks	434	1,173
Fund size	£1,549.5m	-

Source: RLAM, based on the Z share class. Launch date: 31.01.2007.

[1]Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.

[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[1] (%)	Relative (%)
Q2 2021	**2.42**	**1.71**	**0.71**
Year-to-date	-0.27	-2.47	2.20
Rolling 12 months	5.59	1.73	3.85
3 years p.a.	5.98	4.66	1.32
5 years p.a.	5.89	3.95	1.94
10 years p.a.	7.41	5.73	1.68
Since inception p.a. 31.01.2007	6.59	5.37	1.22

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.

[1]Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.

The Z share class was launched on 30 October 2009. Performance data for periods after this date is for the Z share class. Performance shown in the table above for periods extending prior to 30 October 2009 is a merged return which includes that of Class A prior to 30 October 2009, and for Class Z units thereafter. Performance for the Royal London Ethical 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.

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

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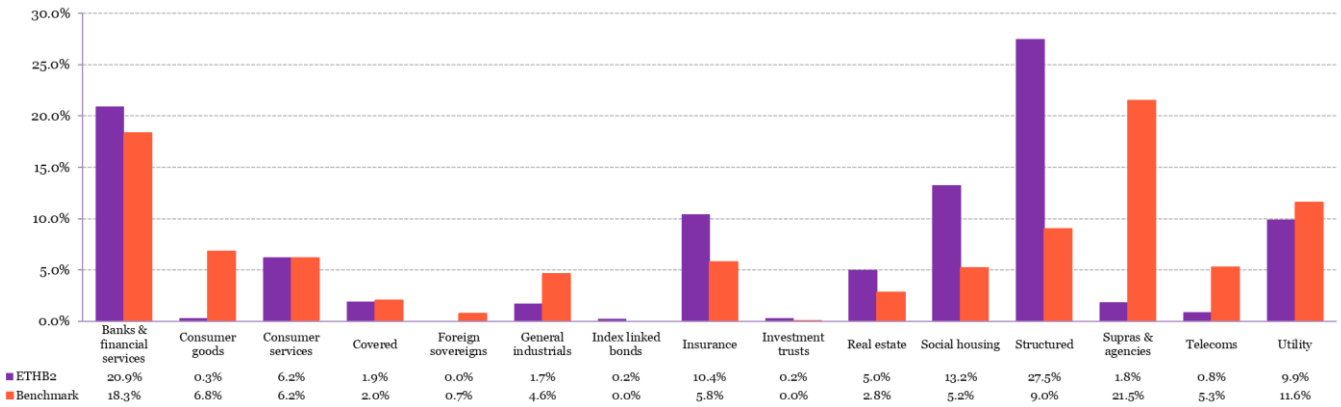
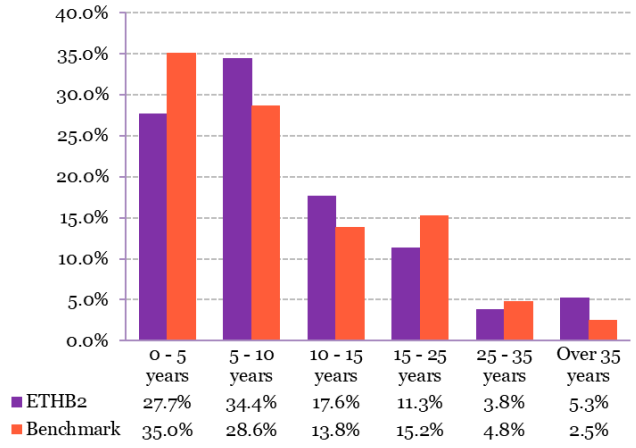
Sector breakdown

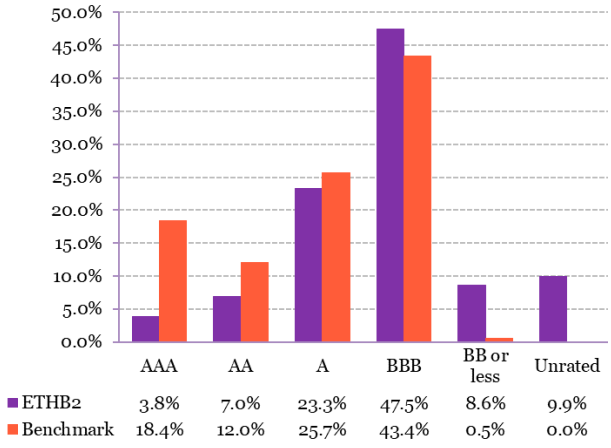


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten largest holdings

	Weighting (%)
Aviva Plc 6.875% 2058	1.0
Thames Water Utilities 2 7.738% 2058	0.8
Income Contingent Student Loans 2058	0.8
Électricité de France 6% 2114	0.8
Progress Health 5.581% 2042	0.8
Co-op Wholesale Soc 6.25% 2026	0.7
UK Municipal Bonds Agency Finance 2025	0.7
M&G 6.25% 2068	0.7
Prudential Corporation 6.125% 2031	0.7
Income Contingent Student Loans 2056	0.7
Total	**7.7**

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

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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.

Portfolio commentary

- The fund performed strongly in the second quarter, producing positive absolute returns, and outperforming its benchmark. Our allocation and stock selection in financials, particularly subordinated bank and insurance bonds, was a major driver of performance, as was our underweight in supranationals.
- 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 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.
- A takeover offer for Morrisons 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.
- Activity reflected new issue opportunities and secondary market availability. Issuance was slightly lower in the second quarter than Q1 but remains on track to comfortably exceed overall issuance in 2020. Increasingly, spreads on new issues are too low to interest us and a number of deals that looked attractive initially have been tightened, during the book building phase, to levels where we passed.
- In the financial sectors we added to senior issues from **JP Morgan** and **Goldman Sachs**, as well as subordinated bonds from **BNP**, **Virgin Money** and **Lloyds**. 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 **Blend**, a social housing debt aggregator that enables smaller housing associations to access capital markets. The Blend deal size was not large but was attractively priced and is a reminder that a small issue size does not imply poor quality.

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- There was further issuance of Green 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 Green or Sustainability 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 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 and is why we prefer to keep portfolio duration somewhat lower than the broader market.
- 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.
- You can find more of our thoughts on the opportunities and risks in the sterling credit sector at rlam.co.uk.

ROYAL LONDON
ASSET MANAGEMENT

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