ROYAL LONDON GLOBAL HIGH YIELD BOND FUND

Quarterly Report 30 June 2021

For professional clients only, not suitable for retail investors

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Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q2 2021	**2.63**	**2.20**	**0.44**
Year-to-date	3.43	2.36	1.07
Rolling 12 months	15.23	11.99	3.24
3 years p.a.	7.09	5.87	1.22
5 years p.a.	6.23	5.60	0.63
Since inception p.a. 15.02.2013	5.70	5.03	0.68

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

[1]Benchmark: ICE BofAML BB-B Global Non-Financial High Yield Constrained,100% hedged to GBP.

Fund price and yields

	Distribution yield[1]
Fund	4.69%

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

[1]Net of standard management charges.

[2] Benchmark: ICE BofAML BB-B Global Non-Financial High Yield Constrained,100% hedged to GBP.

[3]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	Benchmark[2]
Duration[3]	4.1 years	3.7 years
No. of stocks	280	2,981
Fund size	£3,451.5m	-
Launch date	15.02.2013	-

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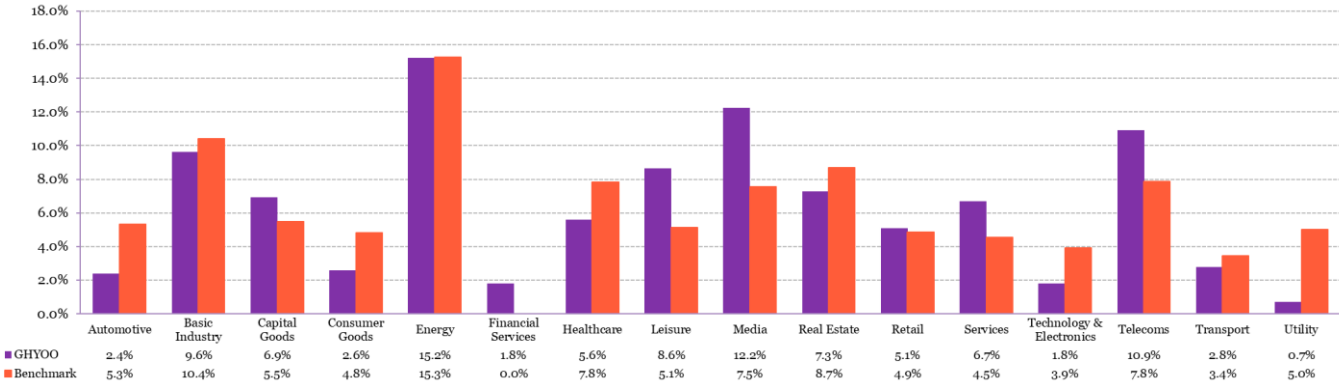
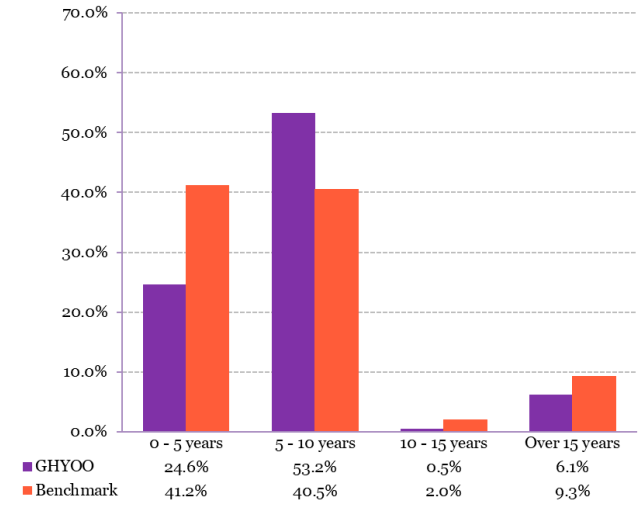
Sector breakdown



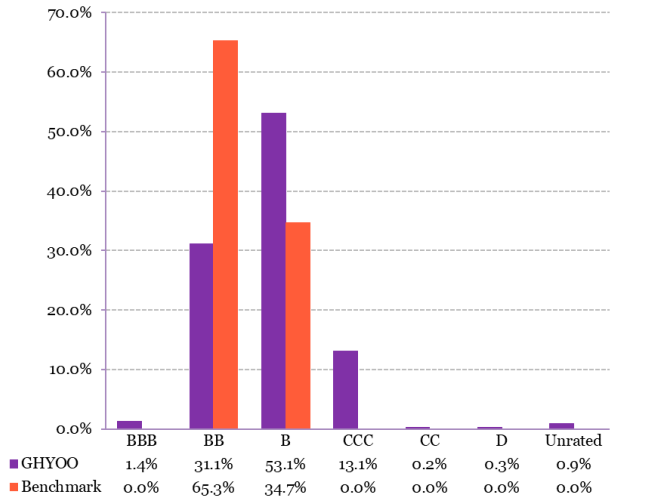
Source: RLAM.

Maturity profile



Source: RLAM. Maturity breakdown is the final maturity. Figures exclude the impact of cash held.

Credit breakdown



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

Ten largest bond holdings

	Weighting (%)
Stonegate Pub Co Financing 8.25% 2025	1.5
TransDigm Inc 5.5% 2027	1.4
Petroleos Mexicanos 6.75% 2047	1.1
Live Nation Entertainment Inc 4.75% 2027	1.1
Allied Universal 6% 2029	1.0
Carnival Corp 7.625% 2026	1.0
Verisure 5.25% 2029	1.0
Nova Chemicals Corp 5.25% 2027	1.0
Garfunkelux Holdco 7.75% 2025	0.9
CSC Holdings Llc 4.625% 2030	0.9
Total	**10.8**

Source: RLAM. Percent of fund is based on security's fund base value over total fund base value less cash and FX hedging.

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Market overview

- As noted in last quarter's market overview, the biggest driver of high yield returns continues to be the global economic recovery. While the first quarter was dominated by concerns over the likelihood of rising interest rates, which suppressed returns from bond markets generally, in the second quarter central banks were firm in their messaging that this was not the time to be changing monetary policy. We therefore continue to be optimistic about the prospects for the asset class, given the confluence of positive economic and policy drivers.
- 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 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 to pass the 60-vote threshold required 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.
- The benchmark 10-year US treasury yield fell 27 basis points (bps) over the quarter from 1.74% to 1.47%, leading treasuries to return 2.0% for maturities over one year (ICE BofAML). This came after significant yield increases in the first quarter, reversing around a quarter of the move seen then. In high yield markets, returns were also driven by carry, due to the higher yield on the asset class, with modest spread compression also adding to the positive backdrop.
- The strong performance of the energy sector was again one of the key dynamics in high yield, as oil and gas prices recovered strongly from last year's depressed levels. By the end of June, the price of Brent crude oil was approaching $75 dollars a barrel, as a result of improved business reopening, improved travel and activity prospects. With higher oil prices and the more positive economic environment in general, new issue activity continued at record breaking levels, maintaining the strong pace of the first quarter. The majority of issuance was in the B rated part of the market and came overwhelmingly from the US, with European high yield issuance materially lower.
- After remaining flat for several months, the US default rate dipped again to its lowest level since last summer. Default rates for both the energy and telecommunications sectors remain higher than the market average, but even here, rates fell. As a result, the market environment for high yield is currently as positive as it can get, and default rate expectations for the next 12 months are at the lowest levels seen for 20 years. Recovery rates on defaults have also been stronger than we could have anticipated over the last 12 months.
- With the wall of money from the Fed and the combination of the $1.9tn fiscal package and proposed $579bn infrastructure spending from the Biden administration, we still expect the US economy to surge in 2021 and 2022.

Portfolio commentary

- Issuance is at record breaking levels and is likely to remain elevated given easy liquidity and investors' search for yield. We continue to be very selective. We are seeing some 'late cycle' issuance where companies with weak business models or fundamentals are able to issue at very low yields. An example of this was airlines, where we passed on Air France, where we felt that the fundamentals were poor, but were happy to pick up a new issue from **United Airlines** as the bonds were senior secured, with claims over assets and reasonable protective features.
- The fund continued to perform well over the quarter and was ahead of its benchmark. Whereas last quarter's outperformance was achieved through broad exposure to the Covid reopening and duration management, performance this quarter came from spread compression in the B rated part of the market and strong performance from a number of holdings. One example was **Lionsgate**, the film and TV studio. We bought this in the first quarter as we thought that the company had a strong catalogue and that the market was overly negative on the name. The recent Amazon purchase of Metro-Goldwyn-Mayer (MGM) studios, which was the catalyst for a revaluation of the sector. As a result, Lionsgate was one of our top performing credits over the quarter.

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- It was another busy period of market activity as low yields, low default rates and corporate concern about the possibility of interest rate increases encouraged companies to refinance and issue new debt. We continued to actively participate, albeit on a selective basis, which made a reasonable contribution to overall performance.
- There has also been a notable return of private equity capital into the market, after a conspicuous absence last year, which is being used to funding a number of leveraged buyouts. One such example was a leveraged purchase of **US Salt**, which produces high purity and environmentally friendly chlorine for the textile and dye industry. We took the opportunity to open a credit position in April.
- Oil prices have continued to increase. Brent crude followed a $12 increase in the first quarter with a further $15 in the second to end June at nearly $75 . This has helped the energy sector performance well and helped fund performance during the quarter. Our exposure remains focused on where we see more robust balance sheets and financials rather than as a straight play on the oil price, but realistically, after a 50% increase in the first half of 2021, it is hard to see the sector performing as strongly in the second half. We participated selectively in new issues in the sector during the quarter, including **Tullow Oil** and **Petrobras**.
- **Punch Taverns** was a notable beneficiary of the UK's better than expected vaccination rollout programme, which heightened expectations of an end to lockdown restrictions. We participated in its refinancing, as we believe the amount of freehold property on the company's books means its credit is priced relatively cheaply. We participated in a similar refinancing for gym operator **David Lloyd**.

Outlook

- There has been some speculation that high yield credit spreads, which traditionally follow both equities and government bond yields, are currently looking rich as they are tightening to post-global financial crisis levels. However, as an asset class, high yield has changed materially over the last two decades. For example, when we compare credit quality, the market average rating has improved; BBs have moved from being 34% of the market to 59%. The average issue size is now three times bigger than in 2001, and larger sizes mean better liquidity as there is more information points to price a credit. In addition, liquidity improved in 2020 – it was the first period of high stress where volumes increased. Finally, the risk-free rate is significantly lower, which means in a lower yield market that the default rate is 'structurally' lower. From a valuation perspective this means high yield spreads will be far more driven by government bond yields from a fundamental perspective from here. Equity volatility will still transmit to high yield, but we think that will be a function of how the discount rate changes within equity valuations, rather than other considerations.
- In April we said: "the biggest risk to our positive outlook would be a change of stance by the Fed regarding its supportive stance… As a result, the US will remain the key driver of the global high yield market". While the Fed continues to manage market expectations carefully, 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.
- 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, we expect default rates to remain benign over the next five years. While the average yield may be very low, the improved economic prospects and policy supply bode well for the asset class for the next few quarters at least.
- Central bank rhetoric around inflation and support measures will be crucial in providing direction for markets, and the Fed is acutely aware of the risks of premature tightening and choking off the recovery. Early signs point towards a potential rise in interest rates in 2022/2023, but crucially, the Fed has reiterated that advance notice will be given well in advance of any policy shift, avoiding the likelihood of another 'taper tantrum' as experience in 2013. Inflation is undoubtedly a great 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. But we do expect inflation to be more transitory, with much of the increase due to technical year on year comparisons, rather than showing up in more worrying areas such as wages.
- Our outlook is largely unchanged from the last quarter and, indeed, the beginning of the year. We said in early January that "there is simply no alternative to the high yield market in its risk-return prospects" and we retain this bullish outlook. We continue to believe that global high yield bonds are attractive on a spread basis and that they overcompensate for default risk, while their level of income generation is also appealing on a relative basis. While there may be nascent signs of problems down the line, conditions remain supportive for high yield investors.
- You can find out more about our thoughts on the risks and opportunities in global high yield at rlam.co.uk.

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