ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Quarterly Report 30 June 2021

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Executive summary

- The fund recorded a return, gross of tax and management fees of the A share class, of 3.71% during the second quarter of 2021. This was a strong result and in excess of the return on sterling investment grade and high yield markets.
- 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%. Sterling high yield returned 1.75%.
- Distributions in respect of Q2 2021, payable at the end of August, are 1.55p, 1.38p, 1.47p and 1.45p respectively for the A, B, Y and Z class income shares, slightly below the amounts of 1.61p, 1.44p, 1.52p and 1.50p distributed for Q1 2021.

Performance

	Fund (Class A) %	Fund (Class Z) %
Q2 2021	**3.71**	**3.71**
Year-to-date	6.17	6.18
Rolling 12 months	16.00	16.00
3 years p.a.	5.94	5.95
5 years p.a.	8.47	8.47
10 years p.a.	8.73	-
Since inception p.a. 13.12.2013	-	7.66
Since inception p.a. 14.04.2003	8.31	-

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.

Source: RLAM. Based on the A and Z Income share classes. Performance for the fund is calculated on a mid basis with income re-invested. The fund returns in the table above are gross of fees.

Fund price and yields

	Gross redemption yield	Gross income yield
Fund (Class A)	3.80%	4.84%
Fund (Class Z)	4.06%	5.10%

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

[2]Excluding cash

Fund data

	Fund
Duration[2]	4.7 years
No. of stocks	220
Fund size	£1,844.1m
Launch date	11.04.2003

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 strategy

- The fund's objective is to achieve a high level of income by seeking attractive investments across a broad spectrum of fixed income opportunities, encompassing investment grade, sub-investment grade and unrated bonds.
- The fund mitigates stock-specific risk by holding a diversified portfolio of investments, so that no individual investment can in isolation have an undue impact on overall performance. In addition, where possible within the yield objective of the fund, investments are focused on bonds where risk is mitigated by structure or a claim on assets or cashflows.
- The fund maintains at least three-quarters of its total assets in sterling-denominated bonds. Currency risk associated with holdings of bonds denominated in other currencies is substantially hedged by forward currency transactions.
- The average duration of the fund's portfolio is relatively short, presently 4.7 years. The sensitivity of the performance of the fund to changes in gilt yields is therefore relatively modest.

ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Fund commentary

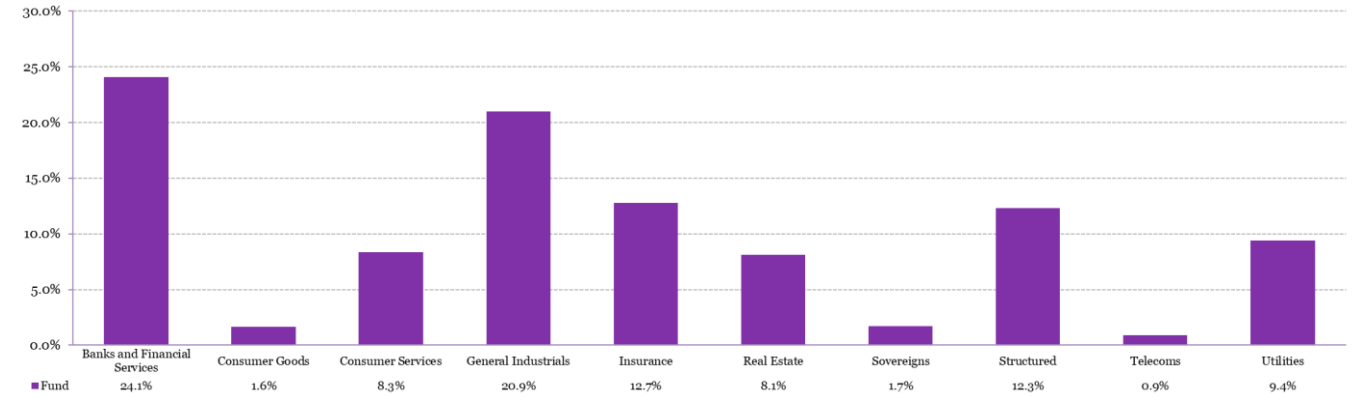
- The quarter began with further progress being made in reducing the spread of Covid-19, with the number of new cases falling and vaccine rollout programmes accelerating in most parts of the world, particularly in the US and Europe. However, as lockdown restrictions started to ease, a sharp rise in deaths 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 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%.
- 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.
- Performance was strong over the quarter, driven by strong contributions at both sector and stock level, as well as the ongoing high yield built into the portfolio. In terms of sectors, insurance performed well, particularly in the subordinated area where the fund has significant exposure through holdings such as **Scottish Widows** and **M&G.** Subordinated bonds also performed strongly in the banking sector. In addition to improved sentiment towards the sector as a whole, **NatWest** offered to repurchase two small outstanding issues of its 'old-fashioned' junior subordinated bonds at a premium to market price. This represented a 10% uplift to the market price but was still surrendering a yield of over 6%. Acceptance of the offer was very low and the current market price of the bonds is above the NatWest's tender level. This news seemed to trigger some response in **Santander UK**'s perpetual bonds, one of the fund's ten largest individual holdings, and therefore had a positive impact on fund performance.
- Looking at notable stock contributions, the repayment and refinancing of the bonds of **Punch Taverns**, was a major positive, as this represented about 2% of fund assets at the time. In addition, we bought new bonds from the issuer which performed well after issue. **Anglian Water** was the other stock of note, as this announced plans to restructure their financing, including migrating their B rated holding company debt into BBB rated bonds within the operating company. Their 2026 bonds, again one of one of the fund's ten largest individual holdings, rose more than 6% on the news.
- Activity was broad-based. During the quarter a number of companies refinanced existing bonds and issued new ones. This did provide a performance fillip as existing bonds were bought back at face value, but obviously presents an issue for an income-oriented fund. We were therefore very selective in participating, with examples including **Punch Taverns**, secured finance business **DDM,** energy business **Tulip Oil** and **Metalcorp,** the latter offering 8½% income for their 5 year life**.**
- New issue purchases also included unrated bonds of energy company **Lime Petroleum,** which operates in the Norwegian sector of the North Sea and benefits from the very supportive tax regime. Bond of UK leisure group **David Lloyd** were purchased at issue and sold within the month to establish a moderate capital gain. Market purchases included investing in the giant €7.8 billion issue of subordinated bonds of Dutch banking group **Rabobank.** We funded several of these trades by taking profits on a number of holdings following strong performance, including Zurich, Lloyds and Allianz, as well as the new issue from DDM purchased earlier in the quarter.

Investment 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.
- 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. 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.
- You can find out more about our thoughts on the risks and opportunities in credit markets at www.rlam.co.uk

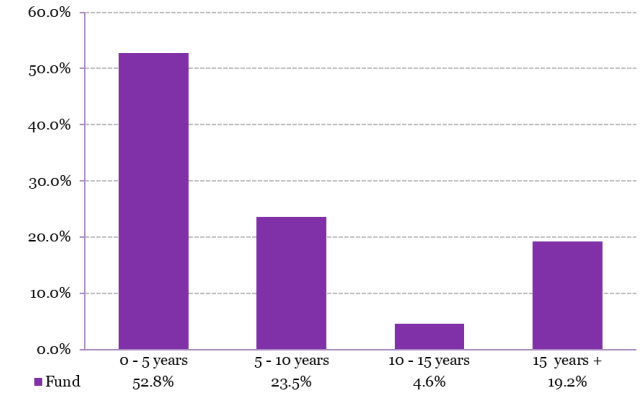
ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Sector breakdown



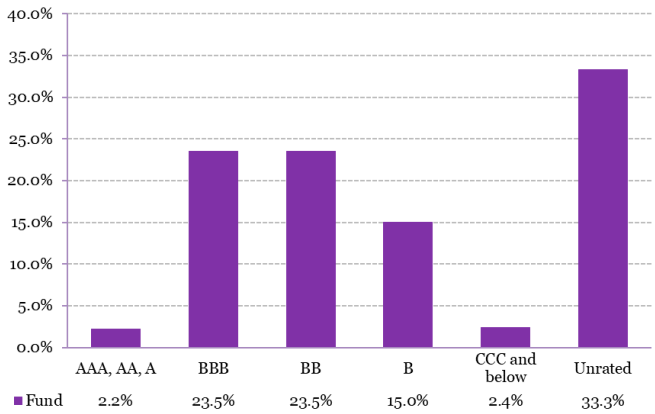
Source: RLAM. Figures exclude the impact of cash held.

Maturity profile



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

Credit breakdown



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

Ten largest bond holdings

	Weighting (%)
Co-op Group 6.25% 2026	2.7
Électricité De France 5.875% 2029	2.3
M&G 6.34% 2043/63	2.3
Centrica 5.25% 2025/75	2.2
Santander UK 10.0625%	2.2
Anglian Water Osprey 4% 2026	1.9
Santander UK 10.375%	1.9
Phoenix Group 5.75% 2028	1.8
Scottish Widows 7% 2043	1.7
Heathrow Finance 3.875% 2027	1.6
Total	**20.5**

Source: RLAM. Figures exclude the impact of cash held, subject to rounding.

ROYAL LONDON
ASSET MANAGEMENT

IMPORTANT INFORMATION

For professional clients only, not suitable for retail investors. The views expressed are the author's own and do not constitute investment advice.

This document is a financial promotion. It does not provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the Fund Information page on www.rlam.co.uk.

Past performance is not a reliable indicator of future results. 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.

Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only, methodology available on request. Information derived from sources other than Royal London Asset Management is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity.

All rights in the FTSE All Stocks Gilt Index, FTSE Over 15 Year Gilts Index, FTSE A Index Linked Over 5 Years Gilt Index and FTSE A Maturities Gilt Index (the "Index") vest in FTSE International Limited ("FTSE"). All rights in the FTSE 350, FTSE All Share, FTSE 100, FTSE 250, FTSE 350 Higher Yield and FTSE Small Cap (the "Index") vest in FTSE International Limited ("FTSE"). "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE under licence. The Royal London Funds (the "funds") have been developed solely by Royal London Asset Management. The Index is calculated by FTSE or its agent. FTSE and its licensors are not connected to and do not sponsor, advise, recommend, endorse or promote the fund and do not accept any liability whatsoever to any person arising out of (a) the use of, reliance on or any error in the Index or (b) investment in or operation of the fund. FTSE makes no claim, prediction, warranty or representation either as to the results to be obtained from the Funds or the suitability of the Index for the purpose to which it is being put by Royal London Asset Management.

All confidential information relating to any Royal London Group company must be treated by you in the strictest confidence. It may only be used for the purposes of assessing the proposal to engage Royal London Asset Management Limited (RLAM). Confidential information should not be disclosed to any third party and should only be disclosed to those of your employees and professional advisers who are required to see such information for the purpose set out above. You should ensure that these persons are made aware of the confidential nature of such information and treat it accordingly. You agree to return and/ or destroy all confidential information on receipt of our written request to do so.

Issued by Royal London Asset Management Limited, Firm Registration Number: 141665, registered in England and Wales number 2244297; Royal London Unit Trust Managers Limited, Firm Registration Number: 144037, registered in England and Wales number 2372439; RLUM Limited, Firm Registration Number: 144032, registered in England and Wales number 2369965. All of these companies are authorised and regulated by the Financial Conduct Authority. Royal London Asset Management Bond Funds Plc, an umbrella company with segregated liability between sub-funds, authorised and regulated by the Central Bank of Ireland, registered in Ireland number 364259. Registered office: 70 Sir John Rogerson's Quay, Dublin 2, Ireland.

All of these companies are subsidiaries of The Royal London Mutual Insurance Society Limited, registered in England and Wales number 99064. Registered Office: 55 Gracechurch Street, London, EC3V 0RL. The Royal London Mutual Insurance Society Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The Royal London Mutual Insurance Society Limited is on the Financial Services Register, registration number 117672. Registered in England and Wales number 99064. FQR RLAM EM 1086.