ROYAL LONDON CASH STRATEGIES

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

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Market overview

- The year started with cautious optimism about vaccines that offered the prospect of the reopening of the global economy and a strong recovery from mid-year, tempered by concerns about new strains of Covid-19 and extended lockdown measures in the short term. This balance shifted over the quarter with vaccinations exceeding expectations in the UK and US, and the route map out of lockdown announced by the UK government. Meanwhile, the Democrats' victory in the Georgia Senate runoffs and President Biden's $1.9tn fiscal package shifted investors' expectations to a more pronounced recovery in the US, leading to higher and steeper bond yields in the US. In addition, there were concerns that higher inflation from ongoing frictions in global supply chains and positive base effects over the coming months could lead to central bank tightening sooner than previously anticipated.
- As a result of these shifting expectations, the benchmark 10-year gilt yield rose from 0.20% to 0.85% over the quarter, leading gilts to return -7.24% on an all maturities basis (FTSE Actuaries). This, however, only takes gilt yields back to the level at which they started 2020. In comparison, credit markets were a relative 'bystander' with investment grade credit spreads broadly unchanged over the quarter. 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 0.99% to 0.96%.
- Cash rates started to move a little higher over the quarter, reflecting the underlying improvement in optimism about the UK and global economy. Three-month Libor started the year at 0.03% and rose to 0.09%, while 12-month Libor rose from 0.08% to 0.16%. The increase suggested that the market had moved on from its expectation in later 2020 that the economy would need increased support using factors such as negative rates. Overnight rates were unchanged, with SONIA remaining at 0.05%, reflecting the reality that a less negative view on the economy still means rates will remain low for some time.
- Cash rates also remained under pressure due to demand and supply factors. Central bank support means banks have had less cause to come to money markets to fund short-term liquidity needs. As a result, there was excess cash looking for short-term homes, limiting the increases in very short-dated money market rates.

Performance and activity

- Our cash funds are standalone vehicles. However, we know that many clients use a combination of these as part of a cash laddering strategy – using short maturity funds for more immediate liquidity needs and using other strategies for cash needs beyond six months or so. The return profiles of these funds will differ, but all are underpinned by a common philosophy and process. We focus on creating diversified portfolios with high credit quality in the underlying banks. These portfolios also screen out tobacco, fossil fuel and armaments, but also factoring in ESG considerations when considering the banks that make up the majority of the portfolios. In this way we believe we create portfolios that meet client needs.
- Performance for RLAM funds was driven by the nature of the investment objective and the subsequent portfolio mix. We always avoid holding too much short-term liquidity coming into year end as counterparty banks are usually looking to reduce short-term cash on their balance sheet. At the start of this year, we felt that the market was too pessimistic about the economy, which depressed rates on traditional money market instruments such as CDs, meaning we started 2021 with a bias towards overnight and very short-dated instruments. As market expectations changed, we were happy to add to higher quality names in three or six month maturity paper as these provide a better return.
- Funds with a much greater focus on near-term liquidity such as the Short Term Money Market Fund are invested solely in classic money market instruments such as treasury bills and short dated certificates of deposit. Rates for these instruments have still to rebound materially from the historic lows seen last year. This has affected absolute returns and we would expect this to remain the case for some months – market expectations are for three-month rates to be back above 0.10% at some point in the second quarter. While we would not rule this out, we feel it does rely on predominantly positive newsflow around vaccinations and the easing of restrictions.
- For the Short Term Money Market Fund, activity during the quarter remained focused on t-bill auctions and rolling maturities of existing paper, extending average maturity of our purchases as yields edged higher. In addition to CDs, we looked for opportunistic purchases elsewhere, for example adding government guaranteed commercial paper from **KfW** to add liquidity and diversification to the portfolio. Covered bonds remained hard to source but we have been able to add very short-dated paper (typically six months maturity or less) occasionally in the secondary market for small yield pick-ups over similar maturity CDs, examples including **ANZ** and **National Bank of Canada** during the quarter.
- The Cash Plus and Enhanced Cash Plus funds look to provide cash investors with returns over and above those on more traditional liquidity funds, by adding targeted exposure to non-money market instruments. Both use covered floating rate notes as part of this strategy, while the Enhanced Cash fund also adds limited exposure to very short dated investment grade credit and secured bonds such as mortgage backed securities. These all contain limited interest rate and credit risk. During

the quarter, the jump in yields was a small negative impact, but this was more than offset by the additional yield these provide, while spreads were broadly flat.

- For the Cash Plus fund, the strength of covered bonds has added to the positive impact we've had from traditional money market instruments, where we followed the same approach as that on the Short Term Money Market fund. Covered bonds' issuance has remained lower than normal as it remains sensible for traditional issuers of these bonds to use the Bank of England Term Financing scheme instead given the lower borrowing costs. There was little change in spreads over the quarter following the compression we saw in the later months of 2020, but the additional yield on these instruments aided performance in the first quarter.
- In the Cash Plus fund, there was little credit activity of note during the quarter. Although new issues of covered bonds were rare, we were able to add occasionally in the secondary market, examples including 2024 covereds from **Skipton Building Society** and **Clydesdale Bank**. We also added a senior short-dated AAA bond from **New York Life**.
- For the Enhanced Cash Fund, activity was somewhat initially subdued but accelerated following the jump in short-dated yields and our view that short-term market sentiment may have jumped too far too fast. Activity allowed us to increase fund yield through selective purchases in favoured areas. Examples included senior five-year bonds from **Skipton Building Society**, structured bonds from **Income Contingent Student Loans** and one year bonds from real estate group **Scentre**, all of which were available at healthy premia to gilts or equivalent CDs. Later in the quarter we were able to add senior bank bonds that are not bailable at attractive premia over gilts – examples including **UBS, Banco Santander** and **HSBC**.

Outlook

- Government and central bank interventions in economies continued to be supportive; this has caused government debt levels to escalate, the impact of which has been neutralised by central bank buying. Government yields remain too low in the medium term as investors will need to adjust to a situation of higher government debt and less QE. The clearing level will ultimately be higher than present yields. Real yields are just too low, especially in the UK and especially at longer maturities.
- The pandemic has heightened geopolitical tensions. Vaccine nationalism and success rates in vaccinations, differing economic recoveries, changing leadership in the US and the rise of China, the desire to protect perceived national interests - all have contributed to a more inward looking mindset. This may be bad for further globalization moves.
- Central bank support has been a major distortion for money markets in recent months. Whether through 'normal' QE or other programmes, returns on a huge range of instruments have been pushed lower. The modest increase in the first quarter has not really altered this – as an example, three month Libor has only returned to the levels seen in summer 2020. Investors in this area will be living with very low returns for some months yet.
- As fund managers, we could increase interest rate or credit risk to compensate for these lower rates. Although vaccination programmes are well-established in the UK and US, and likely to accelerate in the EU over the coming months, Covid-related news is still likely to ebb and flow, and we therefore feel that building portfolios dependent on positive news would be ill-advised.
- For money market exposure in our funds, we will manage these to achieve what we feel is the best combination of yield and liquidity, accepting that the former will be depressed. For exposure outside of these areas, our approach has always placed an emphasis on security and credit quality, both in the nature of assets we buy (such as covered bonds) but also in the way we assess credit quality, with our preference for bonds with security or covenants that we feel offer a degree of protection to investors. A high proportion of the assets in our funds are exempt from bail-in, and we will continue to favour such assets given these provide our clients with greater security. This approach mitigated the initial impact of the crisis on our funds, and although there are encouraging signs of a 'post-lockdown' world, we believe that this remains the most appropriate way to manage these funds.

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