RLPPC BUY AND MAINTAIN CREDIT FUND

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

CONTENTS

RLPPC BUY AND MAINTAIN CREDIT FUND

Asset split

	Fund (%)
Conventional credit bonds[1]	99.3
Index linked credit bonds	0.4
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.3
Foreign index linked sovereign	0.0
Derivatives	0.0

Fund data

	Fund
Duration[2]	8.2 years
Gross redemption yield[3]	2.08%
No. of stocks	253
Fund size	£49.6m
Spread	1.31%

Source: RLAM. Launch date: 24.06.2015.

[1]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[2]Excluding cash

[3]The gross redemption yield is calculated on a weighted average basis.

Figures in relation to the asset spilt table exclude the impact of cash where held.

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 (%) (Accumulation)	Reference index[1] (%)
Q1 2021	**-3.82**	**-4.11**
Year-to-date	-3.82	-4.11
Rolling 12 months	6.78	6.97
3 years p.a.	4.62	4.01
5 years p.a	5.06	4.47
Since inception p.a. 24.06.2015	5.41	4.66

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, gross of standard management fees.

[1]There is no benchmark for the fund. The index data presented in this report is that of the iBoxx Sterling Non-Gilts All Maturities Index and is for reference purposes only. This index is a broad universe of investment grade sterling credit bonds and is therefore a representative comparison.

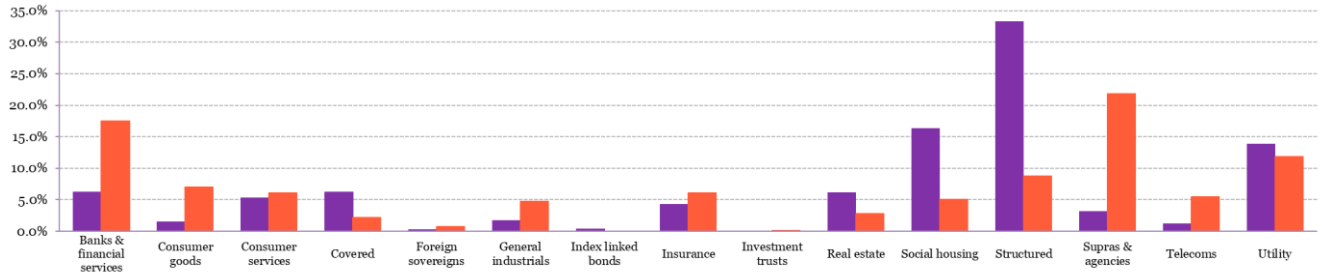
Downgrades

Representative portfolio	% downgraded to sub-investment grade
RLPPC Buy & Maintain	1.03%
iBoxx Sterling Non-Gilt All Maturities Index	5.67%

Source: RLAM, showing downgrades since fund inception. Portfolio and benchmark percentages are based on weight prior to downgrade. Worst of Moodys, S&P and Fitch ratings are considered. RLAM internal ratings used in absence of any public ratings. Only first downgrades are included in the table.

RLPPC BUY AND MAINTAIN CREDIT FUND

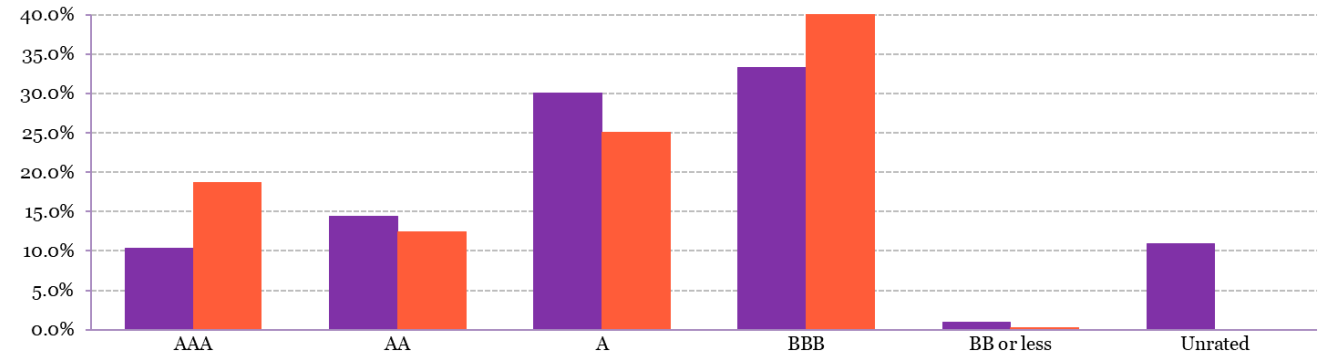
Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Index linked bonds	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
PPBAM	6.2%	1.5%	5.3%	6.2%	0.3%	1.7%	0.4%	4.3%	0.1%	6.1%	16.3%	33.3%	3.2%	1.2%	13.8%
Index	17.5%	7.0%	6.1%	2.1%	0.8%	4.8%	0.0%	6.1%	0.0%	2.8%	5.1%	8.8%	21.8%	5.4%	11.8%

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

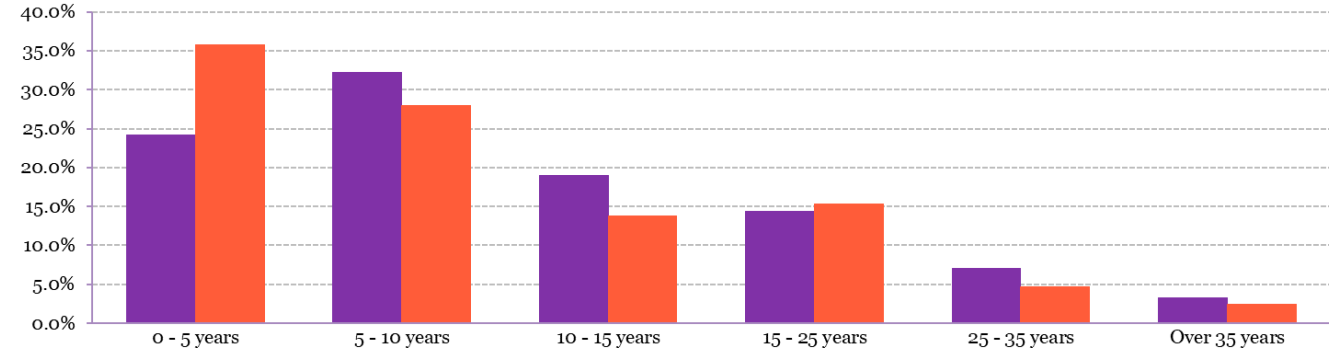
Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPBAM	10.3%	14.4%	30.0%	33.2%	1.0%	11.0%
Index	18.6%	12.4%	25.1%	43.6%	0.3%	0.0%

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

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPBAM	24.2%	32.2%	18.9%	14.4%	7.1%	3.2%
Index	35.8%	28.0%	13.8%	15.3%	4.7%	2.4%

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

RLPPC BUY AND MAINTAIN CREDIT FUND

Ten largest holdings

	Weighting (%)
Western Power Distribution 5.75% 2032	1.7
Électricité De France 6% 2114	1.7
Temasek Financial 5.125% 2040	1.2
Equity Release 5.7% 2031	1.1
Southern Gas Network 4.875% 2029	1.1
Abbey National Treasury 5.75% 2026	1.0
PRS Finance 2026	1.0
Housing And Care 21 3.288% 2049	1.0
Finance For Residence Social Housing 8.569% 2058	1.0
Co-operative Bank 4.75% 2021	1.0
Total	**11.6**

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

Market overview

- The year started with cautious optimism about vaccination programmes 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 vaccine rollouts exceeding expectations in the UK and US. Meanwhile, the Democrats' victory in the Georgia Senate runoffs in January 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 addition, there were concerns that higher inflation from frictions in global supply chains and positive base effects over the coming months could lead to central bank tightening sooner than previously anticipated. Despite this, central banks remained committed to accommodative monetary policies.
- 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%.
- Nearly all sterling credit sectors outperformed gilts during the quarter but, with the rise in gilt yields, total returns were negative across the board. Financials performed strongly, particularly subordinated insurance and covered bonds, as did structured bonds. In contrast, the real estate, utilities and healthcare sectors were notably weak. Supranationals performed surprisingly strongly given the more 'risk on' environment, but this was largely driven by positive duration as shorter-dated bonds notably outperformed longer-dated issues. Otherwise, ratings had a mixed effect: while the AAA band outperformed AA and A rated bonds, BBB rated bonds also outperformed.
- A notable feature of the market was the continued unwinding of the effects of the Bank of England's (BoE) Corporate Bond Purchase Scheme, which played a major role in the recovery of the sterling credit market following the Covid-19 crisis. The BoE bought an additional £10bn of corporate bonds under the pre-existing scheme to support market liquidity. However, the scheme excluded many asset-backed securities (ABS) and all financial bonds, distorting market valuations as eligible bonds (representing c. 28% of typical credit indices) strongly outperformed the wider market. Although the programme was completed on 1 October, these distortions continued to unwind during the first quarter.
- Following weak issuance in January and February, with levels at around 50% of last year, sterling investment grade supply increased sharply in March, reaching the highest level since June 2020. Financials led the way as non-UK banks continued to issue in sterling, along with a number of non-bank financials.

Performance

- Performance for the quarter was negative positive in absolute terms, and slightly behind the broader sterling credit market. The sell-off in government bond markets was a headwind for all credit portfolios, and particularly those with a longer duration. However, in terms of performance relative to credit markets, performance was pleasing, particularly given that longer duration bias given that the broad market has a duration of a little under 8 years. The nature of Buy & Maintain strategies means these tend to have longer duration.

RLPPC BUY AND MAINTAIN CREDIT FUND

- Within financials, the bias towards senior banks was helpful compared to the broader credit market, with these bonds outperforming as the market moved to price in a stronger economy. Although subordinated bank bonds outperformed senior, we feel that the increased risk profile of these bonds is less suited to a Buy & Maintain strategy. Covered bonds remain a key component of the portfolio's strategy, thanks to the mixture of dual recourse security these offer, as well as the floating rate nature of many of these, which provides an element of interest rate risk mitigation. These performed well in the quarter thanks to that lower duration risk, seeing smaller losses than the wider market.
- The portfolio has a low weighting in supranationals, reflecting our view that spreads in this area are very low. Despite the broader risk-on market, these performed well over the quarter as a result of the sector's shorter duration. This hurt portfolio performance compared to sterling credit indices, but we remain comfortable in the long-term rationale for our position.
- Structured bonds performed strongly during the quarter as some of the issuers that were most badly affected last year benefitted from the 'reopening trade'. Sectors such as pubs and restaurants and airports have survived through cost-cutting, government furlough schemes and the supportive approach of bondholders. As the bonds were secured against assets, we were able to take a responsible approach to lending by agreeing to waivers that allowed the issuers more flexibility, while protecting the interests of our clients through time limits and shareholders forgoing dividends to improve cashflow. As our ABS positions currently enjoys a yield advantage over the wider market, security does not come at the expense of lower yields. In addition, the sector also benefitted as less liquid bonds performed strongly as the rally in sterling credit spread across from the most liquid assets.
- 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. Over the last 12 months we have been meeting with issuers as we sought to protect our clients' interests, while appreciating the need to be responsible lenders at a time of unprecedented economic and social disruption. Our orientation towards bonds with security has been highly valuable in enabling this, providing a natural justification for regular meetings. The holders of unsecured bonds do not get the same opportunities, particularly if the bonds have weak covenants, leaving them exposed to the vicissitudes of the market.

Activity

- Activity during the quarter remained relatively low despite increased new issue activity. For our Buy & Maintain strategy, activity is driven by reducing holdings where we believe that there has been deterioration in the quality of the credit, or where new issues give us an opportunity to replace holdings with another that offers more attractive spread, lower risk, or both.
- New issues continued to provide opportunities to enhance the portfolio. In addition, rising yields meant that overall duration fell, and we looked for opportunities to extend duration where this was in line with the portfolio requirements.
- Our credit philosophy is based on the sustainability of our lending position over the long-term. ESG integration is an essential part of this consideration: these factors can play a part in determining the financial future of a company and hence any effective assessment of credit risk has to include ESG. As part of our analysis on spread compensation for ESG risks, we took the opportunity to sell high carbon intensity names and fossil fuel-related names at attractive spreads that did not compensate for longer-term risks, providing funds for a number of attractive switch opportunities during the quarter.
- Examples of this can be seen in portfolio carbon footprint. At the margin, we look to reduce carbon footprint while maintaining or even increasing credit spread. In practice, we have had a bias towards reducing exposure to gas distribution in favour of water or electricity holdings, as the former is more exposed to the risk of stranded assets. In addition, we believe that this gives us a more robust utilities exposure in a net zero world. During the first quarter of 2021 we switched from **MDC** into structured bonds from **Telereal**. MDC is the Abu Dhabi investment company. The bonds are highly rated reflecting the strength of the government of Abu Dhabi which owns the company. These had performed well but are based on underlying petrochemical flows and the credit strength of an oil reliant nation. The Telereal structured bonds were a tap of an existing issue, secured on cashflows from BT commercial property. These benefit from a low loan to value and came to market at around 100bps over gilts, representing a spread enhancement over the MDC bonds while also helping reduce longer term inherent fossil fuel exposure.
- Social housing issuance has increased in recent years and we remained active in this area. We reduced exposure to **Haven Funding** 2037 bonds, these being old style bonds with high levels of collateralisation. A borrower was willing to pay a materially higher price to take advantage of freeing up assets due to the highly constraining asset cover covenants that we lent against. We used the proceeds to buy bonds from Singapore Sovereign Wealth fund **Temasek**, AAA bonds which provide diversification and helped extend duration for a pick-up in spread. Elsewhere in social housing, we switched from

RLPPC BUY AND MAINTAIN CREDIT FUND

Platform Housing 2055 bonds into **EMH** 2044 bonds in the secondary market. Platform had performed strongly and we were able to effect the switch for a spread pick-up of around 20bps.

- In financials, we added to senior bonds over subordinated given the risk profile of our Buy & Maintain strategy and the compression witnessed in subordinated debt relative to senior. New issues continued to provide attractive spreads. We added senior insurance bonds from **MetLife**, which provide an enhanced claim as these benefit from the same protection as policyholders. We also switched **Goldman Sachs** senior 2029 bonds into **Citigroup** senior 2030 bonds for a spread pick-up of around 25bps. The Citigroup issue was smaller in overall size, hence the higher spread, but for a long-term strategy such as ours, we are happy to take the premium for a modest decrease in liquidity.

Outlook

- The success of the UK vaccination programme promises a return to more normal social and economic conditions by the third quarter. However, the economy is likely to be compromised over the medium term by higher taxes given the surge in government debt, the impact of which has so far been neutralised by central bank buying. We expect this quantitative easing (QE) to continue in the near term because the government and BoE will wish to avoid the increase in government bond yields that would result from a substantial increase in net supply. Nevertheless, the level of QE is likely to be reduced over time, and that diminished support for the market is likely to result in higher long-term yields.
- Otherwise, the pandemic has heightened geopolitical tensions. Vaccine nationalism and success rates in vaccinations, differing economic recoveries, changing leadership in the US, the inexorable rise of China and the desire to protect perceived national interests – all have contributed to a more inward-looking mindset. This may be bad for globalisation, which has been a significant factor in keeping inflation low over recent decades. Inflation expectations have risen sharply this year with President Biden passing his initial $1.9tn relief package and announcing a $2tn infrastructure spending programme. In addition, frictions in global supply chains and positive base effects over the coming months could exacerbate headline inflation. While there is a risk of interest rates rising sooner than currently anticipated, which could cause a 2013-style 'taper tantrum', central banks remained committed to accommodative monetary policies and there are still significant headwinds to inflation. Nonetheless, we will continue to be vigilant for signs of higher inflation, particularly in the labour market.
- The recovery in credit spreads over the last 12 months 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.
- We remain committed to ensuring that we are sufficiently compensated for all of the risks that we take. We believe that our approach of capturing excess spread, while mitigating risk through strong covenants, a preference for secured bonds, and security and portfolio diversification is ideally suited for the challenges that may lie ahead.

ROYAL LONDON
ASSET MANAGEMENT