ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Conventional credit bonds[2]	94.2
Index linked credit bonds	0.2
Sterling conventional gilts	5.3
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.4
Foreign index linked sovereign	0.0
Derivatives	0.0
Other	0.0

Fund data

	Fund
Duration[3]	0.5 years
Gross redemption yield[4]	2.50%
No. of stocks	204
Fund size	£192.5m

Source: RLAM, based on the Z share class. Launch date: 24.09.2012.

[1]Benchmark: SONIA.

[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 (%)	Relative (%)
Q1 2021	**2.17**	**0.01**	**2.16**
Year-to-date	2.17	0.01	2.16
Rolling 12 months	10.37	0.06	10.32
3 years p.a.	2.99	0.52	2.47
5 years p.a.	4.57	0.48	4.09
Since inception p.a. 24.09.2012	4.09	0.51	3.58

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, based on the Z share class.

Please note that fund name was changed from RL Duration Hedged Credit Fund on 21 December 2020, and the objective amended, while the benchmark of that fund changed from 3-month LIBOR to SONIA, effective 8 August 2019. Both changes are reflected in the returns shown above.

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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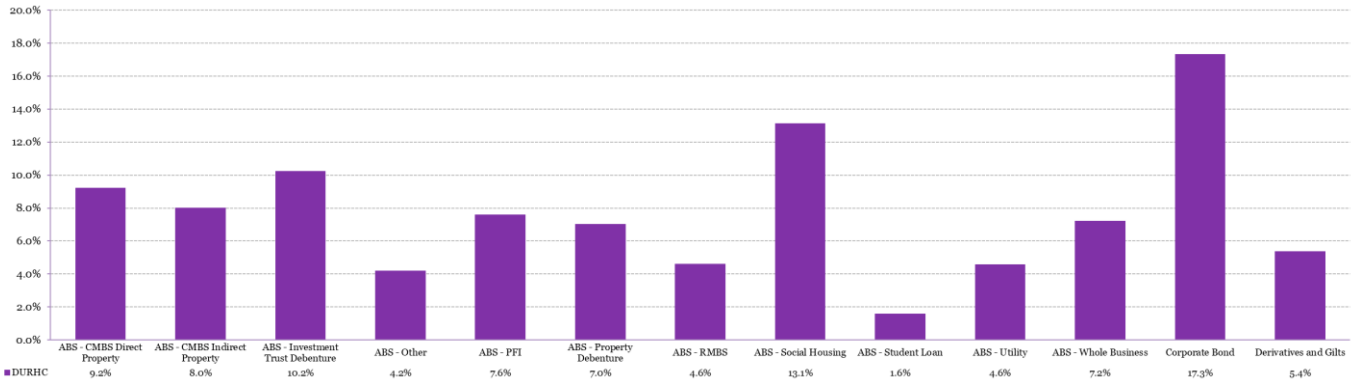
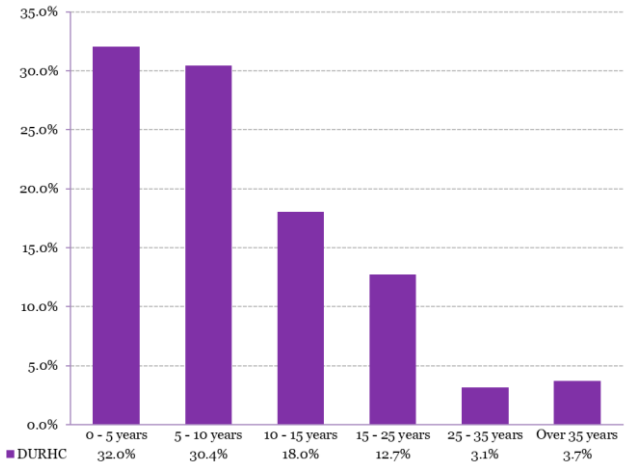
Sector breakdown

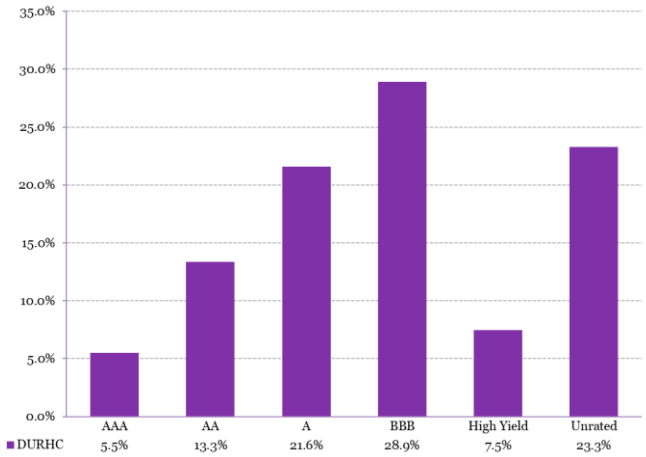


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
Scottish Mortgage 6.875% 2023	2.0
Telereal Securitisation FRN 2033	1.7
British Land Co 5.264% 2035	1.7
Equity Release 5.7% 2031	1.4
Law Debenture 6.125% 2034	1.4
Trafford Centre 2038	1.4
Edinburgh Investment Trust 7.75% 2022	1.3
Grosvenor UK Finance 6.5% 2026	1.2
Mercantile Investment Trust 6.125% 2030	1.2
Finance for Residential Social Housing 8.368% 2058	1.2
Total	**14.6**

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

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Changes to the fund in December 2020

- *Please note:* changes were made to the fund from 21 December 2020 as detailed in the communication that was sent to fund holders in October.
- These include a change to the fund name (from 'Royal London Duration Hedged Credit Fund' to '**Royal London Diversified Asset-Backed Securities Fund**'); its objective ("The Fund's investment objective is to achieve a positive absolute return in all market conditions over rolling 3-year periods, by predominantly investing in asset-backed securities and other sterling-denominated corporate bonds. The Fund's performance target is to outperform, before the deduction of charges, the Bank of England Sterling Overnight Interbank Average (SONIA) plus 2% per annum over rolling 3 year periods."); its benchmark ("SONIA (target) with performance target as shown above"); and fee (Z class: B4K6P77), which will be reduced from 0.56% to 0.425%.
- These changes are for clarity and positioning, rather than any material alteration to how the portfolio is managed. Our definition of ABS reflects a wide range of bonds, including secured corporate bonds and securitisations. The exposure to this type of ABS is expected to remain in excess of 80% of the credit holdings in normal market conditions (i.e. excluding the impact of gilt collateral and swap hedges in place). We have a very diversified approach to lending in a secured bond format.

Fund activity and market commentary

- The fund performed strongly over the quarter, returning 2.17% against 0.01% for its SONIA benchmark. The outperformance against SONIA primarily reflected positive stock selection within ABS and financial debt, which outperformed the broader credit market. The fund's strong performance was driven by three factors: the significant allocations to structured bonds, including social housing, which outperformed; the allocation to the insurance sector, particularly subordinated insurance, and security selection within the banking & financial services sector; and the allocations to bonds rated BBB and below and to unrated bonds, which also outperformed the broader market. The unwinding of the distortive impact of the Bank of England's (BoE) Corporate Bond Purchase Scheme was beneficial for stock selection as these parts of the market were largely excluded from the fund given the bias to unsecured corporate debt within the QE program and the relative expensiveness of the bonds that were distorted in price terms.. This was as we had anticipated as this effect was also observed in the quarters following the scheme's original application in 2016. The fund also outperformed over the rolling 12-month period, returning 10.37% compared to 0.06% for the benchmark.
- 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. The financials sectors 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 BoE's 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.
- The fund's secured and securitised 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 enjoy 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.

- Among the fund's best performing holdings during the quarter were **Telereal**: following a new issue, secondary bonds from the issuer were about 50bps tighter across senior debt, reflecting the realisation from the market of its relative cheapness given credit enhancements and the security on offer. Covid-impacted pubs, such as **Marston's**, **Mitchells & Butlers** and **Spirit**, were also top performers, as were higher spread financials e.g. **Just Group**.
- 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. Issuance in the euro investment grade credit market was more consistent, although down against the first quarter of 2020 with non-financial supply lower than expected.
- As yields rose in the early part of the quarter, the increase in swap valuations led to release of collateral within the fund, which we redeployed into credit markets. We actively participated in new issues over the quarter from **Thames Water**, **Opus** (senior secured lending to SMEs most impacted by Covid-19, but with some government protection), **Heathrow**, **Southern Water** and **Welsh Water**. In social housing, we participated in **Great Places Housing**, **Blend Funding** (tap) and **Poplar** (tap at a wide spread of 190bps). In financials, we bought **New York Life** (secured Guaranteed Investment Contract notes), **HSBC**, **Nationwide** (covered) and in real estate we bought **Medical Properties Trust**.
- While issuance of securitisations and secured bonds in 2021 has lagged, with the former in particular constrained by the availability of new BoE secured funding facilities for banks to finance assets as part of the UK's broader Covid-19 policy response. However, reflecting our extremely diversified approach to sourcing and investing in secured assets, despite this backdrop the fund was able to add high-quality and attractively priced bonds across both primary and secondary markets. Most notably, after a period of due diligence, the fund participated in a new securitisation, **Taurus**. Our senior notes are secured against a portfolio of logistics-related assets at a low loan-to-value. In secondary markets, the fund added to senior positions in **ICSL** (securitisation of student loan repayments) and an insurance premium receivables vehicle, **PCLF 2017-2**. Despite all three of these bonds paying material premiums to SONIA, they are rated highly and benefit from significant levels of over-collateralisation. In addition, we were also able to add strongly covenanted and secured positions across a diverse range of underlying economic sectors, including typically hard-to-source **Spirit** pub bonds, and highly over-collateralised **Quadrant Housing**. Following the strong performance of unsecured bonds and where we had outflows, we took the opportunity to increase the fund's balance to secured assets through the disposal of a range of unsecured credits that had rallied particularly strongly, including **Society Lloyds**, **Barclays**, **University of Oxford**, **SSE**, **Scottish Power** and **Akelius.**
- Reflecting the strength of our lending position, during the quarter, we sold **Haven Funding** (social housing) debt back to a borrower at a significant premium to existing pricing, allowing the borrower to release assets from our strong covenants and borrow elsewhere if needed. In addition, in a similar guise, **Guinness Housing** redeemed its 2025 bonds at 'spens' (gilts plus zero spread), which resulted in a material uplift to valuations on the price received for the c. 0.4% holding.
- 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 sterling credit strategies are well positioned for this. 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 and whims of management.
- Our credit philosophy is based on the sustainability of our lending position over the long term. Environmental, social and governance (ESG) integration has to be a part of this consideration: these factors can play a part in determining the financial future of a company and any effective assessment of credit risk has to include ESG. We continue to believe that lending on a senior secured basis, with strong covenants, can have a dampening effect on rising governance-related risks for a large part of the fund. From an environmental perspective, we continue to carry out bespoke engagement with issuers, such as the railway rolling stock companies on their readiness for net-zero carbon targets.

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Key views within the portfolio

- A bias towards senior asset backed securities, an area that we believe still offers the best risk/return characteristics.
- Very limited exposure to junior tranches of securitisations, where downgrade, loss and extension risks are heightened
- Selective exposure to unsecured debt (less than 20% of the corporate bond element), targeted at well-regulated financial debt and undervalued corporate debt
- Zero exposure to supranational bonds, as we expect secured debt and corporate debt to outperform over the medium term.
- An exposure to credit risk with minimal exposure to interest rate risk (hedged with interest rate swaps).

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, although this should not be excessive.
- 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, friction 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. In addition, income generation will become an increasingly important source of returns. This plays out as excess income is compounded over time. The fund is well positioned for this, since we have long maintained a yield 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 yields parts of the sector in which we found more value. Crucially, this yield advantage can be realised without compromising security.
- We believe that our approach of capturing excess income, 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.
- 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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