ROYAL LONDON SHORT DURATION CREDIT BOND FUND

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON SHORT DURATION CREDIT BOND FUND **3**

ROYAL LONDON SHORT DURATION CREDIT BOND FUND

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.6	99.6
Index linked credit bonds	0.4	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.4
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	2.9 years	2.8 years
Gross redemption yield[4]	2.02%	0.81%
No. of stocks	311	428
Fund size	£1,098.8m	-

Source: RLAM, based on the Z share class. Launch date: 08.11.2013.

[1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index

[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[1] (%)	Relative (%)
Q1 2021	**0.34**	**-0.49**	**0.83**
Year-to-date	0.34	-0.49	0.83
Rolling 12 months	8.98	4.53	4.45
3 years p.a.	3.84	2.34	1.50
5 years p.a	4.22	2.22	2.00
Since inception p.a. 08.11.2013	4.11	2.36	1.75

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.

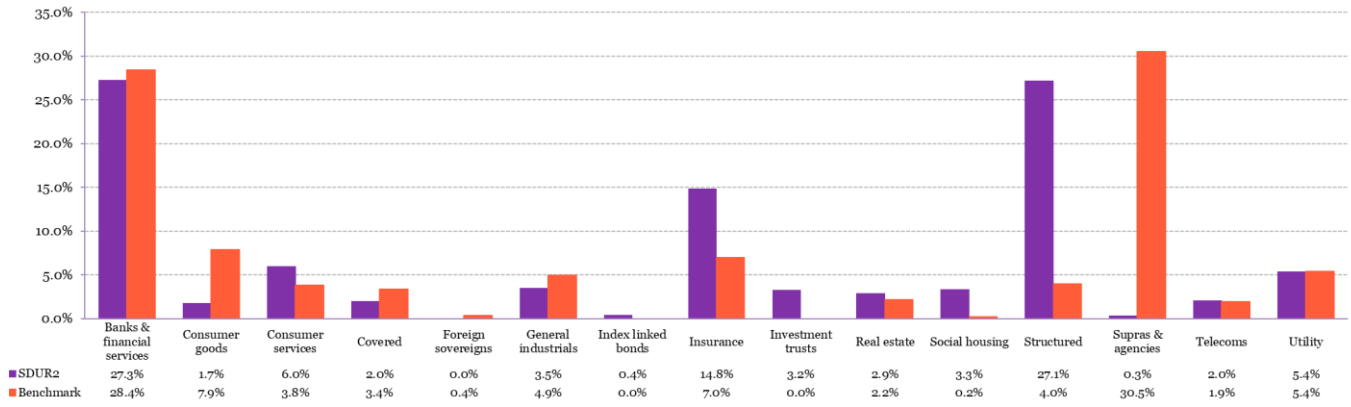
[1]Benchmark: ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index.

Performance for the Royal London Short Duration Credit Bond Fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over longer measurement periods.

As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

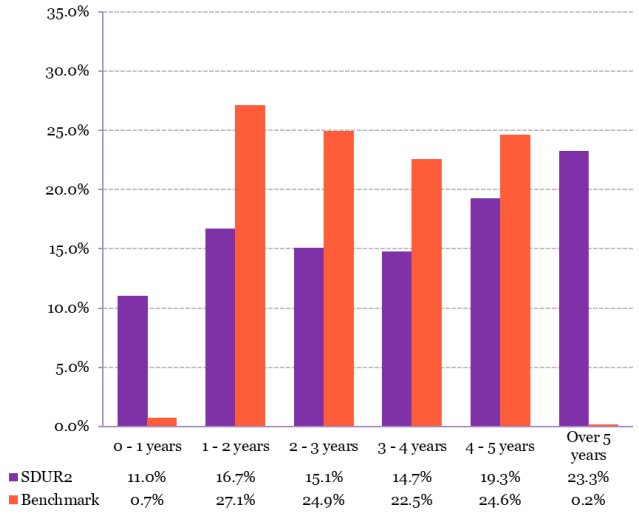
ROYAL LONDON SHORT DURATION CREDIT BOND FUND

Sector breakdown

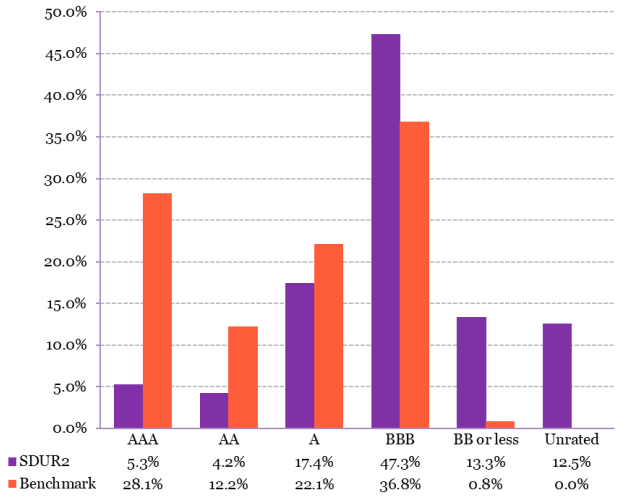


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
First Hydro Finance Plc 9% 2021	1.6
Income Contingent Student Loans 1 A1 2056	1.2
Électricité de France 6% VRN Perpetual	1.2
Income Contingent Student Loans 2 FRN 2058	1.2
Co-operative Bank 4.75% 2021	1.1
M&G Plc 3.875% 2049	1.1
Edinburgh Investment Trust Plc 7.75 2022	1.0
Delamare Finance 5.5457% 2029	1.0
Lloyds Bank Plc 7.625% 2025	1.0
HSBC Bank 5.375% 2030	1.0
Total	**11.3**

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

ROYAL LONDON SHORT DURATION CREDIT BOND FUND

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.
- We actively participated in new issues over the 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. 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.

Portfolio commentary

- The fund performed strongly, significantly outperforming its benchmark over the quarter, although total returns were negative due to the rise in gilt yields. This primarily reflected three factors: the overweight allocations to structured bonds, including social housing, which outperformed; the overweight position in 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. Each of these factors was to some extent driven by the unwinding of the distortive impact of the BoE Corporate Bond Purchase Scheme as these parts of the market were somewhat excluded from the scheme. This was as we had anticipated, as we saw a similar effect in the quarters following the scheme's original application in 2016. Otherwise, relative performance benefitted from being underweight in the utilities, telecoms and healthcare sectors.
- 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.
- We increased our exposure to the financials sectors over 2020 in light of attractive valuations and this paid off during the quarter as these sectors outperformed, particularly subordinated insurance; the tightening of spreads in higher beta bonds was positive for subordinated bonds. Stock selection in the banks sector was also positive for performance. Banks have

benefitted from the government's support for struggling companies and the reopening of the economy over the next quarter will be a boost.

- 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.
- 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. 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. At the margin, this reduces carbon footprint, while maintaining our credit spread premium at the portfolio level. 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.

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. While this should not be excessive, we favour short duration strategies over the medium term.
- 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. In addition, income generation will become an increasingly important source of returns. This plays out as excess income is compounded over time. Our strategies are 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 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 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

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 1019.