



ROYAL LONDON SHORT DURATION GLOBAL HIGH YIELD BOND FUND

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

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Performance

	Fund (%)	Benchmark ¹ (%)	Relative (%)
Q1 2021	0.86	0.01	0.84
Year-to-date	0.86	0.01	0.84
Rolling 12 months	10.13	0.14	9.99
3 years p.a.	2.46	0.57	1.89
5 years p.a.	2.73	0.51	2.22
Since inception p.a. 15.02.2013	3.58	0.53	3.05

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 Inc share class. Performance for the fund is calculated on a mid basis with income re-invested. The fund returns in the table above are gross of standard management fees.

¹Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 15 December 2020, and is reflected in the returns shown above.

Fund price and yields

	Distribution yield ¹
Fund	4.69%

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

¹Net of standard management charges.

²Excluding cash

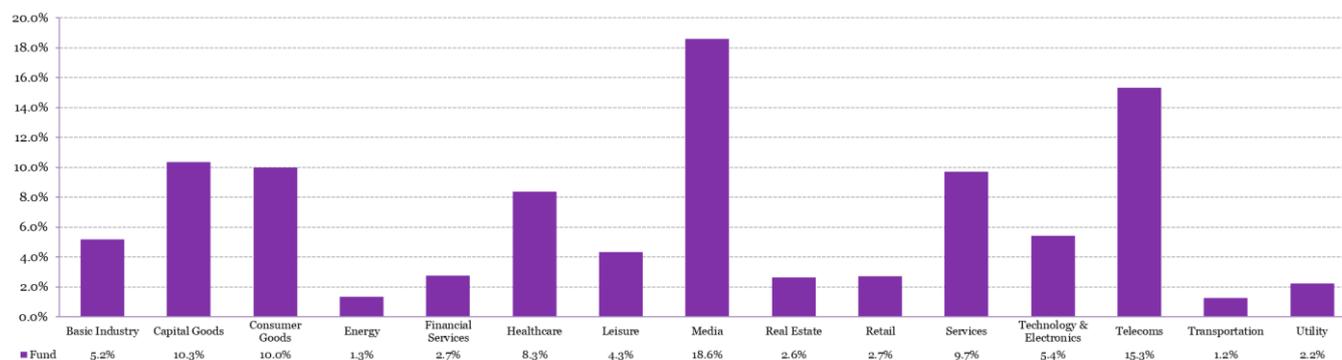
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Fund data

	Fund
Duration ²	0.9 years
No. of stocks	139
Fund size	£1,175.0m
Launch date	15.02.2013

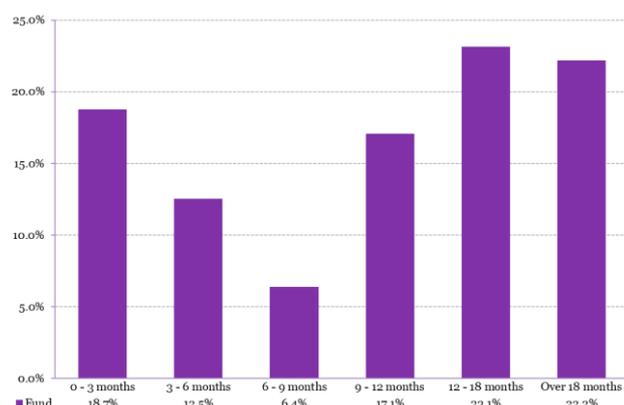
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Sector breakdown



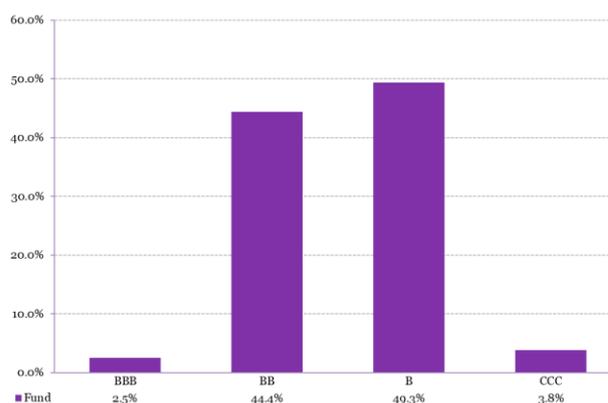
Source: RLAM. Figures exclude the impact of cash held.

Maturity profile



Source: RLAM. Maturity breakdown is the yield to expected maturity rather than actual maturity. Figures exclude the impact of cash held.

Credit breakdown



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

Ten largest bond holdings

	Weighting (%)
Commscope Finance 5.5% 2024	2.0
Grifols 3.2% 2025	1.9
Tenet Healthcare Corp 4.625% 2024	1.8
Dell Int Diamond Finance 7.125% 2024	1.7
Transdigm Inc 6.25% 2026	1.6
Telenet Finance Luxembourg 5.5% 2028	1.6
Silgan Holdings Inc 3.25% 2025	1.6
Ziggo Secured Finance 5.5% 2027	1.6
CSC Cablevision Systems Corp 5.875% 2022	1.5
Arqiva Broadcast Finance Plc 6.75% 2023	1.5
Total	16.8

Source: RLAM. Percent of fund is based on Security's fund Base Value over Total fund Base Value less Cash and FX Hedging, subject to rounding.

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Market overview

- In last quarter's outlook, we wrote: "We expect the biggest driver of high yield returns in the year ahead to be the global economic recovery. This will be especially beneficial if it feeds into higher oil prices, helping the energy companies which constitute a large portion of the high yield market. We think there will be more spread compression, particularly in the weaker parts of the market, as default risks are repriced. And we think that this spread compression will more than compensate for the impact of any increase in underlying government bond yields, which are relatively unimportant in the high yield market."
- This proved very prescient, although the subsequent increase in government bond yields was sharper than we expected and dragged down the absolute returns for the high yield market close to negative territory. However, strong relative performance across our strategies ensured that we more than offset the weakness in government bonds, delivering positive relative and absolute returns for the quarter. Despite this headwind, the recovery over the 12 months since the depths of the Covid crisis has been extraordinary; yet we continue to be optimistic about the prospects for the asset class, given the confluence of positive economic and policy drivers.
- The year started with qualified 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 shifted sharply in 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 about higher inflation from friction in global supply chains and positive base effects over the coming months. Despite this, central banks, in particular the Federal Reserve (Fed), remained firmly committed to accommodative monetary policies.
- As a result of these shifting expectations, the benchmark 10-year treasury yield rose 83 basis points (bps) over the quarter from 0.91% to 1.74%, leading treasuries to return -4.6% for maturities over one year (ICE BofAML). This, however, only takes government yields back to around the levels at which they started last year. The high yield market was insulated from this move and outperformed investment grade credit through its shorter duration (around four years) and through spread compression, particularly where spreads were widest. For the core part of the market (BB-B) on which we focus, spreads tightened around 18bps.
- Beyond the reopening trade and spread compression, the key dynamics in high yield were the strong performance of the energy sector as oil and gas prices recovered further from last summer's lows, and continued refinancings. Having increased from around \$39 at the start of November to \$52 at the end of December, the price of Brent crude oil rose another 22% to nearly \$63 a barrel by quarter end. From the prospect of a tsunami of defaults, the energy sector rebounded strongly. With higher oil prices and the more positive economic environment in general, new issue activity was particularly strong, given low yields, low default rates and corporate concern about the possibility of interest rate increases.
- As we anticipated, the improved environment has reduced defaults to a minimum. They had anyway been lower than expected, even in the energy sector. With the wall of money from the Fed and the combination of the \$1.9tn fiscal package and proposed \$2tn infrastructure spending from the Biden administration, the US economy is set to surge in 2021 and 2022. As a result, default rate expectations for the next 12 months are now at the lowest level for seven years. Weaker issuers will now survive for the foreseeable future. Even airlines, which currently have minimal revenues and are still losing money on an unprecedented scale, have been able to borrow. For example, American Airlines, one of the weakest operators, issued bonds secured against the revenues from credit card companies for its air miles programme. Recovery rates on defaults have also been stronger than we could have anticipated over the last 12 months.

Portfolio commentary

- The fund continued to perform very strongly over the quarter, driven by duration, and was ahead of its benchmark. It has also performed particularly strongly on a 12-month basis and looks well placed for the market conditions in the year ahead.
- In line with our strategy for the fund, we continued to be active in refinancings during the quarter. Companies continued to be active in using the market to extend their maturities, and we were keen to capture the yields at the front end of the market, where we thought these overcompensated for default and other risks. In keeping with the defensive strategy of the fund, we maintained its sector positioning in doing this and did not participate in any primary issuance during the quarter.
- As well as refinancings, tendering benefitted performance as issuers took advantage of the very favourable conditions to tidy up their capital structures. Notable examples for the fund were tenders by **Softbank** and **Expedia**, which we accepted as the terms were particularly attractive.

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- M&A was another theme that led to tenders and refinancings in the quarter. We lost our **Refinitiv** bonds as its merger with London Stock Exchange went through and our **Verisure** bonds were refinanced as the private equity-owned business changed its ownership.

Outlook

- We said in early January that “there is simply no alternative to the high yield market in its risk-return prospects” and we retain this bullish outlook for the next few quarters. While the average yield may be very low, having increased just 10bps over the quarter, the improved economic prospects and policy supply bode extremely well for the asset class for the next few quarters at least. While there may be nascent signs of problems down the line, the conditions remain benign for high yield investors and we believe this market has a lot further to run.
- The biggest driver of the high yield market is the default rate forecast, and we remain optimistic about it. Given the liquidity in the global financial system, we still feel that the market is overly bearish, and that default rates will be benign over the next five years. Our outlook is largely unchanged from the last quarter, with the only change being that we think there is less downside risk as a result of the key negative catalysts for the market having been substantially eliminated. We also think that there will be greater recovery rates on the defaults, reflecting higher corporate valuations and the weight of money.
- The biggest risk to our positive outlook would be a change of stance by the Fed regarding its supportive stance, perhaps if higher wage inflation were to raise fears that sustained inflationary pressures were building in the US economy. This (or even the fear that it *might* happen) could trigger a 2013-style ‘taper tantrum’. However, we believe that the Fed is acutely aware of the risks of premature tightening and choking off the recovery, having seen the impact in 2013 and also being accused of making a similar error in 2019. As a result, the US will remain the key driver of the global high yield market.
- You can find out more about our thoughts on the risks and opportunities in global high yield at www.rlam.co.uk

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