# ROYAL LONDON STERLING EXTRA YIELD BOND FUND

## Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

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# ROYAL LONDON STERLING EXTRA YIELD BOND FUND

## Executive summary

- The fund recorded a return, gross of tax and management fees of the A share class, of 2.37% during the first quarter of 2021. This was a strong result in a quarter when many fixed income assets saw negative returns, underpinned by ongoing strong income generation within the fund.
- Sterling investment grade credit starkly outperformed gilts during the quarter; respective all-maturities returns were -4.12% and -7.24%. Credit spreads on the ML Sterling Non-Gilt index tightened from 0.99% to 0.96% over gilts, with the iBoxx sterling non-gilt index seeing a similar move.
- Distributions in respect of Q1 2021, payable at the end of May, are 1.61p, 1.44p, 1.52p and 1.50p respectively for the A, B, Y and Z class income shares, moderately higher than the amounts of 1.51p, 1.35p, 1.43p and 1.41p distributed in respective of Q4 2020.

## Performance

| | Fund (Class A) % | Fund (Class Z) % |
|---|---|---|
| **Q1 2021** | **2.37** | **2.38** |
| Year-to-date | 2.37 | 2.38 |
| Rolling 12 months | 23.22 | 23.22 |
| 3 years p.a. | 5.20 | 5.20 |
| 5 years p.a. | 8.39 | 8.39 |
| 10 years p.a. | 8.70 | - |
| Since inception p.a. 13.12.2013 | - | 7.40 |
| Since inception p.a. 14.04.2003 | 8.21 | - |

***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.***

*Source: RLAM. Based on the A and Z Income share classes. 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.*

## Fund price and yields

| | Gross redemption yield[1] | Gross income yield[1] |
|---|---|---|
| Fund (Class A) | 4.36% | 5.13% |
| Fund (Class Z) | 4.63% | 5.40% |

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

*[1]Net of standard management charges.*

*[2]Excluding cash*

## Fund data

| | Fund |
|---|---|
| Duration[2] | 4.6 years |
| No. of stocks | 219 |
| Fund size | £1,809.8m |
| Launch date | 11.04.2003 |

*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 strategy

- The fund's objective is to achieve a high level of income by seeking attractive investments across a broad spectrum of fixed income opportunities, encompassing investment grade, sub-investment grade and unrated bonds.
- The fund mitigates stock-specific risk by holding a diversified portfolio of investments, so that no individual investment can in isolation have an undue impact on overall performance. In addition, where possible within the yield objective of the fund, investments are focused on bonds where risk is mitigated by structure or a claim on assets or cashflows.
- The fund maintains at least three-quarters of its total assets in sterling-denominated bonds. Currency risk associated with holdings of bonds denominated in other currencies is substantially hedged by forward currency transactions.
- The average duration of the fund's portfolio is relatively short, presently 4.6 years. The sensitivity of the performance of the fund to changes in gilt yields is therefore relatively modest.

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## Fund commentary

- 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%.
- Sub-investment grade markets were 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.
- In a quarter where fixed income markets were dominated by the rise in government bond yields, the fund's low duration was helpful in protecting investor capital. However, returns were driven by strong sector and security returns over the quarter. Investments in the energy sector generally improved in the wake of the recent rise in the price of oil, while continued buoyancy in shipping rates supported bond prices of companies in that sector, including secured bonds of **MPC Containerships** and **Songa Container**, the latter having sold a vessel in February for $43m after purchase for $23m in September 2017 and for which the proceeds are substantially held as part of the pool of security for the £130m bond issue. Of the few equity holdings in the fund, both **Yew Grove** – the Irish commercial property company, and **Impact Healthcare** – the UK care homes property company, rose in price, reflecting the increase in underlying asset values and the prospect of continued robust income generation. In contrast the holding of **Provident Financial** bonds fell on news that the company is seeking to agree a court-approved cap on the aggregate amount payable under potential claims related to past business in its consumer credit division, this approach being triggered by a recent adverse ruling related to a different company in the sector.
- Conditions in the first quarter provided opportunities in both new issue and secondary market, particularly after a relatively quiet January. New issue opportunities included unrated US dollar denominated bonds of government sponsored Australian mineral sands business **Coburn Resources**, Canadian mining business **Copper Mountain** – benefitting from the recent rise in the price of copper in the context of increased demand related to the trend from fossil fuel to renewable energy, and **Tiger Holdco**, two year bonds secured on offshore oil production assets benefitting from long term contracts with ONGC, India's investment grade national energy company. Reflecting the range of opportunity available to the fund, new issue investment also included £ denominated BB rated subordinated bonds of **NatWest Group**, offering 4½% income generation to first call date in 2028. In addition, new issues from hotel and restaurant group **Whitbread** and from **Bellis Acquisition** (the vehicle for the purchase of ASDA from US owner Walmart) were purchased at issue and sold again within the month to crystallise short-term capital gains. Existing bonds of UK North Sea oil business **Siccar Point** were tendered back to the company and proceeds largely reinvested in a new issue, maintaining coupon rate at 9% and taking five points of capital differential to extend maturity from 2023 to 2026.

## Investment 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.
- 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 12 months, not least due to present central bank liquidity provision into financial markets.
- You can find out more about our thoughts on the risks and opportunities in credit markets at rlam.co.uk.

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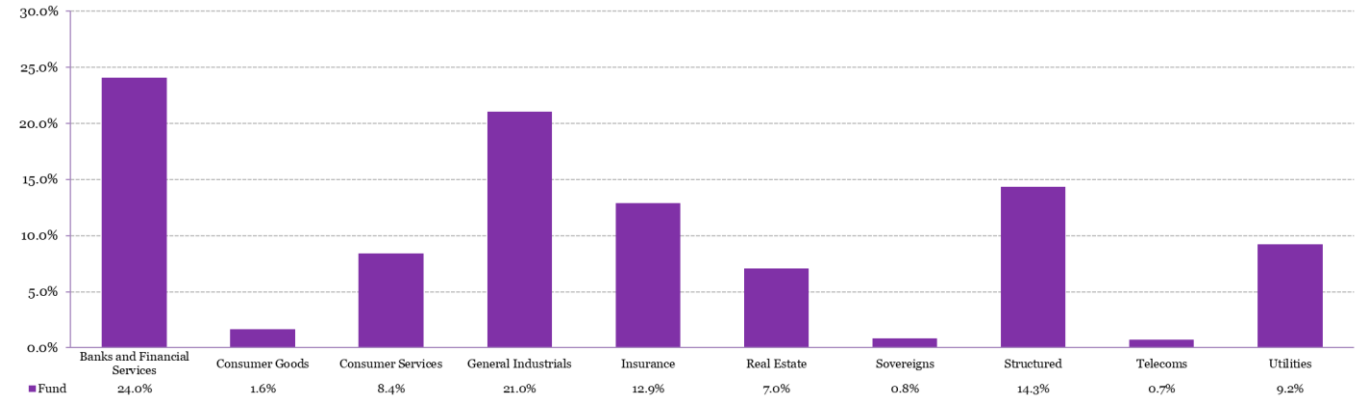
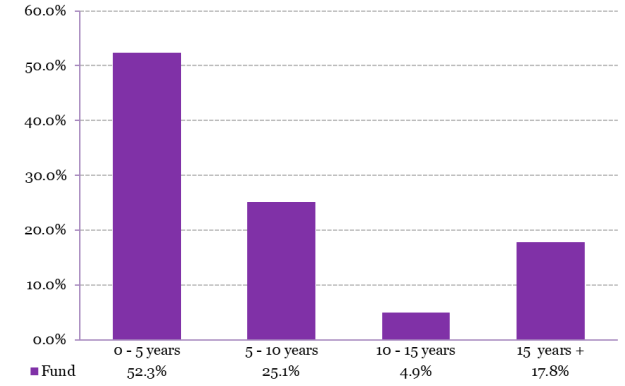
## Sector breakdown



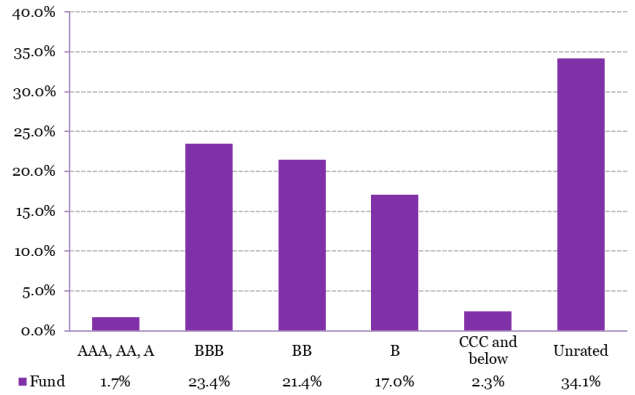

*Source: RLAM. Figures exclude the impact of cash held.*

## Maturity profile




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

## Credit breakdown




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

## Ten largest bond holdings

| | Weighting (%) |
|---|---|
| Co-op Group 6.25% 2026 | 2.7 |
| Électricité De France 5.875% 2029 | 2.3 |
| Centrica 5.25% 2025/75 | 2.3 |
| M&G 6.34% 2043/63 | 2.2 |
| Santander UK 10.0625% | 2.0 |
| Anglian Water Osprey 4% 2026 | 1.8 |
| Phoenix Group 5.75% 2028 | 1.8 |
| Santander UK 10.375% | 1.7 |
| Heathrow Finance 3.875% 2027 | 1.6 |
| Scottish Widows 7% 2043 | 1.6 |
| **Total** | **20.1** |

*Source: RLAM. Figures exclude the impact of cash held, subject to rounding.*

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