RLPPC ENHANCED BUY AND MAINTAIN CREDIT FUND

Quarterly Report 30 September 2021

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Conventional credit bonds[1]	99.7
Index linked credit bonds	0.0
Sterling conventional gilts	0.3
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.1
Foreign index linked sovereign	0.0
Derivatives	0.0

Fund data

	Fund
Duration[2]	8.5 years
Gross redemption yield[3]	2.12%
No. of stocks	473
Fund size	£389.0m
Spread	1.19%

Source: RLAM. Launch date: 16.01.2017.

[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 (%) (Income)	Reference index[1] (%)
Q3 2021	-0.63	-0.98
Year-to-date	-2.32	-3.42
Rolling 12 months	1.35	-0.42
3 years p.a	5.20	4.44
Since inception p.a. 16.01.2017	4.35	3.47

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 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 Enhanced Buy & Maintain	2.87%
iBoxx Sterling Non-Gilt All Maturities Index	2.63%

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.

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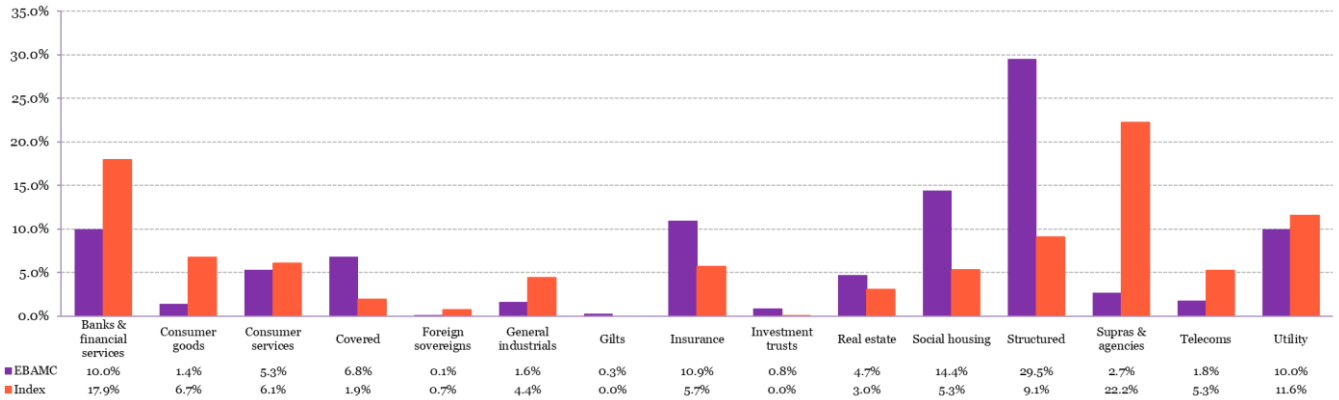
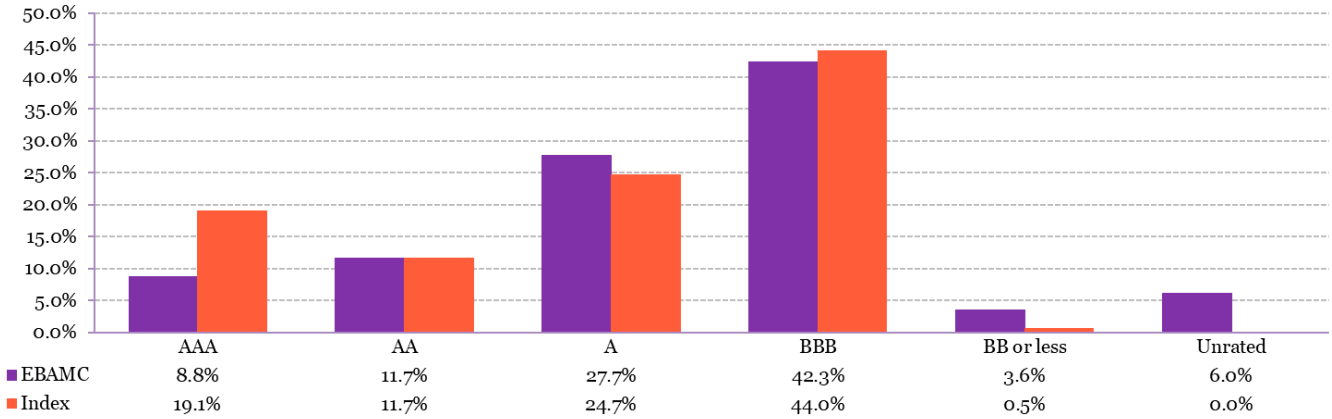
Sector breakdown



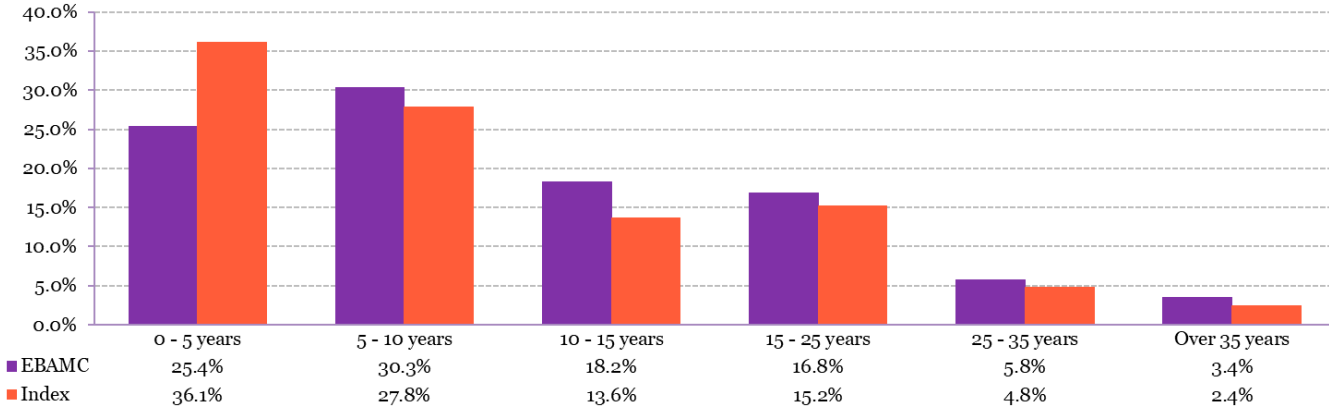
Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Rating breakdown



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



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

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Ten largest holdings

	Weighting (%)
Co-operative Bank 4.75% 2021	1.3
Aviva 6.875% 2058	1.0
HSBC Bank 5.844% VRN Perpetual	0.8
Temasek Financial Ltd 2.75% 2061	0.8
The Housing Finance Corporation 5.20% 2043	0.8
University of Oxford 2.544% 2117	0.8
TSB Bank Plc FRN 2028	0.7
Yorkshire Housing 4.124% 2044	0.7
Clydesdale Bank Plc 4.625% 2026	0.7
Society of Lloyds 4.875% 2047	0.7
Total	**8.2**

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

Market overview

- For much of the quarter, the prevailing sentiment in financial markets was 'more of the same' with the ongoing recovery in economic activity causing some supply chain frictions, interspersed with concern about inflation on the one hand or an autumn Covid spike on the other. The huge recovery in risk asset prices since March 2020, however, meant that markets were increasingly vulnerable to negative news. Several such shocks came more-or-less together in the last weeks of the quarter.
- First, the likely collapse of giant property conglomerate Evergrande shook investors and there were fears that this could be China's 'Lehman moment', with a single corporate bankruptcy leading to systemic failure. Subsequently, bottlenecks in supply chains caused by Covid disruption (and, in the UK, possibly exacerbated by Brexit) led to more-visible shortages and price spikes, which ultimately led central bankers to revise their forward guidance on the tapering of quantitative easing measures and interest rate rises.
- The quarter began with the Delta Covid variant increasingly prevalent across the US, eurozone, the UK and Asia. Over the period, the global picture became more varied, with cases rising in the US and UK, but with waves in Europe, Japan and China seemingly more contained. With vaccine programmes continuing, governments were reluctant to maintain or tighten social distancing restrictions, instead preferring to introduce booster jabs and vaccinate children.
- Global economic data was mixed, with inflation still causing concern and economic growth appearing to slow in the third quarter. In late September, the US Federal Reserve (Fed) made substantial changes to its economic forecasts, revising its growth outlook and increasing inflation expectations. Chair Jerome Powell suggested it could "easily move ahead" with plans to taper its $120bn monthly asset purchases programme as early as November. The market expects US inflation to peak at 4.2% this year before falling back to 2.2% in 2022. The Federal Open Market Committee also revised its interest rate path, signalling three potential interest rate rises of 25bps during 2022.
- In the same week, the Bank of England (BoE) said inflation could reach 4% over the winter months, largely due to rising energy and goods prices. However, it expects it will then fall back towards its 2% target in the medium term. The European Central Bank voted to keep interest rates unchanged at its September meeting, but opted to slow the pace of net asset purchases through the pandemic emergency purchase programme.
- In UK bond markets, the resurgence of inflation fears, and potential for less accommodative monetary policy was the main driver of a sell-off in yields, particularly in September. The benchmark 10-year gilt yield rose from 0.72% to 1.02% over the quarter, leading gilts to return -1.84% on an all-maturities basis (FTSE Actuaries). Credit market returns were also negative, due to the rise in underlying gilt yields, but somewhat tighter spreads and the yield on these assets somewhat offset this impact, with sterling investment grade credit returning -0.96%%. 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 0.91% to 0.87%.
- All sterling credit sectors delivered negative returns during the quarter, although there was some dispersion. The financial sectors (insurance, banks and covered bonds) performed relatively strongly, particularly subordinated insurance and specific subordinated banks bonds; and asset-backed securities were one of the strongest sectors. Supranationals performed broadly in line with the wider market, whereas the telecoms, healthcare and retail sectors notably underperformed. Shorter-

dated bonds strongly outperformed longer-dated issues, but still delivered negative returns; and BBB rated bonds also outperformed their higher-rated peers.

Performance

- The portfolio performed well over the quarter, producing positive absolute returns in a quarter when both gilts and broad sterling credit indices produced negative returns. Returns came from a number of core positions, including allocation and stock selection in structured bonds, our preference for senior bank bonds (over subordinated bank paper) and insurance. Our underweight in supranationals also contributed to returns. Duration positioning was the primary negative over the quarter. The nature of buy & maintain investing means that duration is longer than broad credit indices, and the rise in gilt yields was therefore negative. However, the impact of this on overall returns was more than offset by the attractive level of carry on the portfolio, as well as sector and stock selection.
- Within financials, returns on senior bonds were generally less negative than those on subordinated. This contributed to returns when looking at wider credit markets, but was still negative for the portfolio in terms of absolute returns. Within buy & maintain portfolios, we continue to prefer to be higher in the capital structure when lending to the financial sector reflecting the more conservative risk profile compared to a traditional credit portfolio.
- 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.

Activity

- Market liquidity tends to be lower in the summer months and this year was no exception. Activity was therefore biased towards new issues more than we would usually expect, as secondary market liquidity was somewhat thin. Within new issues, we remain selective: some new issues are coming to market at levels that we feel are not justified by fundamentals, and on occasion, strong market interest can lead to a significant fall in spread between book building and issue stages. We are happy to pass where such contraction leaves little value for our investors. As ever, activity was 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.
- Structured bonds are a significant part of the overall portfolio. During the quarter we added a new structured bond from university accommodation financing company **Uliving**. The bonds have been issued to fund new accommodation at the University of Essex and have an AA rating due to additional protections in the structure. The project will deliver an extra 1,262 rooms and is expected to come on-line in September 2023. As the sole owner of the £65m fixed rate tranche we were able to work closely with the issuer to ensure that our respective requirements were met. Our exposure to education is actually quite wide, covering student accommodation, schools, student loans and direct university funding. None of these opportunities were available 10 years ago and reflects the dynamic nature of credit markets and the bespoke nature of our sterling credit capability.
- In the financial sectors we maintained a preference for senior bonds. We participated in a number of new issues during the quarter. We bought a new senior bond from **First Abu Dhabi** – the five-year bonds coming at a small premium to the market, and an attractive spread premium compared to similar short-dated bonds. We also added a tier 2 new issue from Australian insurer **QBE**, with these new issues providing diversification away from UK risk. Relative value switches also added value over the quarter. We sold 2028 **Investec** callable subordinated bonds into a new issue of 2028 senior bonds from the Investec Holdco, decreasing risk and yet still achieving a modest spread enhancement.
- The real estate sector is one that we tend to favour given the greater security or covenant protection in place on many of the bonds. During the quarter we added a new issue from US REIT **Realty Income**, which came at an above-market spread and also added some non-UK diversification to the portfolio.
- Social housing remains a key area of interest for us. Performance has been strong and despite increased interest in the sector, we continue to find new issues at attractive levels. The sector benefits from implicit government support, and lending on a secured basis to a sector of societal benefit is an excellent fit for our investment philosophy. Although market interest is growing, the unique nature of the bonds and the assets underpinning the bonds still dissuades many investors from the sector given the additional research capabilities needed.
- During the quarter we added a new issue from **Blend Funding**, a tap of an existing 2047 bond that came to market at a premium to the market as well as a new issue from **Clarion Housing**, the UK's largest Housing Association. In addition, we added issues from **Metropolitan Housing** and **Anchor Housing**. Metropolitan owns, manages or administers around 57,000 houses across London, the South East, East Midlands and East of England, while Anchor manages a mix of

social and retirement housing across England. We also added a tap of an existing issue from **Poplar Housing**, as we continue to find opportunities in the social housing sector that we feel offer a good mix of security, credit spread and lower ESG risk. Poplar was available at a significant spread premium which we felt more than compensates for some additional development risk. Finally we added a new issue from **Platform Housing**, selling longer dated bonds from the same issuer to fund the trade, which increased spread and decreased duration.

- Social housing activity wasn't limited to purchases. Although it is a sector we favour, we still take advantage of relative value switches. One example of this was **Optivo Finance**, where we sold 2048 bonds and bought 2035 equivalents, the flat credit curve meaning we could bring down portfolio duration with little impact on spread.
- One trend in recent quarters has been a sharp tightening of spreads for bonds that are less than five years from maturity, as index-led buyers have to add to their portfolios. This can create opportunities for our portfolio – as we benefit from the spread tightening and can then switch into longer dated bonds to enhance spread. An example of this during the quarter was a sale of **Scottish Power Distribution** 2026 bonds, adding **Western Power Distribution** 2027 bonds for a spread enhancement of just over 20bps. This exposure therefore remains centred on the electricity network, giving us access to a highly regulated sector with predictable cashflows.
- Utilities remain another area which fits well with the Buy & Maintain strategy, particularly in the electricity sector, which is highly regulated, produces stable cashflows and is an essential part of the climate change solution. During the quarter we added **Scottish Hydro Electric Transmission**, part of SSE, the company being an obvious part of the trend to decarbonise as more renewable energy is transmitted through the network over time.

Outlook

- After a relatively benign third quarter, the market volatility at the end of September and in the first week of October suggest that vigilance will be required in the coming months. However, while the change of gear has been somewhat abrupt, we are more sanguine than others appear to be about the outlook for inflation. Credit spreads ended the quarter close to their tightest level since 2007; we see little scope for further tightening but expect any pull back to be modest.
- We expect implied UK inflation (i.e. nominal yields minus real yields) to fall back from the highs recorded in September and early October. Higher energy costs will feed through to inflation in 2022 and we can still expect on-going supply disruptions to impact prices in some sectors. However, there are countervailing pressures. In the UK, businesses will face a significant squeeze next year as higher taxes, including National Insurance and increased wage costs impact profitability. Similarly, consumers real disposable income will come under pressure: higher energy bills, an end to the £20 Universal Credit uplift and the prospect of higher mortgage rates will impact. At a global level the deflating of the Chinese property market may impact the Chinese economy and have wider knock-on effects. Taken together we see inflation moderating through the second half of 2022.
- We expect tapering of quantitative easing in developed economies and it is likely that interest rates will rise a bit earlier than anticipated. However, global economies remain highly sensitive to tighter monetary policies and only relatively small increased in rates will have a dampening impact. Therefore, we retain of our view that the rise in government rates which we have expected will be modest and that we remain in a low interest rate environment.
- We will maintain our long-standing focus on risk management by seeking to identify companies with strong balance sheets; favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors and other factors. In addition, we expect to maintain an overweight position in subordinated financial bonds where credit spreads remain attractive.
- It is still our view that credit spreads compensate for the risk of default and credit will outperform government bonds over the medium term. Our portfolios have a material exposure to BBB bonds where compensation for default risk remains elevated. Credit risk is not something that should be taken unthinkingly but it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.

Find out more

- Join us online for the 2021 RLAM Investment Series (our annual client conference) between 1st and 5th November. A range of our fund managers and other in-house specialists will address the macroeconomic environment and prospects for different asset classes, and the issues they are considering in positioning their funds. There will also be sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. For more details and to register, please visit rlam.co.uk.
- In recent years, social housing has become an increasingly important component of our sterling credit and sustainable funds. However, it is crucial to find the right way to invest in the sector, in a manner which respects the strong social benefits that it provides. We prefer to lend to social housing associations through participation in credit issues, rather than make equity

investments through real estate investment trusts (REITs). Shalin Shah and Tom Johnson write about the sector on rlam.co.uk. While it approaches social housing from a sustainable perspective, their article gives a good overview of the sector, and highlights why we believe that a thorough and well-resourced bottom-up active investment approach ultimately delivers the best results for clients.

- You can find more of our thoughts on the opportunities and risks in the sterling credit sector at rlam.co.uk. Head of Fixed Income Jonathan Platt writes a weekly blog each Monday on key issues in sterling credit and other fixed income markets.

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