ROYAL LONDON DIVERSIFIED ASSET-BACKED SECURITIES FUND

Quarterly Report 30 September 2021

For professional clients only, not suitable for retail investors

CONTENTS

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Asset split

	Fund (%)
Conventional credit bonds[2]	93.3
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	0.8
Other	0.0

Fund data

	Fund
Duration[3]	0.4 years
Gross redemption yield[4]	2.49%
No. of stocks	209
Fund size	£198.5m

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 (%)
Q3 2021	**1.43**	**0.01**	**1.41**
Year-to-date	5.29	0.04	5.25
Rolling 12 months	8.49	0.05	8.44
3 years p.a.	3.57	0.41	3.16
5 years p.a.	4.32	0.44	3.89
Since inception p.a. 24.09.2012	4.20	0.48	3.72

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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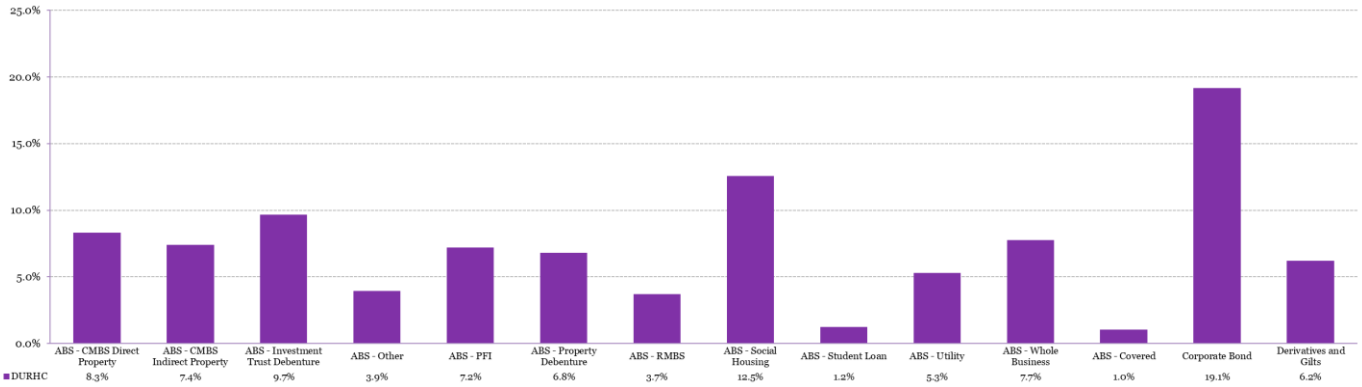
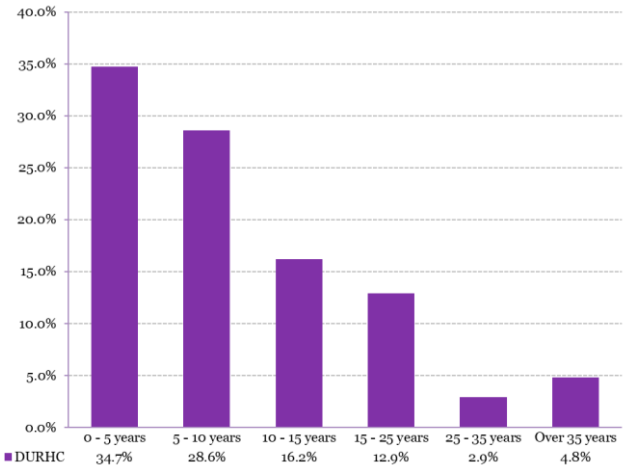
Sector breakdown

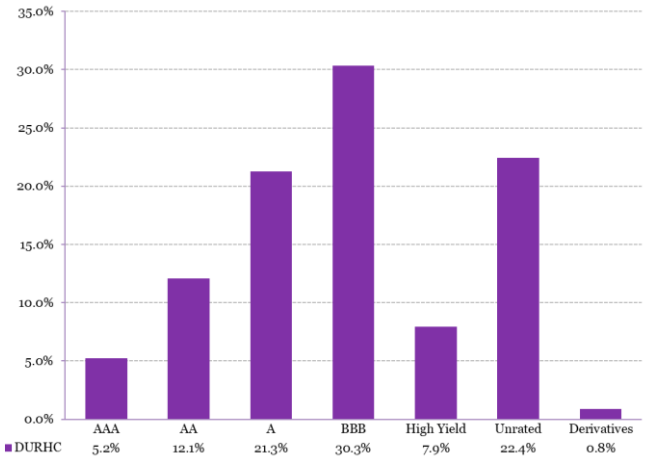


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

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	1.6
Law Debenture 6.125% 2034	1.3
Trafford Centre 2038	1.3
Equity Release 5.7% 2031	1.3
Edinburgh Investment Trust 7.75% 2022	1.3
Grosvenor UK Finance 6.5% 2026	1.2
Mercantile Investment Trust 6.125% 2030	1.1
Finance for Residential Social Housing 8.368% 2058	1.1
Total	**13.9**

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

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Fund activity and market commentary

- The fund performed strongly over the third quarter, returning 1.28% against 0.01% for its SONIA benchmark. The outperformance against SONIA primarily reflected positive stock selection within ABS and financial debt, which both outperformed the broader credit market. The fund has also outperformed over the year to date, returning 4.85% compared to 0.04% for the benchmark.
- 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.
- In addition to the strong performance underpinning from the fund's largely secured exposures, and interest rate hedging, at an individual asset level returns were boosted by our holdings in a number of higher yielding infrastructure bonds. Most notably, the attractions of **Peterborough Progress Health** and **Connect M77**, which were issued over a decade ago to fund the development of Peterborough Hospital and the M77 motorway in Glasgow respectively, began to be recognised by the market and both bonds performed very strongly. We have long understood the attractiveness of secure government linked cashflows in this area and have been able to exploit the credit market's predilection for more conventional corporate bonds.
- Activity reflected new issue opportunities and secondary market availability. Issuance tailed off in July and into August due to seasonal factors, but rebounded in September. Over the quarter, spreads on new issues were increasingly too low to interest us and a number of deals that looked attractive initially were tightened during the book building phase to levels where we passed. Several new issues struggled in the market choppiness at the end of the period and, if the current volatility continues, issuance for 2021 may only match that for 2020.
- We actively participated in new issues over the quarter. Reflecting our experience of sourcing and analysing assets across a diverse range of secured sectors, we purchased a broad range of attractively priced and credit enhanced bonds. By way of

illustration, this included a longer dated fixed rate bond issued by **Platform Housing** in the social housing sector, as well as two AAA rated and shorter-dated mortgage-backed securities issues with floating rate coupons: a residential mortgage-backed securities (RMBS) issue from **Together** (2021-1ST1 A) and a commercial mortgage-backed securities (CMBS) issue from **Atom** (1X A). In addition, we added a new secured bond from the **AA**; and helped to structure a new bond from university accommodation financing company **Uliving** – the bonds have been issued to fund new accommodation at the University of Essex and have an uplifted AA rating due to additional creditor protections in the deal.

- We were also able to add high-quality and attractively priced bonds in the secondary market. Notable purchases included an issue from **Myriad Capital**, secured on the assets of Chelmer Housing Partnership, a housing association based in Essex; and secured bonds of **Arqiva**, **Broadgate** and **Tesco Property**. Tesco Property was a switch from another bond of same issuer. When secured bonds no longer offer sufficient compensation, we are keen to recycle and, in addition to the switches outlined above, following strong performance, we disposed of our holding in the RMBS, **Towd Point Mortgage Funding** (2018-A12X), which we consider to have weaker and more economically-sensitive collateral compared to other holdings in the sector.
- 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 the fund is well positioned for this.
- 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.

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

- After a relatively benign third quarter, the market volatility at the end of September and in the first week of October suggest that extra 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 here. At a global level the deflating of the Chinese property market may impact the economy there 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, these economies remain highly sensitive to tighter monetary policies and only relatively small increased in rates will have a dampening impact. Therefore, we retain our view that the rise in government rates (which we have expected) will be modest and 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. It is still our view that credit spreads compensate for the risk of default and credit will outperform government bonds over the medium term. The fund has a material exposure to BBB bonds where compensation for default risk remains elevated and losses are further dampened by security, strong covenants and, in the majority of cases, a senior claim on issuers'

assets and cashflows. 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 managing 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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