ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Quarterly Report 30 September 2021

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Executive summary

- The fund recorded a return, gross of tax and management fees of **1.8%** during Q3 2021, bringing its 2021 year to date return to **8.1%.** This strong performance in the quarter reflects the fund's fairly low sensitivity to government bond yields, which rose in the quarter, strong performance within some areas of its broad range of investments, and robust income generation.
- Gilt yields rose quite sharply in September on concerns of rising inflation pressures and the outlook for monetary policy, more than offsetting earlier strength. Over the quarter as a whole gilts posted an index return of -1.93%. Sterling investment grade corporate bonds held up relatively well, at -0.96%, while European and Global high yield indices, also less influenced by rising government yields, posted positive returns of 0.65% and 0.18% respectively. 2021 year to date index returns for these asset classes are -7.64%, -3.41%, 3.69% and 3.25% respectively.
- Distributions in respect of Q3 2021, payable at the end of November, are 1.62p, 1.45p, 1.54p and 1.52p respectively for the A, B, Y and Z class income shares, moderately above than the amounts of 1.55p, 1.38p, 1.47p and 1.45p distributed for Q2 2021.

Performance

	Fund (Class A) %	Fund (Class Z) %
Q3 2021	**1.84**	**1.84**
Year-to-date	8.12	8.13
Rolling 12 months	14.84	14.84
3 years p.a.	5.92	5.92
5 years p.a.	7.47	7.47
10 years p.a.	9.56	-
Since inception p.a. 13.12.2013	-	7.66
Since inception p.a. 14.04.2003	8.30	-

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 fees.

Fund price and yields

	Gross redemption yield	Gross income yield
Fund (Class A)	3.83%	4.95%
Fund (Class Z)	4.10%	5.22%

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

[2]Excluding cash

Fund data

	Fund
Duration[2]	4.8 years
No. of stocks	219
Fund size	£1,852.3m
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 4.8 years. The sensitivity of the performance of the fund to changes in gilt yields is therefore relatively modest.

ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Fund commentary

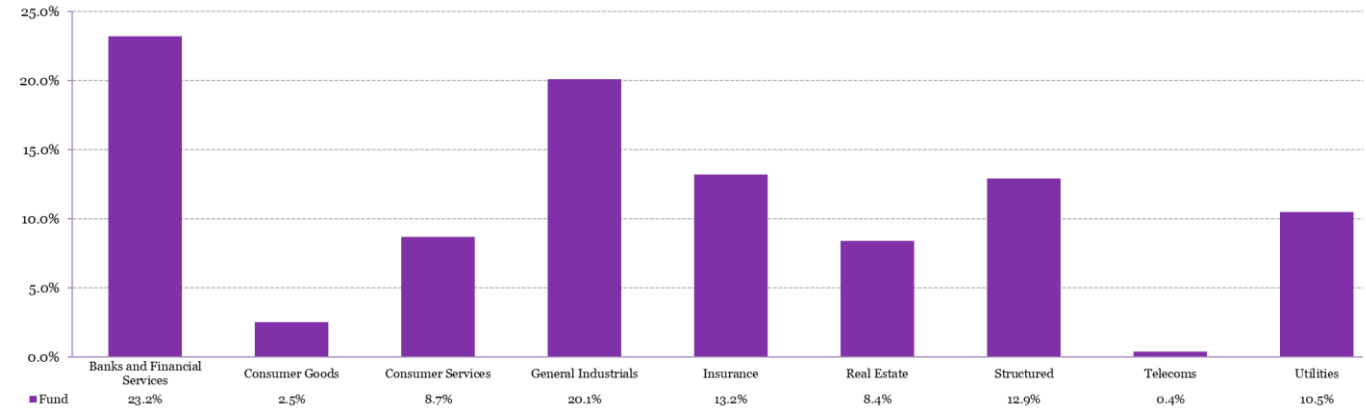
- There was a significant flow of new issues in the quarter and the fund participated selectively. This included sterling denominated bonds of Australian insurance company **QBE**, UK annuity provider **Just Group**, health business **BUPA** and road services operator **AA**. New euro-denominated issues of car parking business **APCOA Parking,** and renewable energy businesses **European Energy** and **Øyfjellet Wind**, while US dollar new issue purchases included shipping group **Euronav**, energy companies **Ithaca Energy**, **Ping Petroleum, Waldorf Production** and **Weltec**, and financials **Allianz**, **Julius Baer** and **Nordea Bank**.
- Market purchases in the quarter included bonds of transport group **National Express**, utility **Thames Water**, UK leisure business **Centre Parcs**, UK airport hub **Heathrow** and media business **Daily Mail and General Trust** – purchased after the bond price fell quite sharply on news that they were selling their US education business and then seeking to take the company into private rather than public ownership, possibly entailing the loss of a formal credit rating.
- Sales in the period included European lending group **DDM**, crystallising a moderate capital gain from purchase at issue in April, and longer dated, BBB rated bonds of **Lloyds Banking Group** and **Standard Chartered** which seemed likely now to be materially sensitive after recent strong performance to a rise in government bond yields. Sales of short-dated gilts in the period reflected cash management, utilising this source of liquidity to invest in attractively priced new opportunities.
- In addition a number of companies chose to exercise options to repay bonds ahead of their final maturity date, at attractive pricing to holders, in order to take advantage of benign market conditions to issue longer-dated new bonds. These included industrial material group **Fiven**, data management company **Digiplex**, shipping groups **Borealis** and **Songa Container**, mineral sands group **Tizir** and energy business **DNO**.
- While the fund was not immune from the rise in government bond yields, its short average duration mitigated the impact and investments in the financial sectors of banking and insurance proved relatively resilient. Investments in the commodity and energy sectors generally performed well in the context of recent commodity and energy price rises, while bonds of lending group **Provident Financial** rose on news of progress on its exit from home credit arm of the business, while the price of unrated bonds of shipping services business **Modex** issued in February rose sharply when the company was acquired by larger group **OEG Offshore**.

Investment 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.

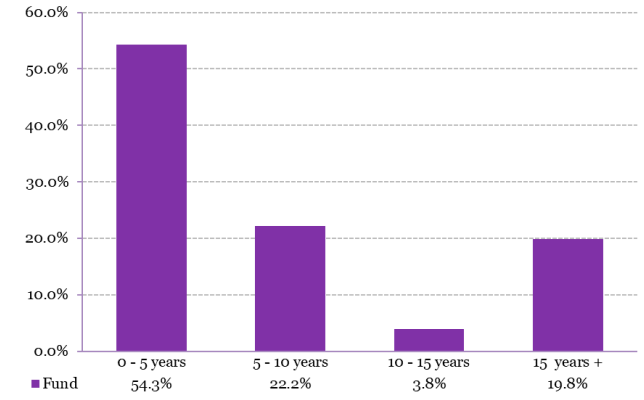
ROYAL LONDON STERLING EXTRA YIELD BOND FUND

Sector breakdown



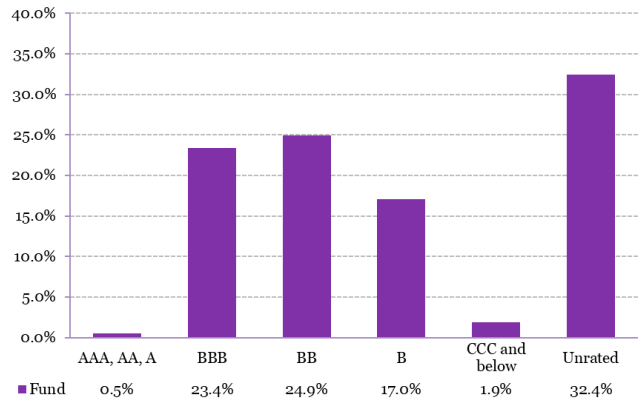
Source: RLAM. Figures exclude the impact of cash held.

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
Santander UK 10.0625%	2.2
Centrica 5.25% 2025/75	2.2
M&G 6.34% 2043/63	2.2
Anglian Water Osprey 4% 2026	1.9
Santander UK 10.375%	1.9
Phoenix Group 5.75% 2028	1.8
Scottish Widows 7% 2043	1.7
Heathrow Finance 3.875% 2027	1.6
Total	**20.4**

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

ROYAL LONDON
ASSET MANAGEMENT