RLPPC Enhanced Buy & Maintain Fund

Quarterly Investment Report

31 December 2023

ROYAL LONDON
ASSET MANAGEMENT

Quarterly Report

The fund as at 31 December 2023

The purpose of this report is to provide an update on the RLPPC Enhanced Buy & Maintain Fund. The report has been produced by Royal London Asset Management. The report starts with a summary dashboard showing key information about the fund. A glossary is located at the end of the report covering the description of some of the more technical terms used within the report. All data is as at the report date unless otherwise stated.

Contents

The fund

Fund performance objective and benchmark

The fund will aim to provide excess income (relative to equivalent UK Government Bonds) over the life of the fund. It will target a spread at inception, relative to gilts, of +1.3%-1.6% (with allowance for +/- 0.1% tolerance at inception). This spread target may move over time, reflecting any change in market conditions.

Reference index: There is no benchmark for this fund. The iBoxx Sterling Non-Gilt All Maturities index has been used in this report for reference purposes only.

Fund value

	Total £m
31 December 2023	212.31

Asset allocation

	Fund (%)	Benchmark
Conventional credit bonds	96.65%	99.38%
Securitised	3.35%	-
Conventional foreign sovereign	-	0.62%

Fund analytics

	Fund	Benchmark
Fund launch date	16 January 2017	
Base currency	GBP	
Duration (years)	6.82	5.54
Gross redemption yield (%)	6.02	4.77
Credit spread (%)	2.27	
Number of holdings	265	1,264
Number of issuers	188	501

Performance and activity

Performance

	Fund (%)
Quarter	8.66
1 Year	10.27
3 Years (p.a.)	(4.42)
5 Years (p.a.)	0.73
10 Years (p.a.)	-
Since inception (p.a.)	1.30

Past performance is not a guide to future performance. Please refer to the Glossary for the basis of calculation and impact of fees. Performance and since inception date based on RLPPC Enhanced Buy and Maintain Fund (Inc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 16 January 2017.

Performance commentary

The fourth quarter saw positive returns for the portfolio, with a positive impact from the fall in government bond yields as well as a positive impact from tighter credit spreads and the carry built into the portfolio. Looking at performance in the context of the wider sterling credit market, the portfolio return was slightly better – primarily because as a buy & maintain strategy, the portfolio has a longer duration than a market index such as the iBoxx Sterling Non-gilt index.

The main driver of positive performance relative to the wider market was our sector positioning, notably our underweight position in supranationals, which continued to lag the wider market having done so in the third quarter. However, stock selection effects were negative due to our exposure to structured bonds, which generally have a lower sensitivity to wider market moves. In addition, our holding in Thames Water was also a detractor from performance over the quarter. We maintained exposure to Thames Water as part of a diversified portfolio, based on the attractiveness of the overall blended yield across holdings in operating company and holding company debt. Whilst structurally junior holding company debt underperformed and was downgraded, our larger exposure to the operating company debt was beneficial for performance over the quarter. We continue to believe that the sector remains attractively valued – largely based on our view that spreads in the sector overcompensate when compared to other regulated infrastructure assets such as UK electricity distribution.

Last quarter we highlighted an issue with our holding in HDL, where the principal was not repaid on maturity at the end of July. We are pleased to confirm that the bond was redeemed in full in November. We believe this is a good outcome as not only did holders receive full repayment, but also accrued interest at the coupon rate since the end of July. In our view, this demonstrates the power of covenants and how these can protect investors' interests in this sort of scenario. The default was not ideal, but as we expressed in our initial update we had confidence in our position. It should be noted that, over time, the investment in HDL has been materially beneficial – despite the default.

Performance and activity

Fund activity

Financials remain the largest part of the market and continued to dominate market issuance during the quarter. We add subordinated bonds where we feel the risk/ reward profile is attractive, examples during the quarter including defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation.

Utilities is an area of natural fit with our Buy & Maintain strategy given the longer-dated debt issued, and the regulated nature of the industry. Southern Water is a regulated utility and we bought a new issue of senior operating company bonds during the quarter. We felt these were attractively priced – the company trades wider than the sector due to perceived operational and financial issues, but in our view operating performance is starting to improve, supported by significant new equity injections over the last few years. We also added a new 2040 issue from Thames Water. The bonds are at the operating company level and came at a very attractive spread compared with existing Thames debt and peers.

Social housing remains a key area for our Buy & Maintain strategy. During the quarter a new issue of 2041 bonds from Places for People. The company owns and manages 240,000 properties across the UK and the bonds came at an attractive spread premium to the market.

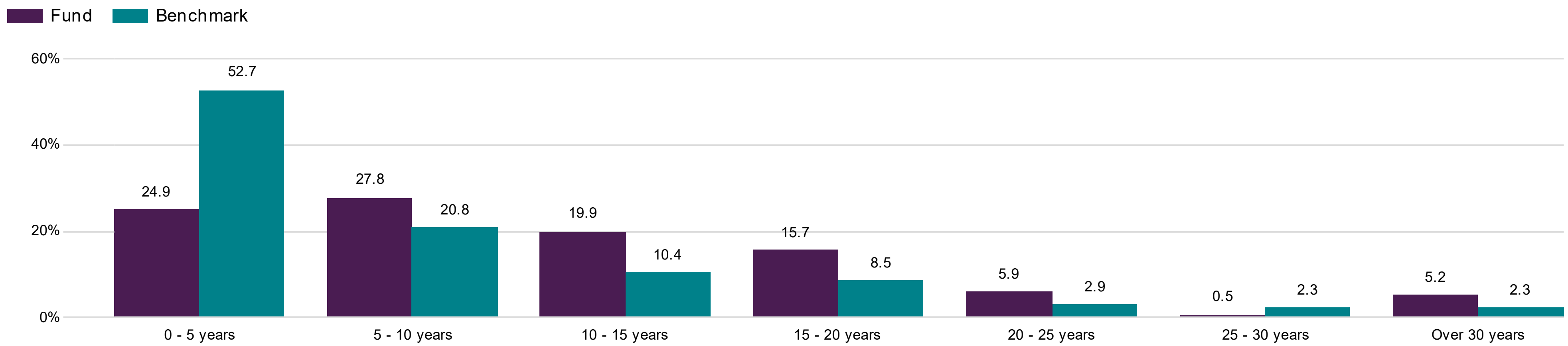
There were noteworthy new issues in the structured sector as well. We added a five-year new issue from the RAC, these bonds yielding over 8%, with the bonds backed by cashflows of the operating company.

Market dynamics and inefficiencies continue to provide opportunities to make switches where we can improve credit quality, yield or spread, with several examples during the quarter. Perhaps the best example of this was a switch from Scottish Hydro into National Grid. Both are regulated utilities operating in electricity transmission, with similar credit quality, but we were able to achieve a yield pick-up of 55bps..

In addition to regular activity, there was an outflow from the fund in November. We raised funds across the portfolio, focusing sales on maintaining the quality and composition of the remaining portfolio.

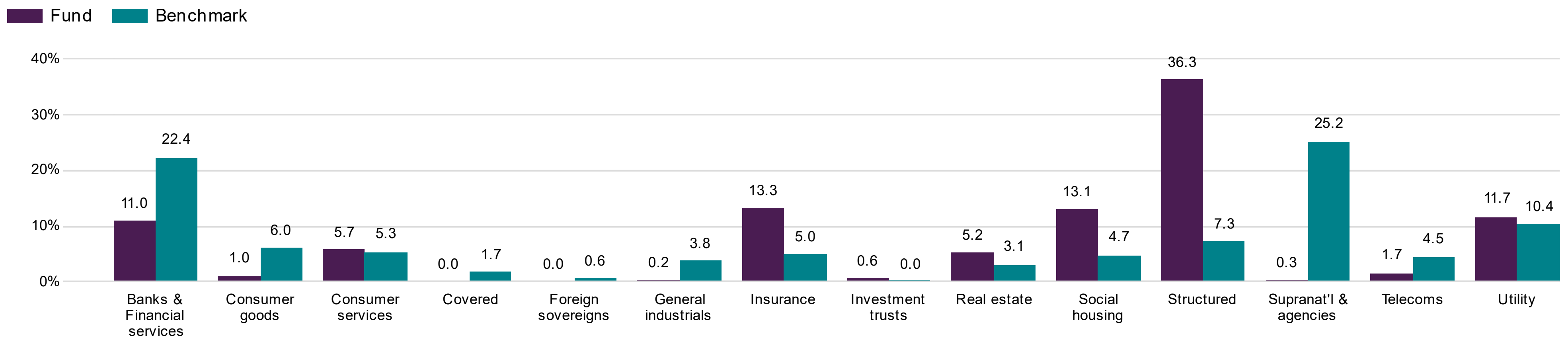
Fund breakdown

Maturity profile



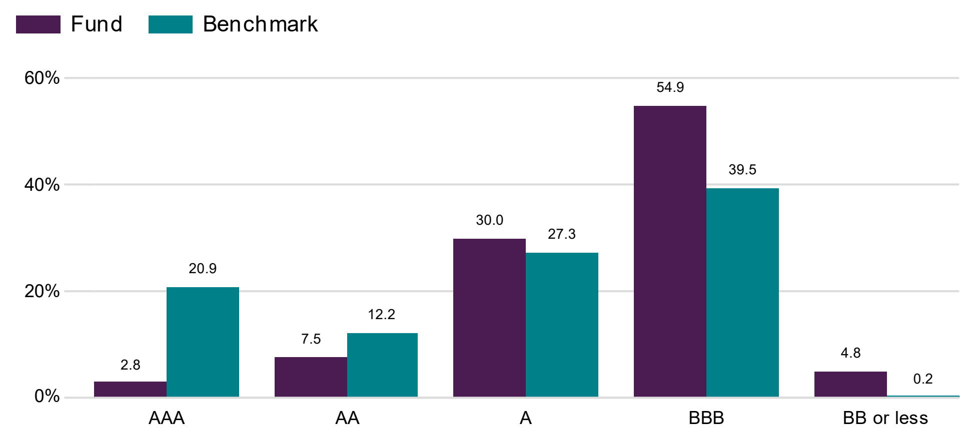
Fund breakdown

Sector breakdown



Credit ratings

Credit ratings



Downgrades

The table below details directly held credit bonds downgraded to sub-investment grade by at least one agency during the quarter.

Asset description	Current Rating	Previous Rating
DIGNITY FINANCE PLC 3.545600000 2034-12-31	B+	BBB-

Upgrades

The table below details directly held credit bonds upgraded from sub-investment grade by at least one agency during the quarter.

Asset description	Current Rating	Previous Rating
No upgrades this quarter		

Market commentary

Market overview

Economic attention over the quarter has been on inflation. At the start of the quarter investors focussed on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period. The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields fell in November and December.

UK government bonds produced strong returns due to falling yields, delivering an 8.1% return (FTSE Actuaries) over the fourth quarter with the benchmark 10-year gilt yield falling from 4.44% to 3.54%. The falling yield environment was helpful for longer duration assets, with longer-dated bonds outperforming shorter-dated bonds.

The sterling investment grade credit market (iBoxx non-gilt index) returned 7.35% over the quarter, helped by lower government bond yields and tighter credit spreads. The underperformance compared to the gilt market is the result of the shorter duration of the credit market index. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightened from 1.38% to 1.15% (iBoxx). Given the fall in yields, sectors with a greater proportion of long-dated bonds performed well, including utilities and social housing. Supranationals was the worst performing sector, while in financials, banks lagged slightly but insurance bonds modestly outperformed the market.

Issuance was relatively low in the fourth quarter, reflecting usual seasonal patterns. For the year as a whole, sterling issuance was £63.9 billion, or £28 billion in net terms, compared with £51.5 billion and -£2.7 billion respectively in 2022.

Outlook

Inflation has come down significantly in 2023 but remains well above the Bank of England's target, and now does not have the 'easy' wins of base effects to push this lower. In our view, wage inflation is the key metric: we believe that the Bank will find it hard to start cutting rates if wages continue to rise at 5-6% pa. Although the economic data remain very mixed, we still believe that higher interest rates will contribute to a slowdown in the UK. This could well impact company earnings and lead to some increase in pressure on credit markets. However, consumer resilience has been greater than expected in both the UK and globally, which has helped support growth and prevent a recession. How this continues into 2024 could prove critical.

As we came into November 2023, we felt that the all-in yield on sterling investment grade credit was looking very attractive, having risen significantly since the start of the year. The falls in gilt yields since then have largely reversed those rises. Our sterling credit strategy focuses on three sources of return: gilt yields, market credit spreads, and the additional credit spread we generate over credit benchmarks. Whilst ten-year gilt yields of 3.5% are not as attractive as the 4.5% seen in October, we feel that the excess yield available on investment grade credit overcompensates for default risk. Further, the additional yield embedded in our Buy & Maintain strategies, over that available from broad credit indices, gives us confidence in our ability to deliver long-term outperformance.

We expect supply to weigh on credit markets in the first quarter but believe that underlying fundamentals will limit spread widening. Our emphasis remains on building diversified portfolios, with a high relative exposure to asset backed and strongly covenanted bonds that offer an attractive yields.

Although recent outperformance means that the relative attractiveness of sterling credit bonds has reduced, we still favour holding them compared to UK government debt as credit spreads remain at levels that more than compensate for the credit risk. Given the potential challenges in the outlook, we remain focused on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

Royal London Sterling credit ESG analysis

TCFD climate report

Find out more

Royal London Asset Management's Outlook 2024 document and podcasts are both available on our website. In this year's Outlook document, our fund managers assess the challenges and opportunities in their respective asset classes for 2024. With an environment of falling inflation and modest recession, the benefits or risk for equities or credit is not so clear cut and knowing your companies is key. We analyse the areas of concern and potential growth within this environment.

In our Outlook 2024 podcast, Piers Hillier, CIO, looks ahead to 2024 and discusses the issues he believes will be prominent over the next 12 months, and where the key investment risks and opportunities may lie.

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

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Risks and Warnings

General Risks

The degree of investment risk depends on the fund you choose.
The prices of units can go down as well as up.
The return from your investment is not guaranteed; therefore, you may get back less or more than shown in the illustrations.
You may not get back the amount that you originally invested.
Past performance is not a guide to future return.
Inflation may, over time, reduce the value of your investments in real terms.
There may be a variation in performance between funds with similar objectives owing to the different assets selected.
Funds aiming for relatively high performance can incur greater risk than those adopting a more standard investment approach.
The use of derivatives in pursuit of a fund's objective may cause its risk profile to change and this may be material.

Fixed interest security risk

Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital. Unlike the income from a single fixed interest security, the level of income (yield) from a fund is not fixed and may go up and down. Bond yields (and as a consequence bond prices) are determined by market perception as to the appropriate level of yields given the economic background. Key determinants include economic growth prospects, inflation, the government's fiscal position, short-term interest rates and international market comparisons. The returns from bonds are fixed as at the time of purchase. Therefore the fixed coupon payable and the final redemption proceeds are known at the outset. This means that if a bond is held until its redemption date, the total return that could be expected is unaltered from its purchase date, subject to counterparty default (see 'Credit risk' below). However, over the life of a bond, the yield priced by the market (as opposed to actual fixed coupons payable) at any given time will depend on the market environment at that time. Therefore, a bond sold before its redemption date is likely to have a different price to its purchase price and a profit or loss may be incurred.

Credit risk

The value of a fixed interest security will fall in the event of the default or reduced credit rating of the issuer. Generally, the higher the rate of interest, the higher the perceived credit risk of the issuer. This fund may invest a percentage of it's assets in sub-investment grade bonds. Such bonds have characteristics which may result in higher probability of default than investment grade bonds and therefore higher risk.

Overseas markets risk

Funds investing in overseas securities are exposed to, and can hold, currencies other than Sterling. As a result, overseas investments may be affected by the rise and fall in exchange rates.

Derivatives risk for Efficient Portfolio Management:

Derivatives may be used by this Fund for the purpose of efficient portfolio management. This restricts the use of derivatives to the reduction of risk and the reduction of cost. Such transactions must be economically appropriate and the exposure fully covered.

Derivatives risk for investment purposes:

This fund may undertake transactions in derivatives and forward transactions (both on exchange and over the counter (OTC)). These may include interest rate swaps and interest rate futures for the purposes of meeting the investment objective, protecting the risk to capital, duration and credit management, as well as for hedging. While the discerning use of derivatives can be beneficial, derivatives also involve specific risks. These risks relate specifically to market risk, management risk, credit risk, liquidity risk, the risk of mispricing or improper valuation of derivatives and the risk that derivatives may not correlate perfectly with underlying assets, interest rates and indices. The use of derivative instruments may from time to time alter the economic exposure of the fund causing it to deviate significantly from the performance of the market as a whole. The use of these derivatives will be within the parameters allowed for linked funds by the Financial Conduct Authority and Prudential Regulation Authority.

Performance to 31 December 2023

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years
Fund (gross)	8.66	10.46	10.27	(12.67)	3.69
Fund (net)	8.60	10.34	10.03	(13.25)	2.59

Annualised (%)

3 Years (p.a.)	5 Years (p.a.)
(4.42)	0.73
(4.63)	0.51

Year on year performance (%)

	31/12/2022 - 31/12/2023	31/12/2021 - 31/12/2022	31/12/2020 - 31/12/2021	31/12/2019 - 31/12/2020	31/12/2018 - 31/12/2019
Fund (gross)	10.27	(19.68)	(1.40)	8.12	9.82
Fund (net)	10.03	(19.86)	(1.61)	7.89	9.60

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

Source: RLAM as at 31 December 2023. All figures are mid-price to mid-price in GBP for the RLPPC Enhanced Buy and Maintain Fund (Inc).

Glossary

Asset allocation

Breakdown of the assets by asset classes. Based on RLAM asset classification scheme.

Credit ratings

Credit ratings are based on RLAM composite ratings which uses a hierarchy of S&P, Moody's and then the Fitch rating.

Credit spread

Credit spread is the difference in yield between two debt securities of the same maturity but different credit quality.

Duration

Measure of sensitivity of a Fixed Income instrument to changes in interest rates, indicating the potential impact of interest rate fluctuations on the value of the investment.

Fund Analytics

All figures exclude cash. Credit bonds include non-sterling bonds and CDs where held within the fund or benchmark.

This is applicable to the following sections: fund Asset Allocation, Duration, Yield curve, Sector breakdown, Financial holdings, Credit ratings.

Fund value

Total value of the fund as of the last business day of the calendar month. The fund value is as at close of business and on a mid-price basis.

Gross redemption yield

Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the fund is the average for its individual holdings, weighted by their current value, net of relevant fund management costs and gross of tax.

Number of holdings

Total number of unique holdings of the Fund excluding cash, currency and derivatives.

Number of issuers

Number of unique issuers of all assets held by the Fund, excluding cash, currency and derivatives.

Performance

Performance is calculated using the daily end of day NAV per share produced by HSBC based on the mid price.

Rating changes - downgrades

Directly held credit bonds downgraded from investment grade to sub-investment grade based on the RLAM composite rating during the quarter.

Rating changes - upgrades

Directly held credit bonds upgraded from sub-investment grade to investment grade based on the RLAM composite rating during the quarter.

Sector breakdown

Breakdown of the fixed income assets, excluding derivatives and cash by RLAM's internal industry sector classification scheme. Figures are subject to rounding.