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# **Royal London Sustainable Short Duration Corporate Bond Fund**

Quarterly Investment Report

**31 December 2023**

# Quarterly Report

## The fund as at 31 December 2023

The purpose of this report is to provide an update on the Royal London Sustainable Short Duration Corporate Bond 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.

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# The fund

## Fund performance objective and benchmark

The Fund's investment objective is to achieve a total return over the medium term, which should be considered as a period of 3-5 years, by predominantly investing in sterling-denominated corporate bonds, which will primarily be short-duration (5 years or less). Investments in the Fund will adhere to the Investment Manager's ethical and sustainable investment policy. The Fund's performance target is to outperform the ICE Bank of America Merrill Lynch Sterling Non-Gilt (1-5 Years) Total Return (GBP Unhedged) Index (the "Index"), after the deduction of charges, over rolling 5-year periods.

Benchmark: ICE BofA 1-5 Year Sterling Non-Gilt Index

## Fund value

	Total £m
31 December 2023	148.84

## Asset allocation

	Fund (%)	Benchmark
Conventional credit bonds	95.41%	99.14%
Securitised	4.59%	-
Conventional foreign sovereign	-	0.86%

## Fund analytics

	Fund	Benchmark
Fund launch date	23 November 2022	
Base currency	GBP	
Duration (years)	3.16	2.41
Gross redemption yield (%)	6.11	4.60
Number of holdings	237	603
Number of issuers	150	294

Past performance is not a guide to future performance. Please refer to the glossary for a description of the yield used.

# Performance and activity

## Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	4.82	4.07	0.76
1 Year	8.53	6.87	1.66
3 Years (p.a.)	-	-	-
5 Years (p.a.)	-	-	-
10 Years (p.a.)	-	-	-
Since inception (p.a.)	7.82	5.82	2.00

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 Royal London Sustainable Short Duration Corporate Bond (Z Acc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 23 November 2022.

## Performance commentary

The fund produced a positive absolute return for the quarter, thanks to the impact of falling gilt yields, narrower credit spreads and the income on the portfolios. On a relative basis, the fund outperformed its benchmark index.

The main positive driver of performance was our sector positioning, notably our underweight position in supranationals, which continued to lag the wider market having done so in the third quarter. Stock selection effects were mixed: we saw positive selection in insurance bonds, notably longer dated subordinated bonds from M&G and Legal & General, but this was outweighed by negative selection effects in 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.

# Performance and activity

## Top 10 holdings

	Weighting (%)
AVIVA PLC 6.125000000 2036-11-14	1.94
BAZALGETTE FINANCE PLC 2.375000000 2027-11-29	1.49
LLOYDS BANKING GROUP PLC 6.625000000 2033-06-02	1.46
LEGAL & GENERAL GROUP 5.375000000 2045-10-27	1.38
EVERSHOLT FUNDING PLC 6.697000000 2035-02-22	1.37
PORTERBROOK RAIL FIN LTD 7.125000000 2026-10-20	1.35
HSBC HOLDINGS PLC 8.201000000 2034-11-16	1.31
HSBC BNK CAO FND STER 1 5.844000000	1.27
NATIONAL GRID PLC 6.000000000 2025-05-09	1.25
PRINCIPALITY BLDNG SOC 8.625000000 2028-07-12	1.23
<b>Total</b>	<b>14.05</b>

## Fund activity

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition. On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors, and to a lesser extent in consumer services.

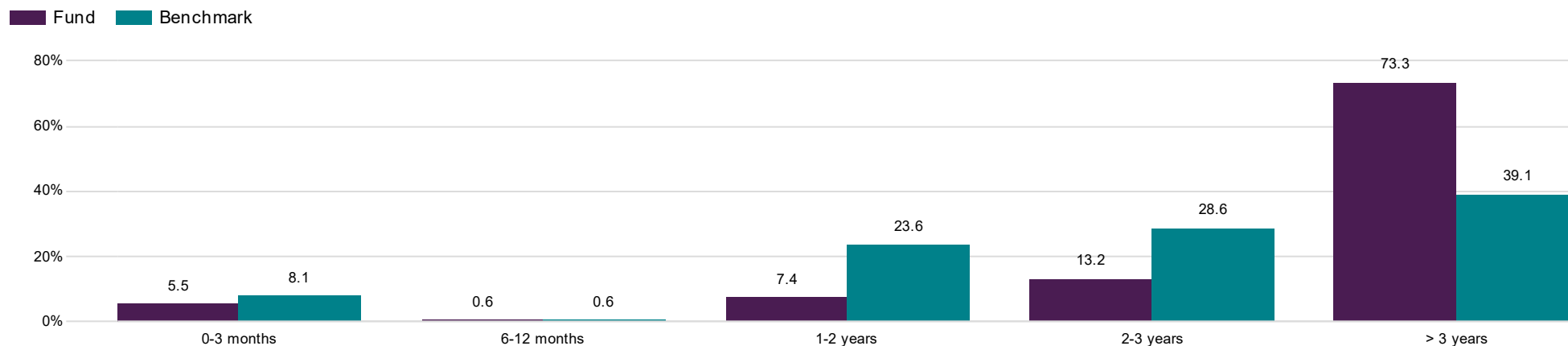
Financials remain the largest part of the market and continued to dominate market issuance during the quarter. We added senior bonds from New York Life, issued at the same level as policyholders, and Coventry Building Society, as well as subordinated new issues from Close Brothers and defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation, the former coming at a yield of over 11%.

There were noteworthy new issues in the structured sector. We added a new issue of Stark Financing, a commercial mortgage-backed security secured against 103 UK property assets, predominantly 'last mile' warehouse assets. The floating rate A notes we bought are rated AAA and have an attractive loan-to-value, also paying an attractive premium to SONIA. We also added a five-year new issue from the RAC, these bonds yielding over 8%.

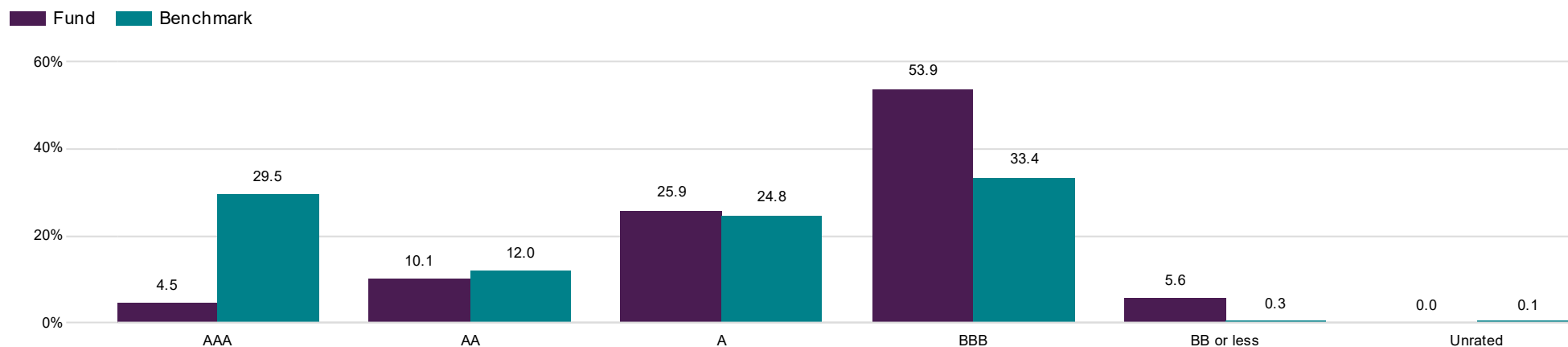
In the secondary market we added selectively to subordinated bank and insurance debt – where yields still remain elevated – buying HSBC and Just Group at attractive levels. Outside of financials, we increased exposure to social housing provider Haven Funding, an older style bond with far stronger covenants than more recent sector issuance. We also added Bazalgette Finance, backed by the Thames 'super sewer' project, with strong sustainability characteristics and an attractive yield premium over the market for what we consider to be a low risk regulated asset. We also added rolling stock bonds from Eversholt Finance and Great Rolling Stock, which both offer strong security over key infrastructure assets and an attractive yield.

# Fund breakdown

## Maturity profile

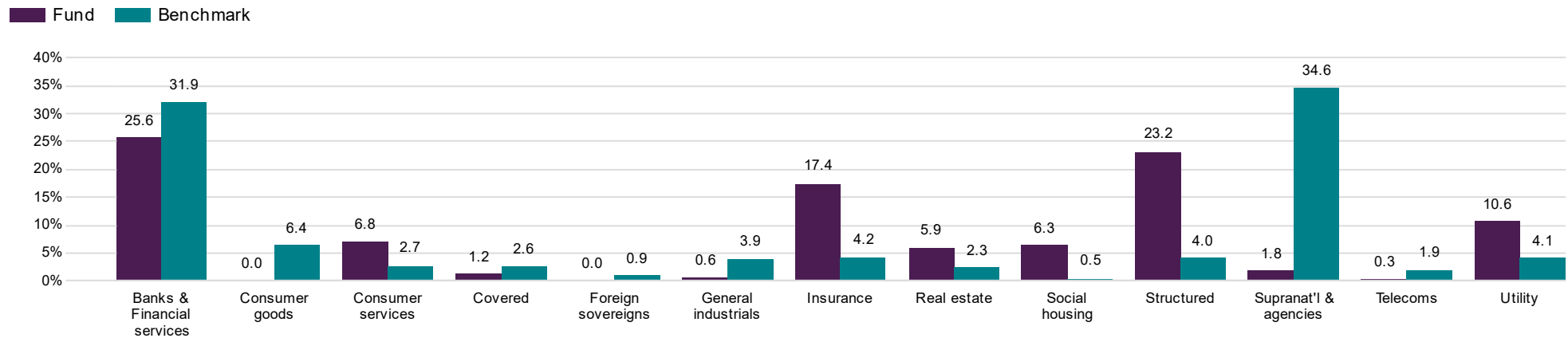


## Credit ratings



# Fund breakdown

## Sector breakdown



# 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.

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.

## 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 to watch: we believe that the Bank will find it hard to start cutting rates if wages continue to rise at 5-6% per annum. 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. We focus 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 strategies, over that available from credit benchmarks, 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. This strategy underpins the excess yield of the portfolio relative to its benchmark.

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:



### 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](http://www.rlam.com), including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

# Disclaimers

## Important information

For professional clients only, not suitable for retail clients.

This is a financial promotion and is not investment advice.

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The Fund is a sub-fund of Royal London Bond Funds II ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC001128.

The Authorised Corporate Director (ACD) is Royal London Unit Trust Managers Limited, authorised and regulated by the Financial Conduct Authority, with firm reference number 144037.

For more information on the fund or the risks of investing, please refer to the Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on [www.rlam.com](http://www.rlam.com).

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# Risks and Warnings

## Investment Risk

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

## Credit Risk

Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

## EPM Techniques

The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

## Interest Rate 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.

## Liquidity Risk

In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

## Counterparty Risk

The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

## Charges from Capital Risk

Charges are taken from the capital of the Fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.

## Responsible Investment Risk

The Fund can only invest in holdings that demonstrate compliance with certain sustainable indicators or ESG characteristics. This reduces the number securities in which the Fund can invest and there may as a result be occasions where it forgoes more strongly performing investment opportunities, potentially underperforming non-sustainable funds.

# Performance to 31 December 2023

## Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	Since Inception		
<b>Fund (gross)</b>	4.82	8.14	8.53	-	8.67	-	7.82
<b>Fund (net)</b>	4.74	7.98	8.19	-	8.30	-	7.49

## Annualised (%)

## 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
<b>Fund (gross)</b>	8.53	-	-	-	-
<b>Fund (net)</b>	8.19	-	-	-	-

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 Royal London Sustainable Short Duration Corporate Bond (Z Acc); Since inception date 23 November 2022.

# 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.

## 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.

## 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.

## Top 10 holdings

Top 10 assets held by market value, excluding derivatives and cash.