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Our approach to liquidity in sterling credit

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Executive summary

Equities and bonds are fundamentally different from one another: equities give permanent ownership of a company, whereas bonds can be held to maturity when the capital is repaid. Crucially, *unlisted* (equities or bonds) means something completely different from *unrated* (bonds).

Our clear, well-established and tested investment process aims to take advantage of large-scale market inefficiencies and mis-valuations of security and liquidity. In our experience, liquidity can be illusory – it is not there for *any* investors in *any* bonds in a broad sell-off. There is a balance to be struck between keeping funds liquid and capturing the 'illiquidity premium' that enhances the returns we deliver to investors.

Diversification is essential. Our portfolios are highly diversified across different issuers, industry sectors and client types. We always keep the benefits of diversification in mind, giving protection should one or more issue, issuer, sector or client type be negatively impacted.

Effective governance and oversight are key principles for RLAM. We are committed to meeting the high expectations of clients with regard to governance, oversight, valuation and administration. In particular, we work hard to identify and prevent conflicts of interest.

We have one of the most experienced sterling credit teams in the UK. **We work collegiately** and do not have a 'star fund manager' culture. As well as strong governance, we believe firmly in peer-group scrutiny of all our funds; we are not afraid to challenge each other and frequently do.

We believe firmly that active management is the right approach. We deliver **consistently higher income and returns** through diversified exposure to credit markets based on deep understanding of credit risk fundamentals and exploitation of market inefficiencies.

In this article, we describe how at Royal London Asset Management (RLAM) we consider and manage liquidity in our sterling credit funds, and explain why a clear, well-established and tested investment process is so important.

Recent events have highlighted the risks of illiquidity in open-ended funds and active managers are under pressure to demonstrate that their funds are adequately liquid, especially in times of market stress. In particular, clients are rightly questioning exposure to unlisted, small and illiquid stocks that are less easily traded than larger-capitalisation stocks.

There are, however, some unhelpful misconceptions concerning this important aspect of fund management that must be ironed out from the outset. Most importantly, equities and bonds are fundamentally different: while there are some aspects of liquidity that apply to both, there are other areas where this is not the case. In particular:

Equities and bonds

- **Equities give permanent ownership of a company, whereas bonds represent a loan** for a finite period (except for perpetual bonds). Bonds will ultimately mature and the principal will be repaid as they are a debt owed to a creditor – who, meaningfully, is more senior than an equity holder in the winding up of a company. Bonds (including those considered illiquid, which don't often, or ever, trade in the market after issuance) can be held to redemption and the capital will be returned: this is not the case for equities.

Unlisted, listed and unrated

- **Unlisted equities and unrated bonds should not be confused with one another.** In mainstream fund management, unlisted equities are very rare and, because of this, very illiquid as they are not listed on a particular exchange and therefore not visible to many investors. It is less well known that most bonds are listed. This is the case for all bonds in most well-referenced benchmark investment

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grade indices and the vast majority of those in most of our portfolios. Unlisted bonds tend to be smaller, non-benchmark, unrated issues aimed at specific investor audiences.

Generally, bonds are listed on the exchange local to the country of domicile of the issuer rather than on the exchange local to the currency of issue. For example, many sterling denominated bonds are listed on exchanges other than the London Stock Exchange. Trading mainly takes place through investment banks' proprietary trading desks or brokers on an agency basis.

- **Unlisted bonds should not be confused with unrated bonds,** which are simply bonds for which the issuer hasn't acquired a rating from a credit ratings agency – this is completely different from unlisted equities and far more widespread.

Understanding liquidity

At RLAM, we run active portfolios according to a clear, well-established and tested investment philosophy. In constructing portfolios, our investment process aims to take advantage of large-scale inefficiencies in markets, which arise from market-imposed constraints and mis-valuations of security and liquidity.

In our experience, security (such as through backing by assets or cash flows over which we have a claim) and strong covenants are often misunderstood and considered unattractively complex and, therefore, widely undervalued. Conversely, liquidity can be illusory – it is generally lower for infrequently traded or more complex and less-widely understood bonds, but is not there for any investors in any bonds in a broad sell-off.

A recent example is from last autumn. GE Capital bonds fell nearly 40% from peak to trough when S&P downgraded GE and GE Capital bonds two notches, from A to BBB+. With no buyers at a 'reasonable price', the bonds fell precipitously and sparked fears of a broader market rout. This highlights two important points: first, even the mighty GE was vulnerable to illiquidity concerns; and secondly there is always liquidity, but not necessarily at a price where a rational investor would wish to sell!

As a result of the misconception that liquidity can be bought for a 'liquidity premium', we believe it is widely overpriced. Indeed, we often take advantage of this by getting paid an 'illiquidity premium' in the form of higher yields offered by bonds that may be small-sized, lower-rated or even unrated, but which can offer greater certainty of delivery of income, which is the key driver of returns from credit bonds, over the medium to long term.

This may lead some to question whether funds that make use of this inefficiency will always be scalable, given their focus on smaller, more esoteric issues. This is a question of availability of the bonds required, of which there is a limited supply, and the knowledge and skill of the manager in accessing them in the market. We believe we are well-placed in this respect.

In summary, liquidity can be illusory to the extent that it often disappears in troubled markets. Experienced and disciplined investors can benefit from this. In the case of GE, we not only resisted the pressure to sell, but also took advantage of the 'illiquidity' and increased our holdings, benefitting from a sharp bounce back in price, first as the market stabilised and subsequently when the company outlined plans for disposals to reduce its debt burden.

Our investment process

When a fund is experiencing substantial redemptions, more liquid holdings that can be disposed of at reasonable prices are sold first, slowly increasing the overall illiquidity of the fund. This effect will be exacerbated if the market gets wind of a fund's difficulties and marks down the prices of its more illiquid holdings, creating a maelstrom from which it is hard to escape.

The best way to avoid such a vicious circle is through diversification, backed up by a thorough and disciplined investment process and rigorous governance. At RLAM, we build highly diversified portfolios that benefit from the more attractive yields offered by lower-profile bonds. Higher yields and returns do not come free, however – there is a price to pay. Understanding that price, in terms of credit risk, security, complexity and liquidity, can be done successfully by only a well-established team of fund managers and research analysts who work together for the benefit of all of our portfolios.

Diversification is an important and differentiating feature of our credit portfolios and, indeed, of our entire fixed income business. Our portfolios constitute a wide variety of issuers across a wide range of sectors: the 10 largest holdings account for a relatively low percentage of the portfolios and are nearly all well-known issuers, rather than esoteric holdings. With reference to some of our largest portfolios, such as the Sterling Credit Bond Fund with 375 holdings across 232 issuers and all of the main industry sectors, we always keep the benefits of diversification in mind, giving protection should one or more issue, issuer or sector be negatively impacted.

Our client base is also very diversified and spans a broad spectrum, including internal (life insurance and pensions) and external (institutional, financial advisers, pension, and charity & endowment), so flows in and out of our credit funds are also diversified and subject to different drivers at any time.

Liquidity in action

Once constructed, even when they are higher-yielding, security-enhanced and diverse, our portfolios must still be managed. Naturally, credit bonds not only generate regular coupon-related income but also mature, producing cash that needs to be invested. New bonds are also issued, so we maintain a keen eye for attractive opportunities here. In addition, our clients have diverse requirements that may lead to investment in or disinvestment from our funds. All this requires us to turn over our portfolios. However, turnover costs money (generally experienced as a negative impact on returns), so we aim to keep this to a minimum – typically 25-30% per annum, which we believe compares favourably to our peers.

Such turnover and flows require us to trade in the market. We have a long-standing and well-respected presence in the sterling credit market. This gives us good access to a stream of attractive new issues in the primary market as well as solid relationships with brokers to execute trades effectively and efficiently. Our large and diverse asset and client base helps to enable this.

We respect the needs and interests of all of our clients, whether long-standing and stable, new and growing, or reducing and even disinvesting and departing. Fairness of treatment is not just a regulatory imperative, but a key element of our treatment of our clients that maintains mutual respect. As a result, swinging prices or a "dilution levy" (whichever is employed for that fund) are applied to protect the interests of all clients in a fund subject to cash flows.

Fairness extends to valuations, with all of our funds' assets benefiting from external pricing; the very small number of exceptions is subject to rigorous internal process to determine fair pricing.

Art or science?

To us, liquidity is as much an art as a science: it's transitory and can't be taken for granted. It's also hard to define accurately – when does a price shift from signalling liquidity to being foolhardy for an investor to accept? Nonetheless, while we may believe that liquidity is a nebulous concept, our clients and their advisers may want reassurance that this is not a self-serving view.

With this in mind, we make use of independent metrics such as those produced by UBS Delta. This analysis presents formulaic examinations of the liquidity of a fund in terms of days to liquidate the portfolio. Note, however, our earlier statement that in a broad market sell-off liquidity may not present itself in line with expectations.

Governance and oversight

However strong our investment philosophy and process, or our track record (we safely navigated the global financial crisis and provided daily liquidity in our open-ended funds throughout), human nature can be prone to drift. In fund management, this can lead to complacency or confirmatory bias. When a fund fails, whatever the particular circumstances, failures in oversight and governance are usually part of the narrative.

To ensure we avoid such shortcomings, we have a rigorous set of processes that ensure proper scrutiny of funds' risk profiles. An independent portfolio risk team is responsible for monitoring risk characteristics and acts as an independent challenge to fund managers. In addition, issues in which we hold a high percentage of the outstanding bonds are reported on a monthly basis to the RLAM Investment Committee. Additionally, funds are scrutinised in detail in regular fund company board meetings, including the review of liquidity profiles for the funds.

Effective governance is a key principle for Royal London at a group level, as well as for RLAM. We are committed to meeting the high expectations of clients with regard to governance, oversight, valuation and administration. In particular, we work hard to identify and prevent conflicts of interest.

People

We have one of the most experienced sterling credit teams in the UK. We work collegiately, sharing ideas across the fund management and credit research functions. Most importantly, while individual members of our team are very highly regarded by the market, we do not have a 'star fund manager' culture, preferring a collaborative approach. As well as strong governance, we believe firmly in peer-group scrutiny of all our sterling credit funds; we are not afraid to challenge each other and frequently do.

What do we stand for?

We believe firmly in active management; it is enshrined in our investment philosophy and process, and continues to deliver strong returns. We are very clear on our position, and feedback from clients and advisers shows strong support for this.

More important to our clients and their advisers than active management or our investment philosophy, however, are their combined results. Rather than undifferentiated products with no distinct approach or advantages, we deliver consistently higher income and returns versus industry averages and peer groups through diversified exposure to credit markets based on deep understanding of credit risk fundamentals and exploitation of market inefficiencies.

At a time when regulators and clients alike are rightly scrutinising the level of active management received for active-level fees, we are confident that our investment philosophy and process will continue to deliver good value to our clients. Understanding the opportunities and limitations of liquidity in sterling credit is at the heart of our approach. As we said earlier, the best way to manage the challenges of illiquidity is: "through diversification, backed up by a thorough and disciplined investment process and rigorous governance."

Contact us

For more information about our range of products and services, please contact us.

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Past performance is not a reliable indicator of future results. 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.

For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Price page on www.rlam.co.uk

59576 07 2019