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ROYAL LONDON
ASSET MANAGEMENT

Royal London
25 years of credit investing

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Head of Fixed Income

This month marks the 25-year anniversary of the launch of the Royal London Corporate Bond Fund. I have overseen the fund, either alone or with others, since it started and only stepped away from managing it last year. So I have a good perspective on how the fund has changed, how credit markets have shifted, and the challenges we have encountered along the way.

A changing asset class

Back in March 1999 the sterling credit market was a different beast. There were 448 bonds in the Merrill Lynch Non-Gilt Index, with a weighted average credit spread of 88bps and an aggregate value of £116bn. Today, that index has 1,319 issues, with a total value of £576bn and a spread of 116bps. Compositionally, there was a greater weighting towards AAA rated securities in 1999 and highly rated supranational bonds, such as those by the EIB or KFW (German state-owned development bank) played a larger part in investors' portfolios.

More fundamentally, there has been a shift in the way investment grade credit is treated as an asset class and, indeed, tracked and traded. Credit was commonly viewed as the wayward brother of the gilt market. I was running both government and credit bonds and the glamour was much more associated with gilts – along with the best brains. Credit spread movement on a daily or weekly basis was low, unless there was a specific credit event and the transparency of those movements was a lot lower. The 1990s still saw banks and brokers sending out daily price sheets showing credit spread changes. The biggest development, though, has been in the role of credit; debt has become the main financing vehicle for many. Put simply, the cost of debt is deemed to be significantly lower than the cost of equity. Whilst big companies continue to use a mixture of bank borrowings, capital market debt and equity, the make-up has changed in 25 years and the size of global credit markets has exploded.

This growth has contributed to the commoditisation of credit as an asset class, supporting the growth of passive strategies but allowing us to take further advantages of the resulting inefficiencies.

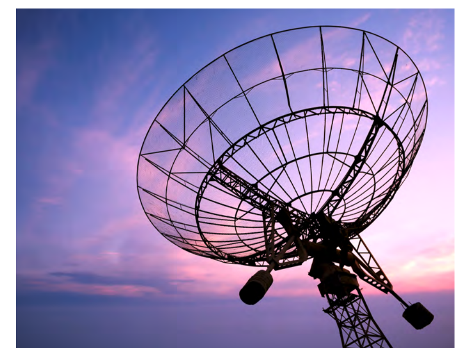
Constant foundations

So how has the fund changed? Despite the market developments the underlying investment philosophy has remained remarkably constant. The founding investment philosophy reflected the views of myself, Eric Holt, as our most experienced credit fund manager, and Martin Foden, our Head of Research, and it is a simple approach. The underlying tenets are that investment grade credit is systematically undervalued, with investors over-compensated for credit risk, and that structural inefficiencies should allow us to deliver long-term outperformance.

What are these inefficiencies? In a benchmark orientated world, investors tend to favour index members – leaving non-constituent bonds under researched and potentially undervalued. There are many debt securities that fall outside indices due to their issue size, lack of investment grade credit rating or specific idiosyncrasies and this is a fertile hunting ground. In themselves, credit rating agencies contribute to valuation anomalies with their focus on probability of default. This is why we find secured debt so attractive. Investment grade credit bonds tend to be senior but unsecured obligations of the issuer. Senior sounds good, until the banks get in front of you, at times of distress. Secured debt is issued with collateral, representing a claim on assets which cannot be subordinated.

This is why just relying on credit ratings as an assessment of risk misses the bigger picture – recovery rate needs to be considered alongside default risk. Moreover, a claim on assets gives secured bondholders a much stronger negotiating position – both at times of distress but also if the issuer wants to free up the asset for sale. As a result, despite the dramatic evolution in credit indices, the fund has consistently remained materially overweight in secured bonds, whilst yielding more than benchmarks.

The management evolution of the fund reflects the stability within the team. Originally managed by me, we moved to a co-manager structure with Saj Vaid. When Saj left, Shalin Shah moved up to be co-manager and we worked successfully together for 15 years. Last year I formally handed over the baton but the preparation work had already been done. Matt Franklin had been part of the Fund's management team for over two years, building on his significant research experience, and is now working with Shalin on a co-manager basis.
A pretty formidable duo with genuinely complementary skills.



Navigating the challenges

There have been highs and lows. The early years were good. We offered a distinctive investment approach that differentiated us from other managers. We avoided the TMT turmoil at the turn of the 2000s, were unaffected by the World Com and Enron scandals, and built a solid client following, despite the perception of being a small team. In hindsight we were too defensive about the size of the team: I have always believed in smaller teams having a structural advantage. What counts most is the quality of the people and the way they collaborate. Despite controlled growth in the team, maintaining a nimble and dynamic approach has never been more important.

The biggest low was the Great Financial Crisis; it was a massively stressful time. Despite my experience I found it really difficult to remain detached, at a personal level. There were clear mistakes: we had too much exposure to subordinated financial debt. More generally, there had been an under appreciation of how events in the US, to which we had no exposure, could ripple through the financial system. Conversely, by having a clear investment philosophy we were able to keep our nerve and take advantage of distressed selling of bonds, to propel the fund forward in the following years. It has not all been plain sailing in subsequent years but we have navigated well by sticking to our understanding of fundamental credit risk, whatever the whims of markets.

Cumulative performance (as at 29 February 2024)

	1 Year	3 Year p.a	5 Year p.a
Share Class M (Accumulation)	7.88	-1.39	1.78
iBoxx Sterling Non-Gilt All Maturities Index	5.56	-3.90	-0.24
Quartile ranking	1	1	1

Past performance is not a guide to 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: Royal London Asset Management and FE fundinfo as at 29.02.24.

Fund performance is shown on a mid to mid price basis, net of fees and gross of taxes, with gross income reinvested unless otherwise stated. Benchmark performance is shown gross of fees and taxes.

Resilient features

There has been sniping from the sidelines from those that could not match what we have done. In the early years, the holding of non-rated bonds was used as a criticism. I took this as a compliment – a critique from those that did not understand true risk. Later, as the non-rated positions declined through maturity and were replaced by rated secured debt, the push back has centred on liquidity, and the criticism that secured bonds are not as liquid. This is an easy one to rebut: the fund has always offered daily liquidity, even in the depths of the Great Financial Crisis. In my view, the beauty of our approach is that through combining a diversified portfolio, with a distinctive bias towards undervalued asset backed and secured bonds, our clients access a differentiated investment philosophy backed by daily liquidity.

Looking at the fund, as it stands in March 2024, there are clear compositional differences that have emerged over 25 years. The BBB weighting is higher, as we see this as a sweet spot when selected well. This is not from a top down viewpoint but because our analysis draws us to the best value. Social housing, where we have multi-decade experience, now plays a greater part as does the insurance sector. Consumer exposure has fallen and there is no mining or energy exposure.

Bank debt is still a key component; banks are better capitalised and our exposure is more diversified than in 2007 – and this is an area where the hard-earned lessons of the crisis have honed and informed our approach.

What will the future hold? I do not know, but I have confidence that Shalin and Matt will continue to target providing our clients with strong income generation relative to our peer group, driven by a consistent investment approach, underpinned by a great research team, and the strength of mind to be different.

Fund facts

Benchmark	iBoxx Sterling Non-Gilt All Maturities Index
Investment Association sector	IA Sterling Corporate Bond
Fund type	OEIC
Currency	GBP

Fund Managers

Shalin Shah
Senior Fund Manager

Matt Franklin
Fund Manager

Investment risks

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.

Efficient portfolio management (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.

Exchange Rate Risk: Investing in assets denominated in a currency other than the base currency of the Fund means the value of the investment can be affected by changes in exchange rates.

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.

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.

Contact us

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

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The views expressed are those of Royal London Asset Management at the date of the event unless otherwise indicated, which are subject to change, and is not investment advice.

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