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Royal London Diversified Asset-Backed Securities Fund

Quarterly Investment Report

30 June 2024

ROYAL LONDON
ASSET MANAGEMENT

Quarterly Report

The fund as at 30 June 2024

The purpose of this report is to provide an update on the Royal London Diversified Asset-Backed Securities 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

ROYAL LONDON

ASSET MANAGEMENT

The fund

Fund performance objective and benchmark

The Fund's investment objective is to achieve a positive absolute return in all market conditions over rolling 3-year periods, by predominantly investing in asset-backed securities and other sterling-denominated corporate bonds. The Fund's performance target is to outperform, before the deduction of charges, the Bank of England Sterling Overnight Interbank Average (SONIA) plus 2% per annum over rolling 3 year periods. The benchmark is considered suitable as it is consistent with how the Fund is managed in seeking to provide a "cash plus" performance outcome.

Benchmark: SONIA (Sterling Overnight Index Average)

Fund value

	Total £m
30 June 2024	281.61

Asset allocation

	Fund (%)
Conventional credit bonds	83.51%
Securitised	14.05%
Conventional gilts	2.19%
Conventional foreign sovereign	0.17%
Index linked credit bonds	0.08%

Fund analytics

	Fund
Fund launch date	24 September 2012
Base currency	GBP
Duration (years)	0.97
Yield to worst (%)	6.44
Number of holdings	316
Number of issuers	197

Performance and activity

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	1.82	1.27	0.55
YTD	4.47	2.56	1.91
1 Year	10.83	5.18	5.65
3 Years (p.a.)	5.72	2.85	2.87
5 Years (p.a.)	5.01	1.82	3.19
10 Years (p.a.)	3.77	1.19	2.58
Since inception (p.a.)	4.27	1.09	3.18

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 RL Diversified Asset-Backed Securities Fund (Z Acc). Source: Royal London Asset Management; Gross performance; Since inception date of the share class is 24 September 2012.

Performance commentary

Despite the slight negative returns for the wider sterling investment grade market, the fund saw a strong positive return in the period and was well ahead of its Sterling Overnight Index Average Rate (SONIA) benchmark. The principal driver of negative market returns was the move higher in yields, but with this effect hedged by the fund, overall returns were positive, and further helped by the positive carry on the fund.

Exposure to two key areas – secured and financials – aided positive returns over the period. Within the banking sector, our exposure to subordinated bonds remained helpful. Subordinated bonds from the likes of Close Brothers performed well, while our exposure to the Co-operative Bank also did well as the proposed takeover by the higher rated Coventry Building Society continued to progress. Secured bonds boosted returns , with strong performance from student loan provider ICSL, real estate company Canary Wharf and Telereal, which is secured on BT telephone exchanges.

News flow continues on the water sector as the regulator’s draft decision on spending over the next five years was deferred as a result of the snap election being called. While the commentary on the sector remains febrile, there have been no real developments that require portfolio positioning to be changed, and we continue to support selective funding of this critical sector.

Performance and activity

Fund activity

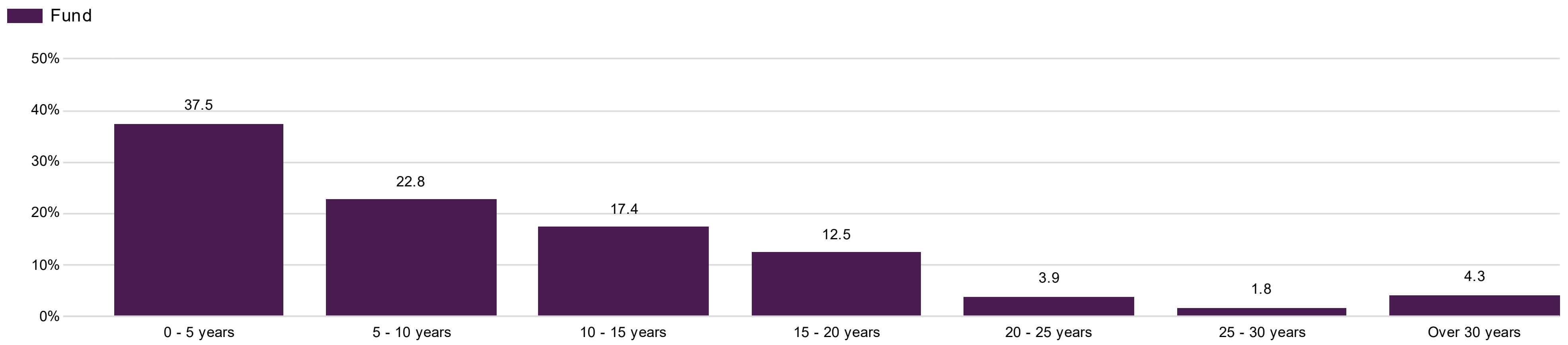
Exposure to secured bonds remains the most fundamental cornerstone of the fund. We continue to believe that the additional security and covenants are underpriced by the wider market and we were pleased to see a relative uptick in new secured issuance during the quarter. Although our diversified exposure to secured bonds allows us to be highly selective, we added a number of attractively priced and well-structured bonds over the period. This included a new issue from Vantage Data Centers, a securitisation of real estate and tenant lease payments from two large-scale data centres in Wales. This deal came with a supportive loan to value (LTV) and a higher credit spread than similarly rated unsecured corporate bonds. We also added Exmoor Funding, an RMBS secured on a portfolio of mortgages from specialist mortgage provider LiveMore, which focuses on lending to later life borrowers (50 to 90+ age group) – promoting financial inclusion for a segment of the UK population underserved by traditional high street lenders. The less conventional nature of the collateral ensured we could receive a higher yield for this bond despite its seniority and AAA rating. In more familiar names, we purchased a new issue from the roadside assistance operator, the AA. Despite these bonds having a senior claim on the whole business of the group we achieved an initial yield of around 7%, and also benefited from the issuer tendering for their shorter dated bonds at a premium to market pricing.

Away from secured bonds, financials continued to dominate primary market activity and we added attractive issues at both senior and subordinated levels. We bought senior bonds from French banking group BPCE (which includes Banque Populaire, Caisse d'Epargne and Natixis brands) – although subordinated French bank bonds weakened slightly after President Macron called parliamentary elections, this had little impact on senior bonds. We also added a new tier 2 issue from asset manager Schroders, issued with a yield of over 6%. In the insurance sector, we added a new issue from US insurer Protective Life. These bonds rank alongside policyholders, offering strong downside protection and were attractively priced at a yield of over 5%.

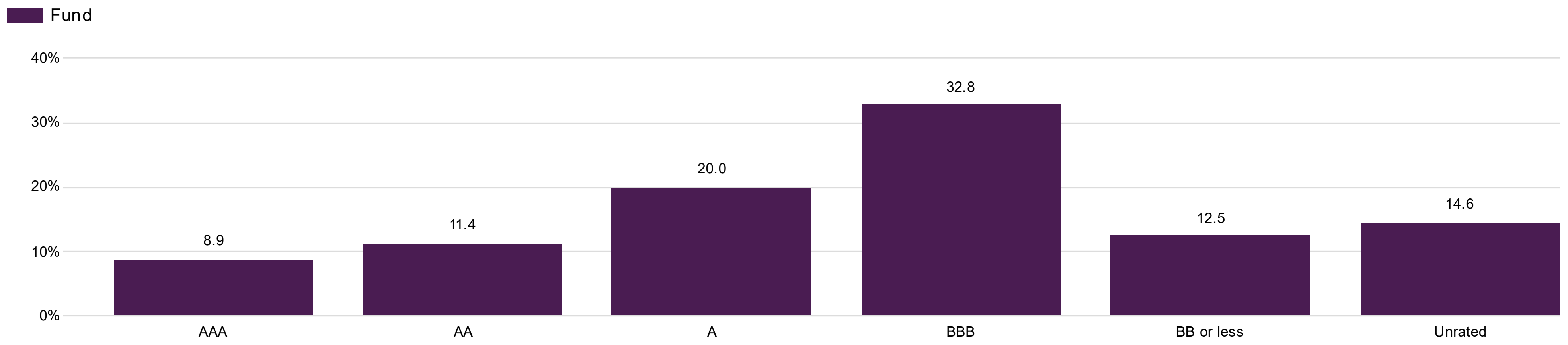
Within the funds unsecured allocation, we strive to be active in the secondary market to add incremental returns to fund performance. During the quarter, we took profits on senior OSB bonds and Aviva after strong performance, and added bonds issued by Co-Operative Bank and Virgin Money, ahead of anticipated takeovers by larger and higher quality institutions (Coventry Buildings Society and Nationwide Building Society) which should lead to further rating and spread compression.

Fund breakdown

Maturity profile

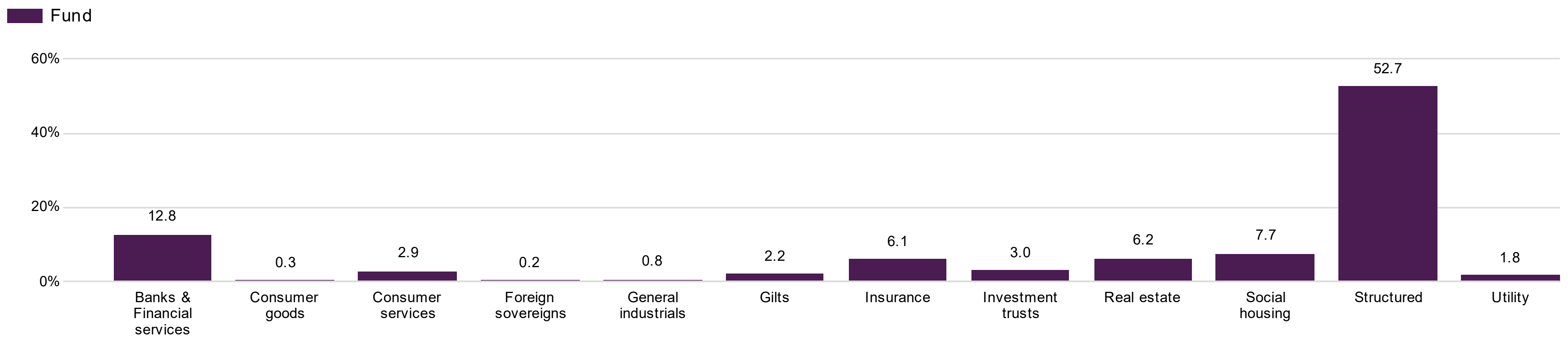


Credit ratings



Fund breakdown

Sector breakdown



Market commentary

Market overview

Markets have once again been dominated by interest rates during the quarter, despite little or no movement in this area. 2024 started with expectations that central banks would cut early and cut often. However, as the year has progressed, those expectations have changed. Inflation has generally not come down quite as fast as hoped, with services inflation proving sticky, particularly in the UK, while growth has generally not been as weak as feared – particularly in the US. Interest rates were cut just once across the Federal Reserve, European Central Bank and Bank of England, with the ECB cutting rates in June. Most central bank forecasters now only expect one or two cuts from each of these banks over the course of 2024 as a whole.

Ahead of the US Presidential elections in November, snap parliamentary elections were called in the UK and France, providing reminders that voter dissatisfaction with the seeming consensus on economic policy and ongoing lack of consensus on longer-term issues such as climate change create an uncertain backdrop for businesses and consumers alike.

The US Federal Reserve continued to keep rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, and the relatively strong core CPI inflation seen over January to April. The May data (released in June) was more reassuring both from a CPI and core PCE perspective. As of their June meeting, the median forecast of participants changed from showing 75 basis points of rate cuts for 2024 to only 25bps of cuts.

The ECB lowered rates by 25bps in June, following good inflation progress and previous hints from ECB speakers. Further rate moves after June are less certain and depend on data. Euro area CPI went up from 2.4% to 2.6% year-on-year in May, which was unexpected, and services inflation rose above 4.0%. The European elections saw incumbent parties suffer a loss of support and prompted President Macron to call an early parliamentary election. This uncertainty saw French government bonds weaken in relation to German government debt.

Data released in the UK in the second quarter confirmed that the country bounced out of technical recession in the Q1 and painted a picture of continued positive economic growth. First quarter GDP rose 0.7% quarter-on-quarter in real terms after falling 0.3% in the fourth quarter. Meanwhile inflation also dropped back to the Bank of England's 2% target. The rate of change in the CPI basket fell from 3.4% year-on-year in February to 2.0% in May, helped by lower electricity and gas bills. The Bank of England kept rates at 5.25%, even though headline inflation dropped. This reflected concern about services inflation and pay growth, both of which remain elevated. The calling of UK general election, which has resulted in a change of government, had minor impact on sterling asset prices, reflecting a view that there would be little shift in economic policy.

Government yields generally rose over the quarter, particularly following poor US inflation data released in April with yields largely range-bound through May and June. In the US, 10-year treasury yields rose from 4.21% to 4.40%, while German 10-year bunds similarly saw yields rise from 2.30% to 2.50%. Benchmark 10-year gilt yields rose from 3.94% to 4.18%.

The sterling investment grade credit market (iBoxx non-gilt index) returned -0.13% over the quarter, with the average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) widening marginally from 1.02% to 1.03% (iBoxx). Given the modest rise in yields, sectors with a greater proportion of long-dated bonds performed less well, including utilities and social housing. Of the major sectors, supranationals and banks produced positive returns, while insurance lagged.

Outlook

Last quarter we highlighted that we expected yields to remain sensitive to economic data, and unless there was a significant deterioration in underlying trends, we expected this to lead to range-bound yields. This is the scenario that unfolded over the quarter, with markets seeming to mark time until central banks – notably the Federal Reserve – start to cut rates. We expect a small fall in government bond yields in Q3.

Headline inflation is now significantly lower in the US, euro zone and UK compared to 2023. Base effects account for a material part of these falls. Beyond the headline figures, the likes of services inflation and wage growth remain higher than most central bankers would prefer. That said, we do expect to see more movement from central banks in the second half of the year, even if the quantum of those moves is less than many were forecasting earlier in the year.

Sterling investment grade yields are higher than they were at the start of the year, reflecting higher gilt yields and a small reduction in credit spread. We believe that the all-in yield on the market (using iBoxx), near 5.3% at the end of June, is attractive both in absolute terms but also relative to government bonds. Despite the contraction in credit spreads they continue to compensate investors for the risk of default.

We target – and achieve – a material yield premium over the market level in our sterling credit strategies. We mitigate the risks by maintaining highly diversified portfolios, with a bias towards bonds that offer greater security and downside protection. Our view remains that over the medium term our focus on delivering greater income than the benchmark will generate outperformance.

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

In an uncertain geopolitical and economic environment, we recognise the importance of keeping our clients updated on our current investment thinking.

Articles, videos, podcasts and webinars giving the latest views of our investment experts 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.

Disclaimers

Important information

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Issued in July 2024 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

The Fund is a sub-fund of Royal London Bond Funds ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC000797.

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.

The "SONIA" mark is used under licence from the Bank of England (the benchmark administrator of SONIA), and the use of such mark does not imply or express any approval or endorsement by the Bank of England. "Bank of England" and "SONIA" are registered trademarks of the Bank of England.

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 risk

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

Changes in currency exchange rates may affect the value of your investment.

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.

Government and public securities risk

The Fund can invest more than 35% of net assets in different Transferable Securities and Money Market Instruments issued or guaranteed by any EEA State, its local authorities, a third country or public international bodies of which one or more EEA States are members.

Leverage risk

The Fund employs leverage with the aim of increasing the Fund's returns or yield, however it also increases costs and its risk to capital. In adverse market conditions the Fund's losses can be magnified significantly.

Performance to 30 June 2024

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years
Fund (gross)	1.82	4.47	10.83	18.19	27.73
Fund (net)	1.71	4.25	10.36	16.69	24.80

Annualised (%)

3 Years (p.a.)	5 Years (p.a.)
5.72	5.01
5.28	4.53

Year on year performance (%)

	30/06/2023 - 30/06/2024	30/06/2022 - 30/06/2023	30/06/2021 - 30/06/2022	30/06/2020 - 30/06/2021	30/06/2019 - 30/06/2020
Fund (gross)	10.83	5.47	1.11	9.05	(0.90)
Fund (net)	10.36	5.03	0.68	8.52	(1.45)

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 30 June 2024. All figures are mid-price to mid-price in GBP for the RL Diversified Asset-Backed Securities Fund (Z Acc).

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.

Distribution yield

The distribution yield reflects the amounts that may be expected to be distributed over the next 12 months. It is calculated net of standard management charges. It reflects RLAM's current perception of market conventions around timing of bond cash flows.

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.

Yield to worst

Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.