



Paola Binns
Head of Sterling Credit

Paola is responsible for the management of corporate bond portfolios. She brings some 20 years' experience in bond markets to RLAM, having joined in August 2007 from Credit Suisse Asset Management where she was responsible for managing sterling credit assets. Paola has developed a wide range of bond asset classes having held a number of roles specialising in European corporate bonds, government bonds and emerging market debt. Paola has a MA degree in History and Spanish Literature from Oxford University.

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Navigating sterling credit

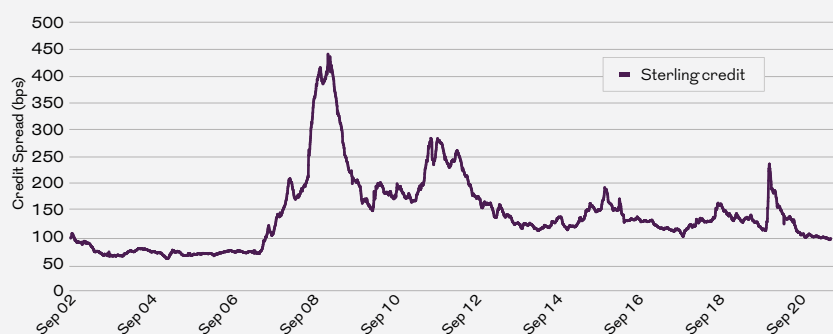
Last year, sterling investment grade credit spreads hit their lowest levels since 2007. With a quantitative easing (QE) programme in place that included the purchase of corporate bonds, and with fiscal programmes including the furlough scheme and bounce-back loans, corporates garnered extremely strong support from policy makers, quelling the likelihood of default. Although we saw sterling investment grade markets trade at the upper limit of the price range we might usually expect, they continued to pay investors incrementally over the levels we believe are required to be fairly compensated for the risk of default. With this in mind, we do not expect overall returns in 2022 to be driven by improvements in corporate pricing. With support for markets rolling back – the Bank of England drew its QE programme to an end in December – we expect bond yields to rise (and prices to fall) in the sterling market this year.

Risk in the absence of traditional credit drivers

We still believe the risk of default is low and will remain low through the year – corporates in the UK have built strong balance sheets with the help of monetary and fiscal policy makers, and many have large cash balances. However, this support has restricted the risks which traditionally drive markets, leading their prices to be more closely tied at present to the underlying gilts of the same maturity. This led to significant volatility into the end of 2021, as investors in UK markets mistakenly priced in a high certainty of a November Bank of England rate rise, and reacted to the emergence of the new Omicron variant of Covid-19 in the same month. We expect sterling markets will continue to take their lead from gilts through 2022.

Although rising yields will provide a headwind for absolute returns for the market broadly, the outlook for

Sterling credit spreads



Sterling credit: Bloomberg Sterling Aggregate ex Government Statistics Index

Source: Bloomberg, RLAM as at 30 September 2021.

corporates is far from weak. Against a backdrop of soaring equity markets, growing consumer demand, and high levels of cash balances, corporates are looking strong going into 2022 and we feel the sterling market is well positioned to cope with the roll back of support. Furthermore, having experienced a number of full lockdowns and partial closures to the economy over the last two years, businesses are better adapted to cope with Covid-19 related shocks. However, while businesses have learnt to deal with coronavirus shocks, financial markets have not – while coronavirus risks remain in play it is likely that animal spirits will drive significant and sudden changes in investor sentiment, raising the risk of the abrupt and material re-pricing of bond assets.

November's market reaction to the emergence of the Omicron variant provides a good example, as investors switched from bulls to bears, with the entire market pulling in the same, single direction during each phase of the market. This put pressure on liquidity in sterling credit, as those wanting to buy into bull market action struggled to find sellers, and investors wanting out during bear markets struggled to find buyers.

Takeovers and recoveries could affect credit ratings

There are other short-term risks to sterling corporate prices in 2022 too, mainly driven by the potential for changes in credit ratings. This could potentially benefit investors, as corporates whose creditworthiness was downgraded to sub-investment status during the pandemic may regain their investment grade standing after a period of strong recovery – investors holding issues that switch from 'fallen angel' to a 'rising star' could see bumper returns this year, although we expect this trend to be more prevalent in the US. Perhaps more pertinent to UK investors is the risk that aggressive mergers and acquisitions (M&A) and leveraged buyouts (LBOs)

pose to the creditworthiness of issuers on sterling indices – takeovers from cash rich corporates, private equity firms and private debt firms could lead to the downgrading of credit ratings, risking capital losses.

Another key set of risks for investors to consider in 2022, which can be prevalent across the short, medium and long term, are environmental, social, and governance (ESG) risks. Last year we took the opportunity to sell high carbon intensity names and fossil fuel-related names at relatively low credit spreads across our sterling credit funds, as we believe they do not compensate for long-term risks. This reduces the carbon output of the funds on average, while maintaining our credit spread premium at the portfolio level. We also further reduced our exposure to regulated gas distribution in favour of regulated water or electricity holdings – the former being more exposed to stranded asset risk – which helped performance in 2021 and will maintain this bias through 2022. This should give us a more robust utilities exposure in a net-zero world.

Navigating the sterling credit market

Regardless of the conditions in markets and the broader economy, RLAM's approach remains consistent. As long-term investors, we act as lenders in our participation in sterling credit markets rather than as speculators of short-term price volatility. As such, through bottom-up research, we focus on credit fundamentals to uncover pockets of value which can be found outside of market benchmarks. Our preference for secured bonds with strong covenants underpins the stable returns profiles of our products, most of which have outperformed their broad market benchmarks over three- and five-year periods.

With this in mind, the positions we take are far less tactical, meaning that the

composition of our funds is only likely to change incrementally as the broader sterling credit environment moves through any period of economic recovery and change. In 2021, for example, our portfolios benefited from their bias towards the subordinated financials sector, placing emphasis on a sector with a strong income capability and reduced negative sensitivity to interest rate rises. It is unlikely that we will unwind our exposures to subordinated financials in response to a change in the credit environment, as the positions we hold are not broad market bets. Instead, we hold targeted positions based on the strengths of each issuer and the protections underlying each bond.

Both bank and insurance sectors saw credit spreads widen following the emergence of the Omicron variant. While we remain in favour of both sectors, the move highlighted the importance of sector diversification in credit. We sometimes hear that RLAM's sterling credit portfolios are too diversified – naturally we disagree. Our strategies have high active risk, meaning we diverge from index composition. But we spread this active risk over multiple opportunities, helping us to avoid exposure to broad economic factors.

Diversification beyond the UK

As part of our diversification strategy, we also seek to run geographically diverse portfolios within the sterling credit market. Global credit is often touted as a better investment than sterling credit, with more diverse geographic profiles reducing any portfolio's concentrated market risk. However, we can still add geographic diversification to our sterling credit funds by investing in UK headquartered firms with a global footprint, or by holding bonds from non-UK headquartered firms issuing sterling denominated debt. Sterling credit doesn't necessarily have to mean UK credit.

Our National Express holding is a good example of the types of debt that we look for. The company is a diversified public transport firm headquartered in the UK but with a global footprint, operating in the UK, Spain and the US, and maintaining a strong balance sheet with stable cashflows. Finding strong and favourable issuers such as this through our processes of bottom-up research also helps us to pick up extra yield across our funds by adding risk to our funds in very selective ways. For example, while the senior bond tranches offered by National Express traded at 50bps above gilts at the time of writing, providing an all-in yield of 1%, the pick-up in yield

available through lending on a junior basis was very attractive. We therefore built holdings via the junior tranche, taking slightly more risk but in a business with a solid and stable credit profile.

Mitigating inflation and interest rate risk

With a cycle of rising interest rates impending there are steps that investors should consider to protect their holdings from unnecessary capital losses. And while many of our clients have asked us whether they should be investing in index-linked corporates, the obvious safe haven is short duration strategies – we are

already seeing a lack of appetite for the long-end of the investment grade sterling market as a result, which led to liquidity issues at the ultra-long end at points during 2021.

Regarding index-linked corporate bonds, investors holding these assets will still gain an incremental income over the gilt equivalent but at a risk of a price correction – the underlying index-linked gilt is very expensive at present. However, whether buying index-linked or nominal bonds, I believe that moving short duration is key, as these strategies carry far less exposure to interest rate risk.



Investment risks

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested. Portfolio holdings are subject to change, for information only and are not investment recommendations.

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Issued in January 2022 by Royal London Asset Management Limited, 55 Gracechurch Street, London, EC3V 0RL. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

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