ROYAL LONDON SHORT DURATION GILT FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	6.5	0.0
Index linked credit bonds	0.0	0.0
Treasury bills	0.0	0.0
Sterling conventional gilts	93.5	100.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	2.3 years	2.5 years
Gross redemption yield[4]	-0.06%	-0.13%
No. of stocks	32	15
Fund size	£828.1m	-

Source: RLAM, based on the Z share class. Launch date: 07.11.2013.

[1]Benchmark: FTSE® Actuaries Gilt <5 years Index.

[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[3]Excluding cash

[4]The gross redemption yield is calculated on a weighted average basis

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**0.11**	**0.10**	**0.01**
Year-to-date	1.58	1.52	0.06
Rolling 12 months	1.58	1.52	0.06
3 years p.a.	1.08	0.99	0.09
5 years p.a	1.02	1.06	-0.03
Since inception p.a. 07.11.2013	1.09	1.20	-0.11

Past performance is not necessarily a reliable indicator of 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.

All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.

Source: RLAM, based on the Z share class.

[1]Benchmark: FTSE® Actuaries Gilt <5 years Index.

Performance for the Royal London Short Duration Gilt Fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over longer measurement periods.

As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

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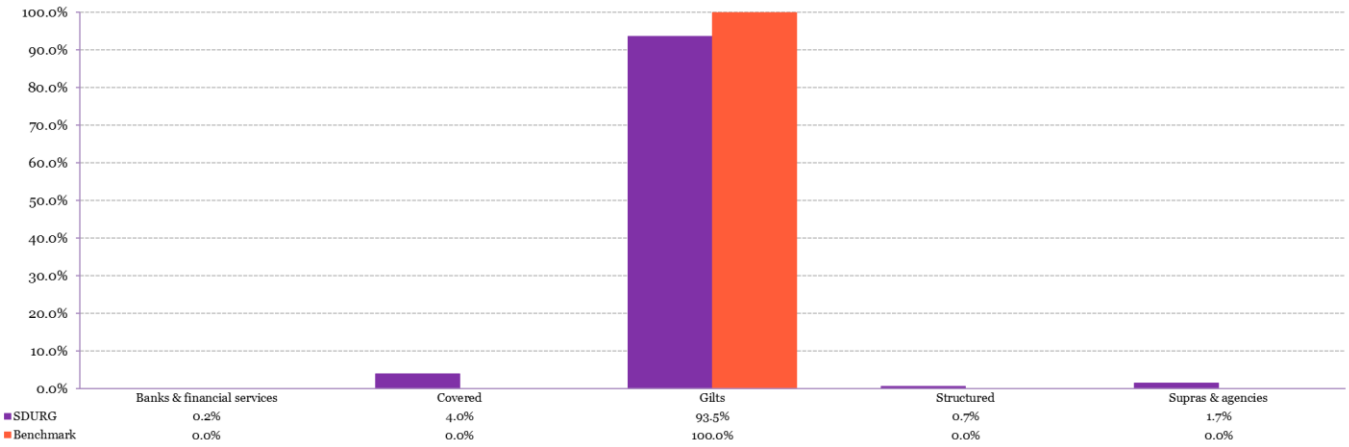
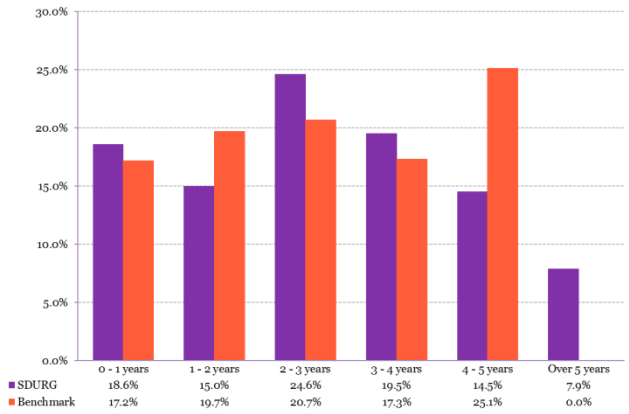
Sector breakdown

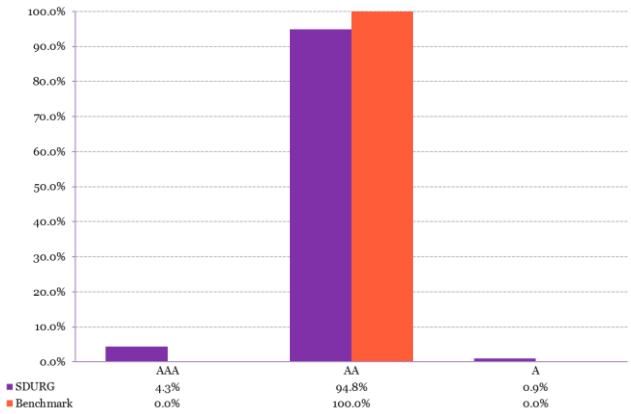


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
UK Treasury 0.125% 2023	23.7
UK Treasury 0.125% 2024	18.5
UK Treasury 0.625% 2025	10.6
UK Treasury 3.75% 2021	9.9
UK Treasury 4.0% 2022	7.1
UK Treasury 0.125% 2026	7.0
UK Treasury 0.5% 2022	6.5
UK Treasury Bill 0.0% 2021	5.0
UK Treasury 8.0% 2021	2.9
UK Treasury 5.0% 2025	2.4
Total	**93.5**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

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Market overview

- There was considerable divergence in the performance of government bond markets during the quarter. While yields generally declined in Europe, especially in peripheral markets, they rose in the US and Canada. The risk-off environment in Europe was caused by a renewal of national lockdowns amid a second wave of Covid-19, with several new strains emerging. Partially offsetting this, however, were the series of positive announcements in November regarding the development of vaccines. Several countries were able to begin rolling out the vaccines before the end of the year, raising the prospects of a return to normality for societies in 2021.
- The US was impacted by these same developments, with daily Covid-19 case numbers and deaths rising to record highs during the quarter. However, the market was additionally affected significantly by the US elections and economic data. There were expectations in October for a 'blue sweep' in the November elections, with Biden winning the presidency and the Democrats taking the Senate. That caused a sell-off in US treasuries because it was likely to result in higher levels of fiscal stimulus. In actuality, the election outcome was closer than the polls had implied, leading to a partial retracement of the surge in treasury yields. At the same time, while economic data appeared to be better than expected, the US Treasury's closure of several Federal Reserve lending facilities led to growth concerns, pulling treasury yields lower. In aggregate, however, the combination of the vaccine news and the electoral outcome pushed yields higher overall.
- The 10-year UK gilt yield was little changed over the quarter, declining from 0.23% to 0.20%, and shorter-dated gilt yields remained negative. Yet this masks the considerable level of volatility in the market. Fluctuating headlines around the state of the Brexit negotiations, with multiple missed deadlines for achieving a trade deal, pulled the market in two directions for much of the quarter. Additionally, investors weighed up the possibility that the Chancellor's Spending Review in November might shake up the index-linked bond market by changing RPI as early as 2025. Ultimately, a Brexit deal was agreed at the end of December and it was decided that the RPI reform would take place at the end of 2030.
- The Bank of England (BoE) continued to neutralise the impact of government bond issuance through asset purchases. The Bank announced an additional £150bn of gilt purchases in November, above market expectations for £100bn of purchases. This will take the total stock of bonds held by the BoE's Asset Purchase Facility to £895bn. The Federal Reserve (Fed) and European Central Bank (ECB) operated similar quantitative easing programmes. In addition, the removal of roadblocks to the dispersal of the €750bn EU Recovery Fund was a significant positive for European economies.

Portfolio commentary

- We continued to run a short duration position in the fund relative to the FTSE Actuaries UK Conventional Gilts up to 5 years index throughout the quarter. We were convinced that the market was overestimating the likelihood of the BoE implementing negative interest rates in the near term. Negative rates would create serious challenges for the UK banking system, while other tools like forward guidance and additional quantitative easing were still available for the Bank. We were correct on this point, as the BoE avoided negative rates during the quarter.
- The short duration positioning had little impact on performance in October, with the accommodative policies of the BoE keeping the front end of the gilt curve relatively pinned. In November, yields rose on news that several of the Covid-19 vaccine trials were more successful than expected, which was beneficial for the fund. Yet this was offset in December when the market rallied. That prompted us to further increase the fund's duration short because we considered gilts yields to be at the wrong level compared to other markets. We also sold all of the fund's shortest-dated bonds into six-month UK treasury bills, thereby achieving a reasonable pick-up in yield of around 0.1%.
- With regard to curve positioning, we maintained a flattening bias in the fund in October and November to offset the fund's short duration stance. This did not have much impact upon returns given that the shape of the front end of the curve was little changed over that period. We decided to move to a steepening bias in December given how flat the curve already was, believing that it was unlikely to invert between two- and five-year maturities.
- The fund was slightly underweight gilts on a cross-market basis in October through its holdings of French and Spanish government bonds, on which we took profits. Among the more notable overseas trades during the quarter, we switched the fund's strongly performing 5-year Australian government bonds into 10-year Australian bonds which had not done as well at the end of October, based on our view that the Reserve Bank of Australia would cut interest rates and extend its quantitative easing programme at its November meeting. This transpired and we took profits on the position in early November, switching into four-year gilts.
- The fund's modest highly-rated sterling credit exposure added slightly to returns during the quarter as credit spreads continued to contract as several key market risks subsided. The average sterling investment grade credit spread tightened from 1.29% to 0.99% during the quarter, causing corporate bonds to strongly outperform gilts.

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Outlook

- The BoE's ongoing quantitative easing program should remain relatively supportive for bond markets in 2021. Nevertheless, the level of quantitative easing is likely to be reduced over time, and we expect yields to rise as economies return to more normal conditions as the Covid-19 vaccine rollout contains the spread of the virus. We consequently favour short duration strategies and curve steepening trades over the medium term.
- In addition, we anticipate that market volatility will remain high in the first quarter due to the conflict between further lockdowns and the rollout of the vaccine. Additionally, there are risks around new strains of the virus, the distribution of vaccines and the timeframe within which second doses must be administered. There is also the possibility that the BoE might decide to implement negative rates, though we do not expect this in the near term, considering it more likely that the Bank would opt for other monetary policy tools. Given the elevated volatility levels that all of these factors imply, we will continue to take advantage of market extremes by trading tactically.
- We think that real yields are too low and will rise over time. Despite the announcement on RPI reform, longer-dated breakevens remain elevated as a consequence of buying at the end of the year. Conversely, inflation protection, on a global basis, looks undervalued. This is not because we expect a surge in inflation, but due to the asymmetry of risk in an environment with a high level of uncertainty. Central banks and governments may be happy for inflation to overrun as they prioritise economic growth.
- Otherwise, we are mindful of the strategy review that is currently being undertaken by the ECB. Following the increased flexibility around inflation adopted by the Fed in its revised monetary strategy, we expect the ECB to take a similar approach. ECB president Christine Lagarde has openly discussed average inflation targeting. The euro has been notably strong against the dollar and we anticipate further currency volatility over coming months, even though the UK-EU trade deal negotiations have now concluded positively.
- You can read more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2021 document.

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