ROYAL LONDON SHORT DURATION GLOBAL INDEX LINKED 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]	0.0	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	24.7	30.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	75.3	70.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	5.3 years	5.2 years
Real yield[4]	-1.77%	-2.08%
No. of stocks	61	97
Fund size	£501.4m	-

Source: RLAM, based on the Z share class. Launch date: 23.02.2016.

[1]Benchmark: 30% Barclays UK Government Inflation Linked Bond 1-10 year index,70% Barclays World Government Inflation Linked Bond (ex UK) 1-10 year index (GBP hedged).

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

[3]Excluding cash.

[4]Real yield shows the inflation-adjusted redemption yield for the underlying portfolio and therefore does not include the impact of fees. For share class level yields, please see the latest factsheet

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	**0.89**	**0.78**	**0.11**
Year-to-date	5.18	4.37	0.82
Rolling 12 months	5.18	4.37	0.82
3 years p.a	3.03	2.61	0.43
Since inception p.a. 23.02.2016	2.91	2.68	0.23

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: 30% Barclays UK Government Inflation Linked Bond 1-10 year index, 70% Barclays World Government Inflation Linked Bond (ex UK) 1-10 year index (GBP hedged).

Performance for the Royal London Global Index Linked Fund is based on pricing at noon, while index performance is based on pricing at close of business, preventing direct performance comparison. The significance of this timing discrepancy is likely to be greater for shorter measurement periods.

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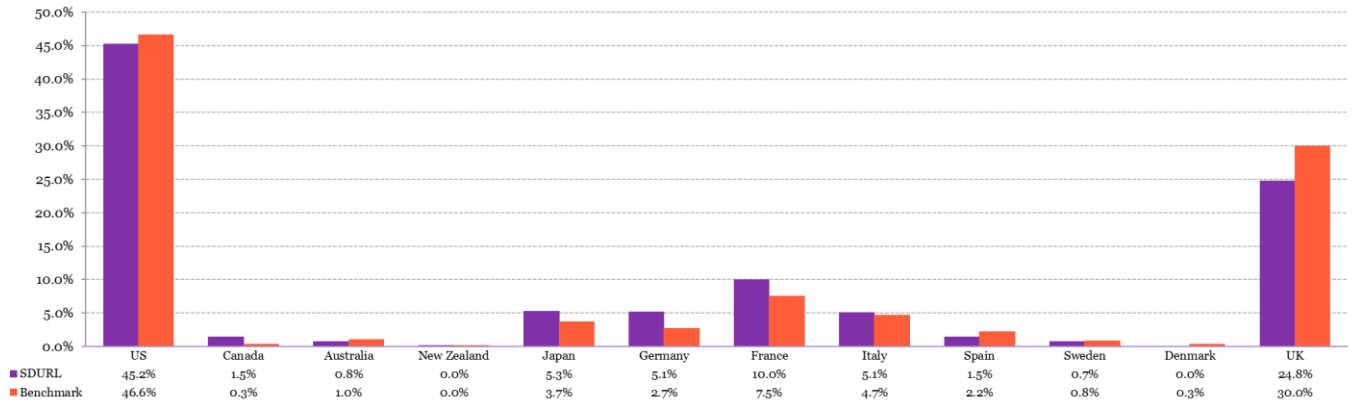
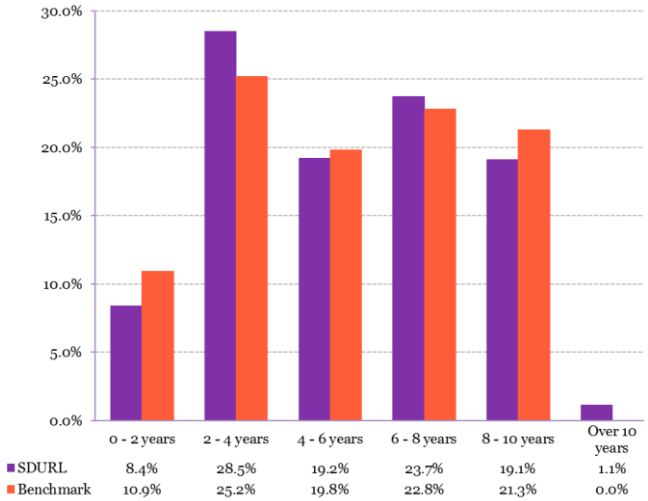
Regional breakdown

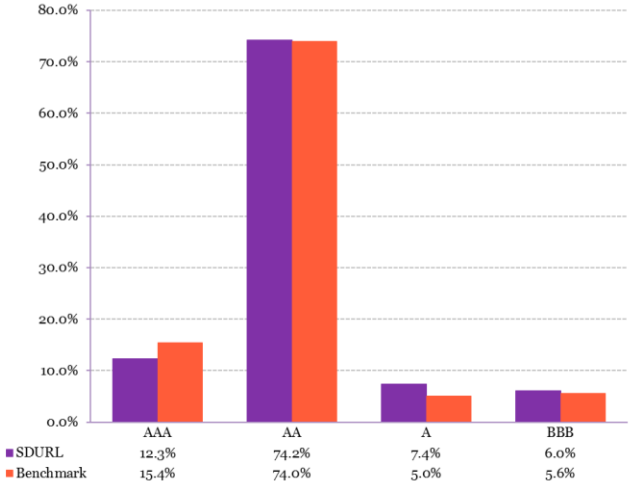


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
US Treasury 0.5% IL 2028	6.1
UK Treasury 0.125% IL 2029	5.9
US Treasury 0.125% IL 2024	5.4
UK Treasury 1.875% IL 2022	5.1
US Treasury 2.0% IL 2026	3.7
US Treasury 1.75% IL 2028	3.6
UK Treasury 0.125% IL 2026	3.4
UK Treasury 4.125% IL 2030	3.1
US Treasury 0.125% IL 2030	3.0
UK Treasury 2.5% IL 2024	3.0
Total	**42.3**

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

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Executive summary

- This was another good quarter for our index linked strategies and they have consequently delivered strong full-year performance on an absolute and relative basis. For the fourth quarter, as reported, the strategies returned:
  - **RL Index Linked Fund**: -0.22%, benchmark +1.21%
  - **RL Global Index Linked Fund**: +1.03%, benchmark +1.64%
  - **RL Short Duration Global Index Linked Fund**: +0.75%, benchmark +0.78%
- These figures (all M share classes, net of fees), however, are distorted by timing differences between the funds and their indices. On a like-for-like basis, the **Index Linked Fund** outperformed by +21 basis points (bps), the **Global Index Linked Fund** outperformed by +15bps and the **Short Duration Global Index Linked Fund** outperformed by +26bps. On this basis, outperformance for the year as a whole for the three funds is +58bps, +51bps and +88bps, respectively.
- The key drivers of performance were overweight positions in global markets relative to the UK, which underperformed over the quarter as a UK-EU trade deal was finally agreed. Tactical duration positioning between 0.5 years long and 0.5 years short added value as yields remained volatile around key events. Yield curve positions were generally neutral, but the Short Duration Global Index Linked Fund benefitted from having larger short-dated (i.e. <10 years) cross-market positions as sub-10-year real spreads tightened sharply. In contrast, the longer-dated Global Index Linked Fund was penalised by its exposure to the longer-dated UK curve, but still delivered relative outperformance.
- Four distinct factors drove inflation expectations over the quarter. From a global perspective, the positive **vaccines** trial data that were published in November and subsequent approval of the Pfizer/BioNTech vaccine in the UK caused a profound shift in sentiment. Despite rising Covid-19 cases in many countries and the subsequent identification of a more contagious strain of the virus leading to renewed lockdowns, investors looked through to the prospect of a sharp recovery in the second half of 2021 and a positive 'risk on' sentiment largely prevailed for the rest of the quarter. The **US elections** also had a significant impact with fears about a Democratic sweep of the Presidency and Congress initially appearing to be unfounded. Investors concluded that political gridlock was better for financial markets, with less risk of higher taxes and radical reforms. In the UK, the long-awaited conclusion of the **RPI reform** consultation was announced in the Chancellor's Spending Review 2020. As widely expected, RPI will change in 2030 with no compensation for investors: despite an initial price reaction, the removal of the uncertainty then unleashed a wave of LDI buying drove long yields lower, flattening the curve. Finally, the spectre of the failure of the negotiations to agree a **UK-EU trade deal** hung over gilt markets for much of the period as a sharp fall in sterling would have fed through to inflation through higher prices for imported goods. The agreement of a deal on Christmas Eve therefore removed a key risk investors.
- Given these various developments, we believe that UK real yields remain expensive on a legacy Brexit basis and, despite the announcement on RPI reform, longer-dated breakevens remain elevated as a consequence of buying at the end of the year. However, these factors could be sustained for some time if cross-border frictions (such as paperwork and VAT issues) affect imports and pension industry technical factors continue to drive the market. On a global basis, with the Georgia Senate runoffs, US bond markets have certainly started to discount higher inflation with US 5-year breakevens rising to 211bps (having reached just 20bps in the initial crisis), although we feel that a more centrist consensus will emerge with the support of moderate Republican senators and feel that US inflation no longer offers value. In contrast, with the success of China and neighbouring countries in dealing with the pandemic, the Asia-Pacific region is well placed for strong economic growth and Australian breakevens are more attractive.
- The first quarter will remain volatile due to the conflict between further lockdowns and the rollout of the vaccine, and this volatility could be amplified by base effects compared to 2020. We believe yields are likely to be higher by the end of the year and will use any strength to reduce duration in the funds and to increase global index linked exposure.

Market overview

- Major global stock markets delivered a strong fourth quarter. The MSCI World Index rose +7.9% in sterling terms. Remarkably, despite the pandemic, 2020 as a whole posted positive returns (+12.3%). Companies that had been struggling because of Covid-19 tended to perform well on the Pfizer vaccine news, while several sectors rose on the prospect of a more traditional US president and gridlock in the legislative bodies preventing extreme policy decisions. Unlike prior quarters, it was not technology that led sectors (+6.8% in sterling terms during quarter), but a strong recovery in energy (+20.3%) and financials (+17.4%), which had previously underperformed.
- The Bank of England (BoE) has continued to neutralise the impact of government bond issuance through asset purchases, which were extended in the quarter. The Federal Reserve (Fed) and European Central Bank (ECB) are operating 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.

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- With renewed lockdowns in many countries and activity remaining below normal levels, yields on benchmark 10-year government bonds fell over the quarter in most major developed markets, apart from the US, Canada, Sweden and Japan. The yield on 10-year gilts decreased 3 basis points (bps) to 0.20% and shorter-dated government bond yields remained negative, although the BoE continued to eschew the policy option of negative base rates.
- In the UK index linked market, yields were mixed over the period, falling at the longer end, but increasing slightly at the short end. The short end was also notably volatile. The yield on the 10-year index linked gilt rose 3bps to -2.90%. US 10-year index linked treasury yields fell 14bps over the quarter, whereas German index linked bund yields decreased by 29bps. Breakevens generally increased over the quarter, but fell in the UK as a trade deal was finally agreed with the EU, which removed the inflation risk of sharp sterling weakness. In the UK, the 10-year breakeven (implied) inflation rate decreased 6bps to 3.00%; in the US and Germany, however, 10-year breakevens rose 35bps and 25bps to 1.99% and 0.91%, respectively. The yield spread between UK index linked gilts and US TIPS tightened by another 17bps to 181bps at the end of the quarter as the Fed's revised approach to US monetary policy – average inflation targeting, under which inflation and employment will be allowed to run higher – continued to affect inflation expectations and cause dollar weakness.
- Credit spreads tightened further reflecting increased economic activity and government support packages. The average sterling investment grade spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) ended the quarter a further 30bps tighter at 0.99%, which compares with an average spread of 1.14% at the end of 2019. This is a remarkable turnaround considering that the average spread was as wide as 2.25% at the peak of the market sell-off in March.
- Sterling was among the stronger major currencies over the quarter, strengthening another 5.4% against the US dollar following the recent decision by the Fed to alter its inflation targeting methodology. It also strengthened marginally against the euro and against the yen. This strength tempered the returns for sterling investors in global equities.
- Oil prices recovered strongly in the quarter as global economy continued to grow and Saudi Arabia announced production cuts. The price of Brent crude oil rose by +26.5% to over $52 a barrel. Copper continued to strengthen as economic activity strengthened in China, rising +15.8% over the quarter. Gold fell -0.2% to $1,933/oz., although this masked its volatility across the quarter as some investors sought a safe haven on renewed fears about Covid-19 and political risks.

Performance and activity

- Total returns for UK index linked gilts were +1.21% for the fourth quarter (FTSE Actuaries UK Index Linked Gilts Index – all maturities), driven by the long end, underperforming the +1.68% return for global index linked sovereigns (Barclays), but outperforming the +0.63% return on conventional gilts (FTSE Actuaries).
- UK real yields were driven predominantly by two factors during the quarter. First, discussion around RPI reform, which drove long-dated yields higher initially and steepened the curve on the announcement that the consultation findings would be announced at the Chancellor's Spending Review 2020 in late November. Fears of a 'no-deal Brexit' also supported the shorter end of the market for the majority of that month and also supported breakevens, which were also supported by a more 'risk on' environment as positive vaccine trial data were announced. Following the announcement of a change to RPI in February 2030 with no compensation for investors, a wave of deferred LDI buying drove long yields lower, flattening the curve. This continued with the Christmas Eve UK-EU trade deal that led to breakevens falling and a further underperformance of the short end of the market. On a cross-market basis, the UK underperformed, particularly towards the end of the quarter following the agreement of a trade deal.
- The fund was traded tactically over the quarter, given the volatility around key events. The fund was short UK relative to global index linked bonds (US, France, Germany, Australia and Italy), ending the period long Italy, Canada, Japan and France.
- In duration terms the fund was managed between 0.5 years long and 0.5 years short, ending the year flat.
- On the curve, the fund was generally in flatteners for most of the quarter, particularly in the latter half as curves steepened. Sub 5-year bonds were switched longer, particularly in the US and Europe after a strong performance as inflation expectations improved.

Outlook

- Several key risks have now been removed, although others have inevitably emerged in their place. The positive conclusion of the UK-EU trade deal negotiations was a clear positive and while the market had largely discounted the final RPI reform announcement, the removal of the uncertainty unleashed a wave of LDI buying. The positive Covid-19 vaccines developments may be less definitive than they initially appeared, however, with new strains of the virus emerging and the logistical challenges of rolling out mass vaccination programmes. Similarly, it initially appeared that US political risks had

receded with deadlock in Congress: however, the victory of the two Democrats in the Georgia Senate runoff has shifted the balance and increases the prospect of higher spending and taxes, and more radical reforms of the US economy.

- Given these various developments, we believe that UK real yields remain expensive on a legacy Brexit basis and, despite the announcement on RPI reform, longer-dated breakevens remain elevated as a consequence of buying at the end of the year. However, these factors could be sustained for some time if cross-border frictions (such as paperwork and VAT issues) affect imports and pension industry technical factors continue to drive the market. On a global basis, with the Georgia Senate runoffs, US bond markets have certainly started to discount higher inflation with US 5-year breakevens rising to 211bps (having reached just 20bps in the initial crisis), although we feel that a more centrist consensus will emerge with the support of moderate Republican senators and feel that US inflation no longer offers value. In contrast, with the success of China and neighbouring countries in dealing with the pandemic, the Asia-Pacific region is well placed and Australian breakevens are more attractive.
- The first quarter will remain volatile due to the conflict between further lockdowns and the rollout of the vaccine, and this volatility could be amplified by base effects compared to 2020. We believe yields are likely to be higher by the end of the year and will use any strength to reduce duration in the fund and to increase global index linked exposure.
- 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.

More on Government Bonds

- To find out more about our investment approach to investing in conventional and index linked government bonds and our current thinking, please visit rlam.co.uk.
- Talks from the online *RLAM Investment Series* that was held in the week of 28 September 2020 can be viewed on BrightTALK.com; including *Government bonds and quantitative easing* by Craig Inches, *The return of global inflation* by Paul Rayner and *From surviving to thriving – insurer fixed income portfolios* by Andrew Epsom. Each presentation lasts for 30 minutes, including Q&A.
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2021 document.

ROYAL LONDON
ASSET MANAGEMENT

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