ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Quarterly Report 30 September 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	4.9	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	93.7	100.0
Foreign index linked sovereign	1.4	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	8.8 years	8.5 years
Gross redemption yield[4]	0.29%	0.25%
No. of stocks	97	857
Fund size	£473.0m	-

Source: RLAM, based on the M share class. Launch date: 01.11.2011.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

[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 (%)
Q3 2020	**1.02**	**0.66**	**0.36**
Year-to-date	5.96	5.49	0.47
Rolling 12 months	4.43	3.83	0.60
3 years p.a.	4.33	4.18	0.15
5 years p.a.	3.53	3.26	0.26
Since inception p.a. 01.11.2011	3.57	3.61	-0.04

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 M share class.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

On 26th November 2012 the RL International Government Bond Fund (Class B) was renamed the RL International Government Bond Fund (Class M).In the above table, the fund returns in the first column are gross of fees and net of taxes. The fund returns in the second column are gross of fees and gross of taxes. Both include the impact of cash holdings over the period. The benchmark returns are gross of tax. Your tax situation may differ and as such your actual return may be less than the gross of tax fund return shown in this table.

Performance for the Royal London International Government Bond 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 smaller for 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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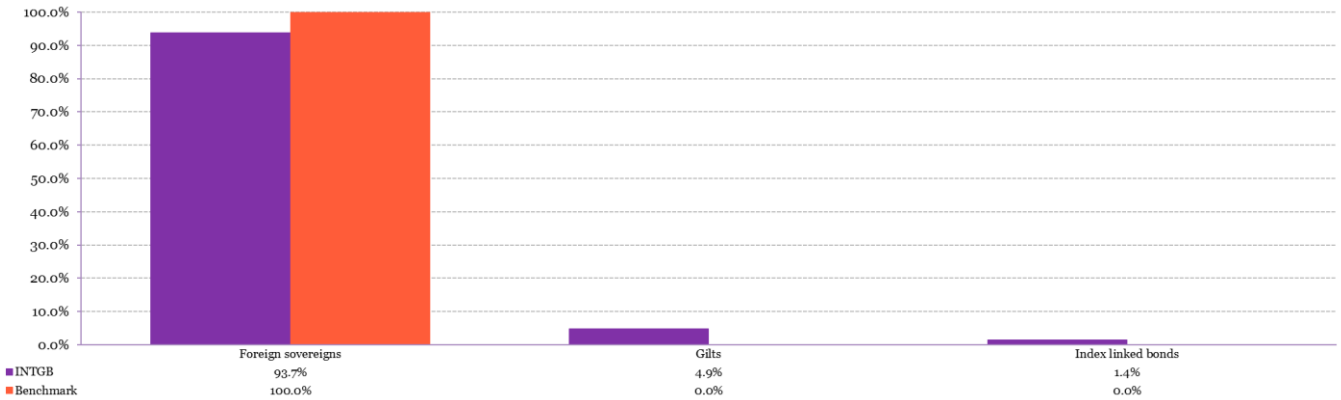
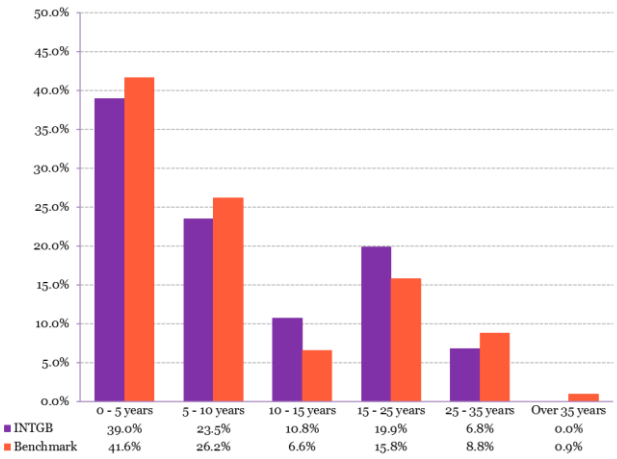
Sector breakdown

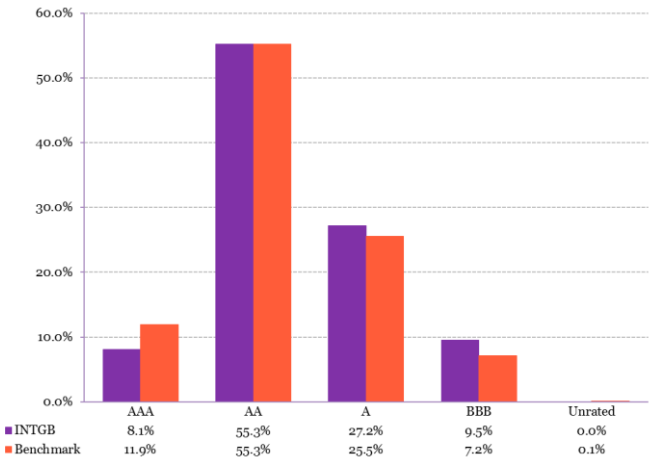


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
UK Treasury 1.5% 2021	4.9
US Treasury 2.25% 2024	4.3
US Treasury 0.625% 2026	4.1
US Treasury 2.0% 2022	3.7
US Treasury 2.0% 2022	3.5
Japan (govt Of) 0.8% 2022	3.4
US Treasury 4.375% 2041	3.3
Japan (govt Of) 2.2% 2031	3.3
France (govt Of) 0.0% 2021	3.1
Japan (govt Of) 0.4% 2039	3.0
Total	**36.5**

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

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Market overview

- Government bond markets were fairly range-bound during the quarter, contained by mixed newsflow on the coronavirus and the prospects for a vaccine or treatment. There was a lot of issuance from governments needing to finance their elevated budgets. At the start of the quarter much of the issuance came at substantial discounts, reflecting the fact that governments needed to issue more debt than investors had anticipated. The issuance was easily absorbed by the market owing to the aggressive bond buying programmes of central banks, which reassured investors in the bonds that the risks were not excessive. This healthy demand encouraged governments to reduce the extent of their discounting, such that by the end of the quarter it was much less significant.
- Yields were broadly unchanged in traditional safe havens like the US and Germany. By contrast, Spain and Italy performed extremely well as their spreads over core markets tightened. The outperformance of Spain was due to the hunt for yield from investors, coupled with support from the European Central Bank (ECB) and the newly-created European Recovery Fund. Investors in Italy were comforted by the regional elections going smoothly, with little support for Matteo Salvini's far-right Lega Nord party. This meant that electoral reforms went through and rendered a snap election less likely than in the past, due to incumbent parties having fewer seats in Parliament. This more benign political environment, coupled with the fact that Italy was one of very few countries still issuing positive yields, resulted in Italy's outperformance.

Portfolio commentary

- We avoided putting on large directional or structural positions during the quarter, conscious that the volatile newsflow around the coronavirus would continue to dictate market movements. As such, our strategic duration positioning did not have a significant impact upon performance.
- We participated in a lot of the supply events during the quarter and held onto many of the bonds we bought. Even though the absolute levels of government bond yields were very low, not reflecting the true underlying risks, we were confident that yields were unlikely to rise significantly given the impact of the central bank bond buying programmes. While there is a risk that rating agencies might take a view on longer-term debt sustainability, causing debt downgrades, we think that the bond buying programmes have made ratings less important at this juncture. The one exception would be if Italy were to fall to sub-investment grade because that would lead to a lot of forced sellers, but that event is thought to be unlikely at this stage, particularly since the rating agencies are likely to be cognisant of the risks that would entail.
- We had been overweight Italy at the start of the quarter, and increased that position following the Italian regional elections. We are now 0.25 years long Italy, content that the risk/reward dynamics are skewed towards further spread tightening. While the BTP/bund spread is close to its tightest levels of the past few years, we think it is more likely to go tighter than wider given the supportive central bank action and reduction in political risk. In addition to Italy, we were also overweight Spain and Portugal during the quarter. All of these positions contributed to returns, as periphery market outperformed. The one position which did not do well was our underweight exposure to France. We had thought France's spread relative to Germany was too tight and that France would need to issue more debt, but the debt continued to perform well, which detracted from relative returns.
- We reduced our exposure to inflation during the quarter, having been long US and European breakevens. We had previously been adding to European breakevens when there was very low demand in the market for them, and this paid off well when inflation bounced from its very depressed levels. Conscious that Covid-19 was leading to a collapse in economic activity, which could cause inflation to fall once more, we decided to take profits on our positions in European breakevens in July and exited them entirely in August. This proved timely, since inflation subsequently declined. We likewise benefitted from strong performance in US breakevens, before selling them as the recovery in inflation lost momentum. Our long-held holding in Japan is our only remaining inflation position, which we consider to be less risky given how liquid it is.

Outlook

- The uncertainties surrounding Covid-19, with fears of a second wave, make it hard for markets to move in any direction, despite yields being very low. Until there is a mass-available vaccine, countries will remain unable to open up completely, suppressing economic activity and risking sharply rising unemployment. More positively, though, we are seeing the increasing use of targeted lockdowns, rather than blanket ones, which has been enabled by improvements in testing availability and tools like track-and-trace. This has kept schools and a number of businesses open.
- We expect that economic activity will gradually improve in 2021, particularly if a successful vaccine or treatment for the Covid-19 becomes widely available. There are, however, many threats to this expectation: the possibility of new waves of the virus, complications in the development and distribution of vaccines, subdued consumer confidence and business investment, corporate failures, and government and central bank policies. Over the next two or three years, interest rates

look set to remain at very low levels, with yield curves heavily managed by central banks. Central banks appear increasingly comfortable that as a consequence of lower rates for longer, inflation could run above their historic target levels.

- We do not think the current environment is conducive to taking long-term directional positions. While the support of the ECB is helpful for peripheral markets, we are not running large positions. Instead, we will seek to trade the many forthcoming supply events more tactically, avoiding too much duration risk. Since we expect the markets to continue trading within a range, we can use the events as opportunities to top up existing positions at discounts, or to enter positions that we can exit when new discounts come along; thereby maintaining our exposure while taking advantage of the discounts on offer. That has become possible by virtue of better telegraphing of the supply events, avoiding aggressive selloffs on the announcements.
- 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, although this isn't expected to be announced until next year. The euro has been notably strong against the dollar and we anticipate further currency volatility over coming months, even before the wildcard of the post-Brexit trade deal negotiations.

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