ROYAL LONDON SHORT DURATION GLOBAL INDEX LINKED FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

CONTENTS

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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	5.5	0.0
Sterling index linked gilts	17.8	30.0
Foreign conventional sovereign	2.5	0.0
Foreign index linked sovereign	74.1	70.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	5.4 years	5.4 years
Real yield[4]	-1.43%	-1.89%
No. of stocks	60	96
Fund size	£495.2m	-

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 (%)
Q3 2020	**1.73**	**1.51**	**0.21**
Year-to-date	4.26	3.56	0.70
Rolling 12 months	3.54	2.41	1.13
3 years p.a	2.81	2.55	0.26
Since inception p.a. 23.02.2016	2.88	2.66	0.22

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.

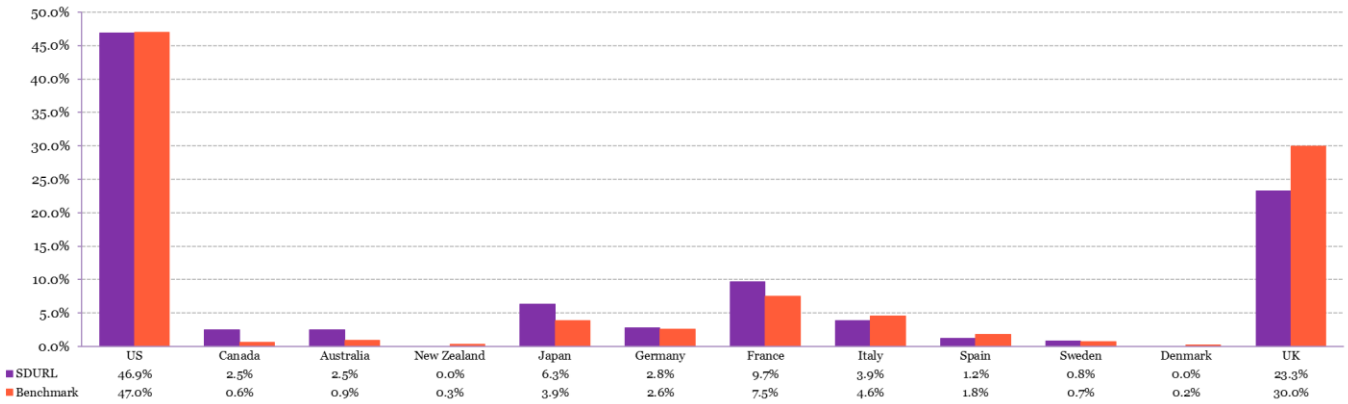
Source: RLAM, based on the Z share class.

[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.

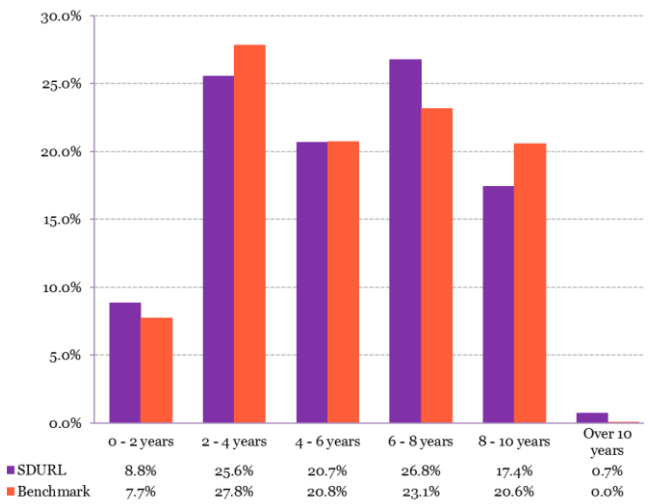
ROYAL LONDON SHORT DURATION GLOBAL INDEX LINKED

Regional breakdown

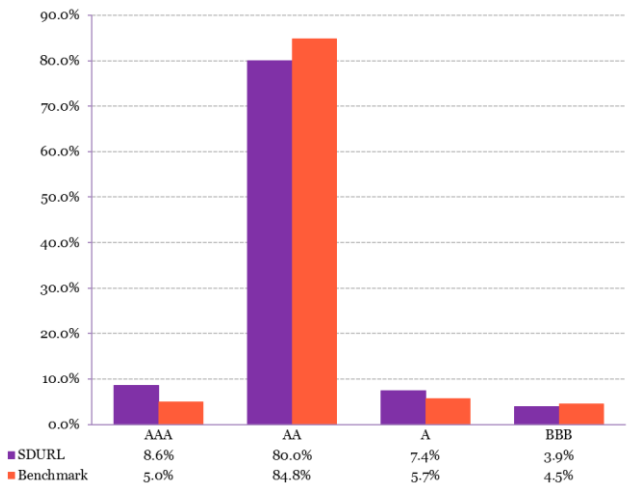


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
UK Treasury 0.125% IL 2029	6.4
UK Treasury 1.5% IL 2021	5.5
US Treasury 0.125% IL 2024	5.5
US Treasury 0.5% IL 2028	5.4
UK Treasury 2.5% IL 2024	5.3
US Treasury 2.0% IL 2026	3.7
US Treasury 1.75% IL 2028	3.7
US Treasury 0.125% IL 2030	3.1
US Treasury 0.625% IL 2023	2.8
US Treasury 0.5% IL 2024	2.6
Total	**44.0**

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

ROYAL LONDON SHORT DURATION GLOBAL INDEX LINKED

Market overview

- Major global stock markets were more muted in the third quarter after the previous quarter's dramatic recovery, but still posted positive aggregate returns in sterling terms. The MSCI ACWI index (covering major developed and emerging markets) rose +3.8%. However, within this there was a wide geographical dispersion, with the UK and many European markets falling, and the US once again proving robust. As with the last quarter, the strong recovery in equities since March may seem surprising given the ongoing Covid-19 crisis. The pandemic has had clear negative impacts on corporate performance, which in some cases look to be structural rather than a shorter, cyclical hit. However, the monetary and fiscal responses have been equally dramatic, and have driven down fixed income yields and the equity discount rate to very low levels.
- The impact of the pandemic on government finances became clearer. UK government borrowing in the current year is now estimated to be £470bn (c. 23% of GDP). The Bank of England (BoE) continued to neutralise the impact of government bond issuance through quantitative easing; the current tranche is due to be completed in late November or early December, although a further extension of is probable. With the economic recovery slowing and activity remaining below normal levels, and with so much monetary stimulus, yields on benchmark 10-year government bonds fell over the quarter in nearly all major developed markets, apart from the UK, US and Canada. The yield on 10-year gilts increased 6bps to 0.23% and short-dated government bond yields remained negative at maturities of less than seven years, although the BoE played down the imminent likelihood of negative base rates.
- In the UK index linked market, yields generally decreased over the period, albeit not at the longer end. The yield on the 10-year index linked gilt fell 9bps to -2.93%. US 10-year index linked treasury yields fell 24bps over the quarter, whereas German index linked bund yields decreased by 7bps. Breakevens increased over the quarter. In the UK, the 10-year breakeven (implied) inflation rate increased 16bps to 3.06%; in the US and Germany, 10-year breakevens rose 29bps and 1bp to 1.63% and 0.66%, respectively. The yield spread between UK index linked gilts and US TIPS tightened by 16bps to 198bps at the end of the quarter. At the annual Jackson Hole symposium in late August, Federal Reserve (Fed) Chair Jerome Powell announced a revised approach to US monetary policy – average inflation targeting – under which inflation and employment will be allowed to run higher. This is likely to keep interest rates low for several years, causing dollar weakness, and drove outperformance of the front end of the US yield curve.
- Sterling was among the strongest major currencies over the quarter, strengthening over 4% against the US dollar as the Federal Reserve altered its inflation targeting methodology. It strengthened only marginally against the euro.
- The price of Brent crude oil fell by -0.5% over the third quarter, although it was notably weaker in September, falling by -9.6% to under $42 a barrel. Copper continued to strengthen as economic activity picked up in China, rising +10.6% over the quarter. Gold rose +6.4% to $1,900/oz., despite weakness in September. It had reached multi-decade highs in early August of nearly $2,100/oz. as some investors sought a safe haven should markets fall.

Performance and activity

- Total returns for UK index linked gilts were -2.18% for the period (FTSE Actuaries UK Index Linked Gilts Index – all maturities), driven by weakness at the longer end, underperforming the +1.23% return for global index linked sovereigns (Barclays) and the -1.23% return on conventional gilts (FTSE Actuaries).
- All the funds benefitted from cross-market positions and tactical trading of duration between 0.2 years long and 0.3 short. However, the UK fund marginally underperformed as curve positions offset duration and cross-market positions.
- Real yields in the UK were marginally lower on quarter with strong demand for inflation protection with Brexit uncertainty and for pension scheme buyouts. Earlier in the quarter, inflation remained higher than expected given the scale of the economic shock that lockdowns had delivered. However, this was not sustained and eurozone core inflation came in at a record low of +0.2%yoy at the end of September. Economic growth also surprised on the upside, although there is a 'phoney war' at present with unemployment deferred by government furlough schemes and other measures. Central banks remain very concerned about longer-term damage to the economy, particularly in the labour market.
- UK inflation expectations, however, have been driven more by speculation that negotiations between the UK and European Union (EU) will fail to deliver a mutually-acceptable trade deal, which would cause sterling to fall sharply and increase the cost of imports. Markets have been reacting disproportionately to comments from key participants with fears of 'no deal' supportive for shorter-dated bonds. The UK market has also been waiting for the decision on RPI reform.
- The UK underperformed on a cross-market basis, but the future direction will be dictated by Brexit headlines. The announcement of 'average inflation targeting' by the Fed raised fears of higher inflation with short-dated US bonds the best performers globally. Conversely, short-dated European bonds lagged as core inflation reached record lows in September.
- While the curve steepened in the UK, ultra-long bonds outperforming their shorter-dated long peers.

ROYAL LONDON SHORT DURATION GLOBAL INDEX LINKED

- Breakevens rose sharply as trade talks deteriorated but fell towards the end of the quarter as fears increased that a second wave of Covid-19 could lead to widespread lockdown measures and further economic costs.
- Corporate index linked bonds outperformed government index linked bonds because of the increased appetite for risk, which caused credit spreads to tighten further. Carry enhanced the positive contribution in the strategies in which we have a small exposure to these bonds.
- The fund remains underweight UK and this position was increased in September into UK strength on Brexit fears. Australian bonds were purchased in the 5-year syndication in September. Over the quarter, peripheral exposure was reduced through sales of Italy after strong performance. We are underweight shorter bonds on curve after recent outperformance – this position was increased in September. Duration remains marginally long as real yields are expected to fall on further economic weakness and inflation hedging.

Outlook

- Given the current elevated volatility in index linked markets, particularly concerning the possibility of a 'no-deal' Brexit and the crucial talks in mid-October, we are taking tactical positions, rather than longer-term strategic positions. This applies to both the UK and global strategies. However, we have a long-term strategic view that UK inflation is too expensive against its global counterparts. We expect real yields, particularly in the UK, to rise over the next year and the UK to underperform. Yield pick-ups of c. 2% in European and US markets offer long-term value, particularly as global index linked bonds are included in quantitative easing programmes (unlike in the UK). We envisage increasing this exposure once there is clarity around a trade deal.
- The other key risk for the UK market is the prospect of RPI reform now that the consultation process has been concluded. Already delayed from earlier in the year, an announcement had been expected in the Budget in due in October or November. However, with the ever-shifting backdrop of the Covid-19 pandemic making it difficult to make longer-term plans, the Chancellor of the Exchequer cancelled the Budget and instead announced his Winter Economy Plan on 24 September. It now seems likely that the announcement on RPI reform will be postponed until the new year.
- 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, 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.

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 our website (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.

ROYAL LONDON
ASSET MANAGEMENT

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