ROYAL LONDON UK GOVERNMENT BOND FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for investors

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	5.4	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	92.3	100.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	1.3	0.0
Foreign index linked sovereign	0.9	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	13.0 years	12.8 years
Gross redemption yield[4]	0.39%	0.35%
No. of stocks	43	50
Fund size	£999.4m	-

Source: RLAM, based on the Z share class. Launch date: 30.01.1990.

[1]Benchmark: FTSE® Actuaries All Stock Gilts 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 (%)
Q3 2020	**-0.69**	**-1.23**	**0.54**
Year-to-date	9.14	7.59	1.55
Rolling 12 months	5.19	3.41	1.79
3 years p.a.	6.20	5.66	0.54
5 years p.a.	5.56	5.08	0.48
10 years p.a.	5.43	5.18	0.24
Since inception p.a. 30.04.2010	5.72	5.35	0.37

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.

Source: RLAM, based on the Z share class.

[1]Benchmark: FTSE® Actuaries All Stock Gilts Index.

On 1 May 2012, the Royal London UK Government Bond Fund (Class B) was renamed the Royal London UK Government Bond Fund (Class Z). The Z share class was launched on 30 April 2010. All performance after this date is for the Z share class. All performance for periods prior to 30 April 2010 is for the Royal London UK Government Bond Fund (Class A).Therefore the performance shown in this table is a merged return which includes the historical 'A' share return for the periods to 30 April 2010, before the Z share existed. If you were invested in the fund prior to this, your investment was in the A shares. If you require separate performance solely for the Z shares since 30 April 2010, please contact your Client Account Manager.

Performance for the Royal London UK 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 greater for shorter 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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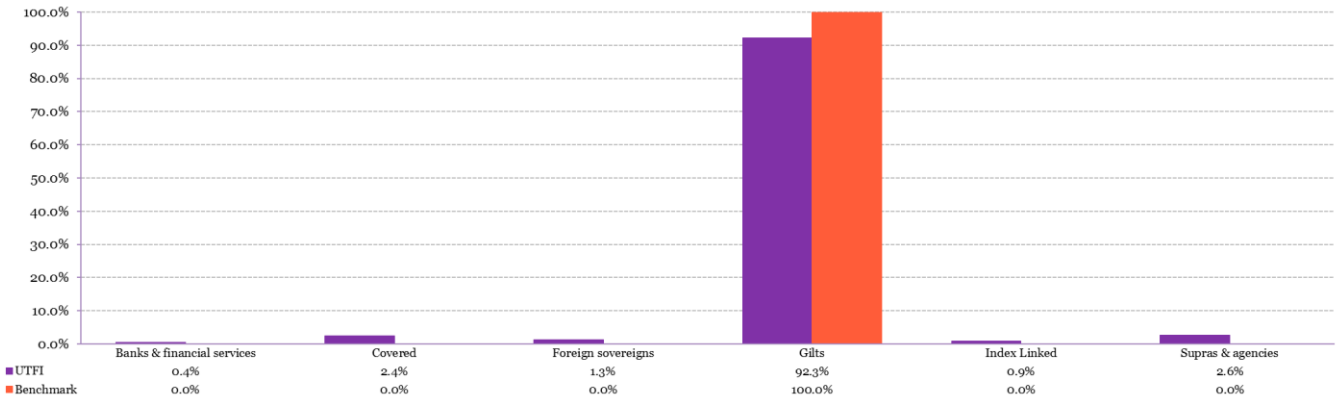
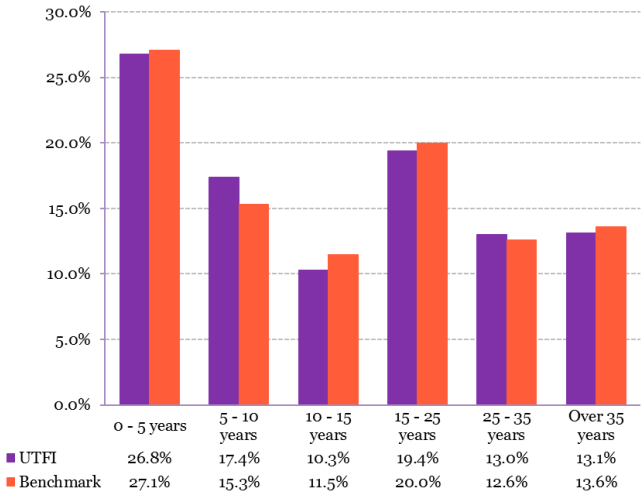
Sector breakdown

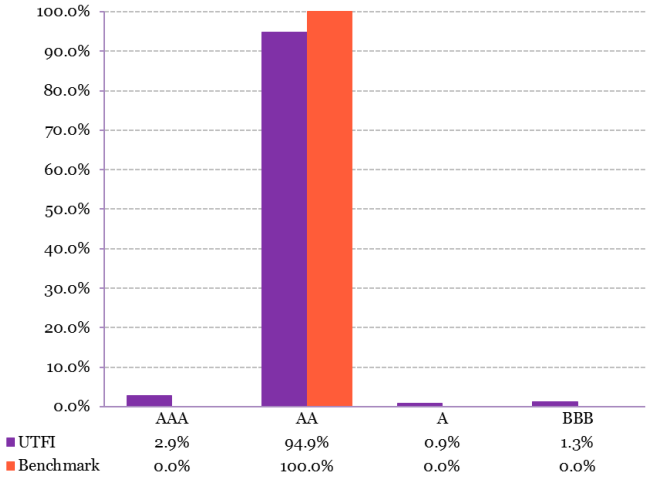


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
UK Treasury 1.5% 2021	9.4
UK Treasury 0.125% 2026	7.5
UK Treasury 1.75% 2037	6.4
UK Treasury 0.125% 2028	6.4
UK Treasury 0.625% 2050	5.7
UK Treasury 0.375% 2030	4.6
UK Treasury 2.5% 2065	4.5
UK Treasury 4.0% 2022	3.9
UK Treasury 4.25% 2040	3.9
UK Treasury 1.75% 2049	3.9
Total	**56.2**

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

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Market overview

- There was divergence in the performance of government bond markets during the quarter. While core global markets such as the UK and US saw flat-to-higher yields, mainly at longer maturities, yields declined significantly in Europe. The strength of European government bond markets relative to global peers reflected both the strength of the European Central Bank's (ECB's) bond buying program, as well as ongoing progress towards joint European bond issuance. The UK's gilt market was poor in comparison, as investors anticipated a record amount of long-dated (over 30-year maturity) gilt issuance from the Debt Management Office over the coming months, at a time when the Bank of England (BoE) continued to reduce the pace at which it bought bonds in the secondary market via its quantitative easing programme. This resulted in the yield curve steepening.
- The UK government continued to support the economy through its Coronavirus Job Retention Scheme ("furlough"), tax deferrals, business grants and loan guarantees. In late September, Chancellor Rishi Sunak announced that the furlough scheme would be replaced on 1 November by a new Job Support Programme. The programme requires an employee to work a minimum of 33% of their regular hours, with the government and employer each paying one third of the employee's salary for the remaining hours in which they do not work. Additionally, larger businesses must show that their turnover has fallen to remain eligible for the support.
- The scale of the impact of these programmes on the UK government's finances became clearer during the quarter. In our last quarterly report, we noted that UK government borrowing in the current year would exceed £300bn. It is now estimated to be £470bn, representing approximately 23% of GDP. As mentioned above, the BoE continued to neutralise much of the impact of the heavy government bond issuance this implies by buying many of the bonds. This is due to end in early December, although a further extension of quantitative easing is now being expected by the market.
- The yield on 10-year gilts was just 0.23% at the end of September, little changed from 0.17% at the end of June. Short-dated government bond yields remained mostly negative for maturities of less than seven years. While the BoE has discussed negative rates more frequently of late, practical challenges in the banking system suggest that implementation may still be some way off. Against this background, credit outperformed gilts during the quarter, reflecting a tightening of credit spreads. The broad gilt market returned -1.23%, while sterling investment grade corporate debt returned 1.16%. The average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) narrowed from 1.47% to 1.29%.
- In the UK index linked market, yields generally decreased over the period, albeit not at the longer end, with the yield on the 10-year index linked gilt declining from -2.85% to -2.93%. The 10-year breakeven (implied) inflation rate increased from 2.91% to 3.06%, reflecting a pick-up in economic activity, boosted by the success of schemes such as 'Eat Out to Help Out'. The yield spread between UK index linked gilts and US TIPS tightened by 0.16% to 1.98%. At the annual Jackson Hole symposium in late August, Federal Reserve 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.

Performance and activity

- The fund outperformed its benchmark over the quarter. It should be noted that the relative performance differential partly reflects timing differences between fund pricing at midday and end-of-day market indices.
- We continued to implement our strategy of trading duration tactically, rather than taking large strategic positions. As such, we kept the fund's duration within a narrow range of 0.25 years short to 0.2 years long relative to the FTSE Actuaries UK Conventional Gilts All Stocks index over the quarter. Given this positioning close to the benchmark, duration did not have a significant impact on performance from a strategic perspective. We were able to add value tactically, however, trading a number of supply events both in the UK and overseas.
- Heading towards the BoE meeting at the start of August, we implemented an underweight position in gilts with maturities of less than four years, believing the market to be overestimating the likelihood of imminent negative rates. Although this call proved correct, it was overshadowed by a global sell-off in government bond markets. The yield curve steepened as long-dated gilts sold off on news that central banks would tolerate higher levels of inflation, while the front end of the curve remained pinned due to the reluctance of central banks to hike interest rates in a recession. Given the fund's bias towards 10-year and 25-year maturity bonds versus shorter-dated bonds, this was detrimental to performance during the quarter.
- Sticking with curve, the fund had been running a long held steepening position between 30-year and 50-year gilts given the inversion of the curve in that range. This proved beneficial in July when the yield curve steepened significantly. We closed out positions here as the spread between the two maturities approached its least inverted level in two years.

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- Another major theme for us during the quarter was holding an underweight position in gilts relative to the benchmark, with an overweight holding of overseas government bonds. In light of the news that the BoE would be reducing its pace of bond buying, at a time in which the ECB was committed to absorbing the supply of government bonds in the eurozone at any price, we expected that gilts would underperform on a cross-market basis. This indeed transpired and was the major driver of the fund's relative performance. We held debt from a multitude of overseas government bond markets, which did very well in aggregate, and we were able to take profits on most of the holdings.
- Credit spreads continued to contract over the quarter, which slightly enhanced the fund's performance. The impact was limited as a result of our decision to reduce the fund's exposure to longer-dated credit. While the fund still has around 5% of the portfolio in credit, we have shortened the duration of that credit. We were concerned that credit spreads had already tightened significantly, and so the risk/reward ratio had deteriorated for longer-dated credit. We now view the fund's credit exposure as a means of enhancing the fund's yield at the very front end of the curve, rather than seeking to take advantage of credit spread tightening.

Outlook

- The recent upturn in Covid-19 case numbers in the UK has forced the government to tighten its social distancing measures, including a 10pm curfew for pubs and restaurants, as well as encouraging everyone to work from home where possible. The current indications are that this policy will last the whole winter, and there is the potential for further restrictions if the measures fail to contain the spread of the virus. The economic recovery, which had already been slowing during the summer, may be jeopardised by these new lockdown measures and rising unemployment seems likely.
- Even if the measures succeed in curtailing the spread of Covid-19 and societies are able to return to more normal conditions, the economy is likely to be compromised over the medium term. The level of government debt has surged to levels not seen since the Second World War, while tax receipts will become increasingly challenged by rising unemployment. We expect the greater supply of government debt, which is presently being absorbed by the BoE, will eventually lead investors to seek higher yields, and thereby cause an upward trend in long-term interest rates.
- Over the next two or three years, however, 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. As yet, there are few signs of higher inflation, but it remains a possibility that will need to be monitored. We do not anticipate negative rates from the BoE in the near term, considering it more likely that the Bank will opt for other monetary policy tools such as quantitative easing or forward guidance.
- 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. The UK also faces the additional uncertainty of new trading arrangements with the EU following the Brexit vote.
- Given the multitude of political risks currently, such as the possibility of a 'no-deal' Brexit and the US presidential elections, the volatility of longer-dated government bonds could be significant. Ultimately, though, we think that the BoE will remain supportive for long-dated bonds. Given the elevated levels of volatility, we generally prefer taking tactical positions, rather than long-term strategic ones. However, we do have a strategic view that European bond markets will outperform given the aggressive bond buying from the ECB, and so the fund has overweight exposure to Europe.
- A key risk for the UK index-linked 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 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.

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