Royal London Index Linked Fund

Quarterly Report 31 December 2021

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	0.0	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.1	0.0
Sterling index linked gilts	89.0	100.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	10.9	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	20.7 years	20.9 years
Real yield[4]	-2.51%	-2.66%
No. of stocks	38	32
Fund size	£512.4m	-

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

[1]Benchmark: FTSE® Actuaries UK Index Linked Gilts All stocks Index.

[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 2021	**4.90**	**4.94**	**-0.04**
Year-to-date	4.62	4.16	0.45
Rolling 12 months	4.62	4.16	0.45
3 years p.a.	7.76	7.16	0.60
5 years p.a.	5.32	4.66	0.66
10 years p.a.	6.79	6.41	0.38
Since inception p.a. 30.01.1990	7.14	7.20	-0.05

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.

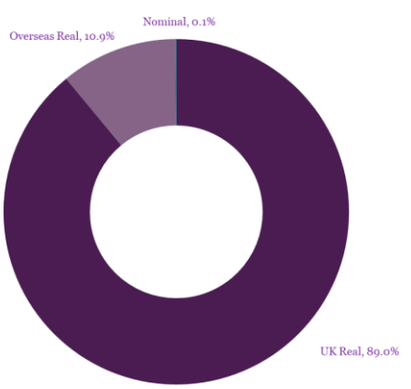
All performance figures stated gross of fees and tax unless otherwise stated.
Source: RLAM, based on the M Income share class.
[1]Benchmark: FTSE® Actuaries Index Linked Gilt All Stocks Index.
On 26 November 2012 the Royal London Index Linked Fund (Class B) was renamed the Royal London Index Linked Fund (Class M). The Royal London Index Linked Fund (Class B) was launched on 30 April 2010. All performance after this date and up to 26 November 2012 is for the B share class. All performance after 26 November is for the M share class. All performance for periods prior to 30 April 2010 is for the Royal London Index Linked 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 B 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 B shares since 30 April 2010, please contact your Client Account Manager.
Performance for the Royal London 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 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.

Ten Largest Holdings

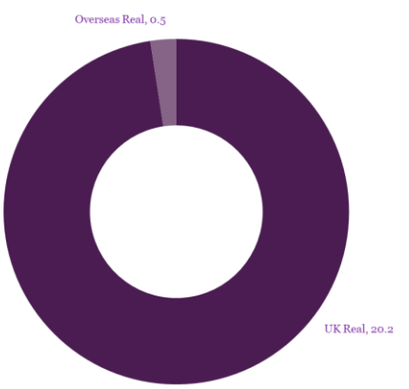
	Weighting (%)
UK Treasury 0.125% IL 2044	7.2
UK Treasury 1.25% IL 2055	6.8
UK Treasury 0.75% IL 2047	6.6
UK Treasury 0.75% IL 2034	5.7
UK Treasury 0.375% IL 2062	5.5
UK Treasury 0.125% IL 2068	5.5
UK Treasury 1.125% IL 2037	5.1
UK Treasury 0.125% IL 2058	4.9
Deutschland 0.1% IL 2023	4.8
UK Treasury 0.125% IL 2036	4.2
Total	**56.3**

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

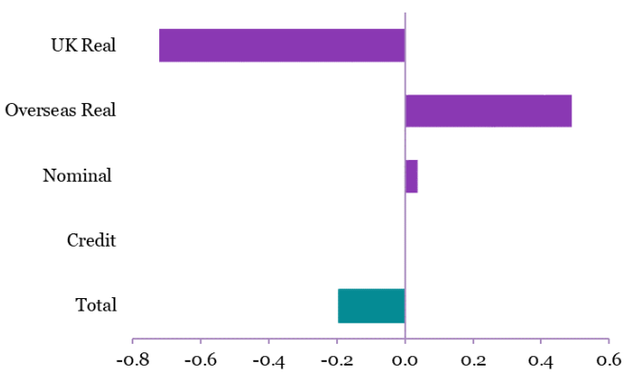
Asset split by percentage



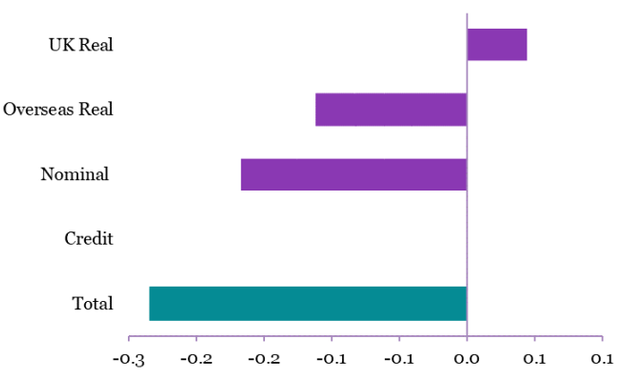
Asset split by duration



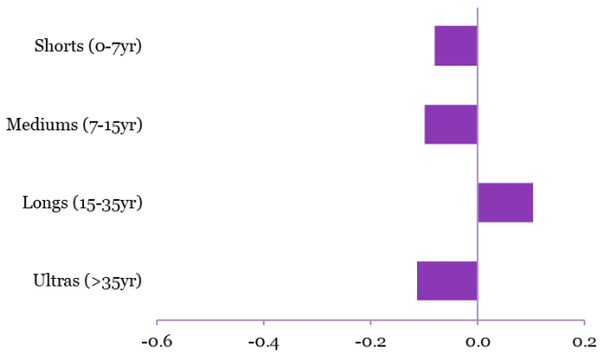
Asset allocation relative to benchmark (duration)



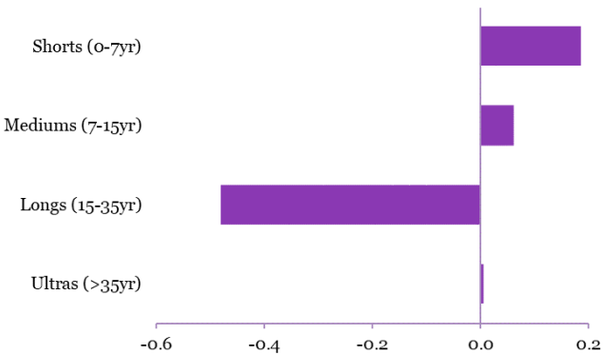
Asset allocation change on the quarter (duration)



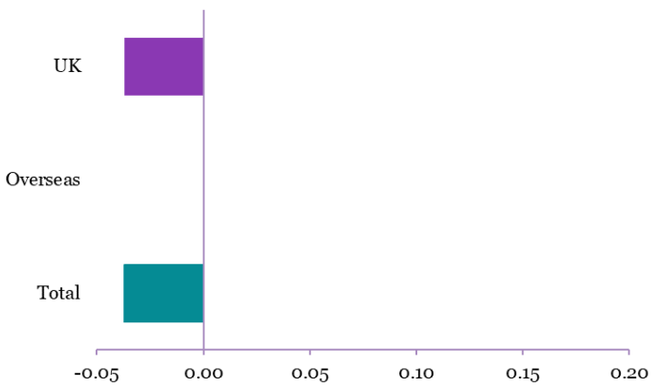
Yield curve relative to benchmark (duration)



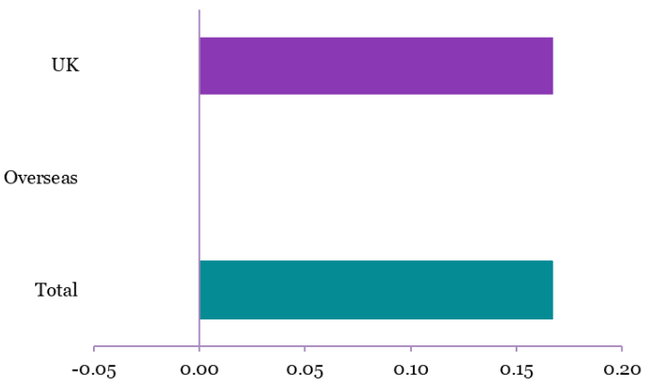
Yield curve change on the quarter (duration)



Inflation exposure (duration)



Inflation exposure change on the quarter (duration)



Executive summary

- The final quarter of 2021 saw markets grapple with the emergence of a new variant of Covid-19, with a surge in case numbers leading to increased restrictions on mobility across a number of countries. Meanwhile, the quarter also saw very definite hawkish tilt from a number of central banks under pressure from persistently high global inflation data. Real yields were relatively stable globally compared to previous periods, although the UK market was major exception. Nonetheless, our index-linked range again provided strong absolute returns in the quarter, significantly outperforming conventional bond funds.

  RL Index Linked Fund: 4.81%, benchmark 4.94%

  RL Global Index Linked Fund: 3.12%, benchmark 3.11%

  RL Short Duration Global Index Linked Fund: 1.18%, benchmark 1.41%

- These figures (all M share classes, net of fees), are distorted by timing differences between the funds and their indices. On a like-for-like basis, the **Index Linked Fund** outperformed by 19 basis points (bps) in the quarter (returning +4.88%) and by 30bps for the year (+4.64%); the **Global Index Linked Fund** outperformed by 14bps for the quarter (+3.25%) and by 63bps for the year (+5.99%); and the **Short Duration Global Index Linked Fund** underperformed by 16bps for the quarter (+1.25%) and by 33bps for the year (+4.87%).

- Cross market positions were the major driver of performance in the quarter for all funds. The funds built underweights in the UK towards the end of November, after the BoE's failure to increase interest rates led to significant market strength. This was a significant positive for performance, as global markets subsequently outperformed the UK in December by between 50 and 100 basis points.

- It was the combination of rising nominal yields and falling inflation during December which resulted in aggressive upwards movements in UK real yields into year-end – the BoE's decision to raise rates in mid-December drove nominal yields higher across the curve, while a 60% collapse in natural gas prices in the last week of the year saw the UK's 10-year breakeven (implied) inflation rate close the quarter 23bps lower at 3.94%. In all, five-year UK real yields rose by 59bps in the quarter closing 2021 at -3.32%, around 0.5% below where they began the year; 10-year and 30-year real yields rose by 39bps and 31bps respectively to close the year at -2.97% and -2.28%, more or less returning to where they been at the beginning of 2021.
- For the long funds, outperformance was predominantly due to a very strong December when global bonds materially outperformed the UK, and the UK real curve flattened sharply – the flattening of the US real curve also benefitted the long global fund. The short duration fund, which posted strong absolute returns over the quarter and recovered relatively during December, did not manage to completely recover in December from periods of weakness in October and November – an underweight in the shortest dated UK bonds over the quarter detracted from relative performance, as the UK real curve steepened.
- We expect markets to remain volatile during 2022 as they come to terms with rising interest rates and the removal of central bank support as QE programmes end. Inflation prints will remain high in the first quarter, with RPI expected to be above 7% at its peak in April when utility bill prices rise. However, the combination of tighter monetary policy globally and inflation valuations falling from record high levels should see real yields rise in 2022.

Market overview

- Global government bond markets were mixed in the fourth quarter, a period notable for its volatility. Markets grappled with the emergence of a new variant of Covid-19, Omicron, and experienced a surge in case numbers that led to increased restrictions on mobility across a number of countries. The quarter also saw very definite hawkish tilt from a number of central banks under pressure from persistently high global inflation data.
- In the US, messaging from the Federal Reserve (Fed) saw the removal of the term "transitory" from its inflation commentary. Fed Chair Powell gave very clear messaging regarding the likely future path of monetary policy, including a likely increase in the pace of the tapering (an increase in pace of quantitative easing (QE)), which in turn brought forward expectations of the first rate hike in the US. The Fed's December policy announcements delivered on its messaging, causing US yields to rise during December, somewhat reversing the fall in yields in November in response to fears over Omicron.
- In Europe, the European Central Bank (ECB) met in December and announced what was perceived as a hawkish set of measures. It announced that the end of the Pandemic Emergency Purchase Programme (PEPP) in March 2022 will be accompanied by a doubling of its Asset Purchase Programme (APP) to €40 billion a month for the second quarter, reducing to €30bn and €20bn in the third and fourth quarters. Despite assurances of flexibility in the re-investment of maturing PEPP proceeds, the market viewed the policy as less supportive for peripheral European bonds – European yields rose into year-end as a result, and periphery market spreads widened versus German bonds.
- In UK bond markets, the benchmark 10-year gilt yield fell from 1.02% to 0.97% over the quarter, leading gilts to return 2.42% on an all-maturities basis (FTSE Actuaries). The apparent stability of the gilts market is misleading, however: having risen to 1.20% in late October, the 10-year gilt yield rallied to just 0.70% on 13 December (before the Bank of England raised the UK base rate). A mismatch in supply and demand dynamics in the fourth quarter accentuated the periods of volatility experienced in UK markets. Not only did the Bank of England not raise rates at the November meeting when the market fully expected a hike, the Bank decided to maintain its QE program at £875bn, rather than ending it early. This only exaggerated seasonal trends and reduced market liquidity into year end, a time when market liquidity naturally reduces as banks reduce balance their balance sheets.
- Real yields were relatively stable on a global basis in the fourth quarter, with US 10-year real yields edging lower by 2bps to -1.1% and German 10-year real yields increasing by 7bps to -2.1% – both traded within 15bps range. In the UK, real yield movements were far more aggressive and extremely volatile. Led by the short end of markets, index-linked gilt yields fell to their all-time lows in early December, with five-year, 10-year and 30-year real yields dropping to respective lows of -4.19%, -3.45% and -2.61%, causing curves to steepen significantly. Nonetheless, these trends reversed by the end the close of the year. While a new supply of 52-year bonds helped to relieve downwards pressure on long-dated index-linked gilt yields during November, it was the combination of rising nominal yields and falling inflation during December which resulted in aggressive upwards movements in UK real yields into year-end – the BoE's decision to raise rates in mid-December drove nominal yields higher across the curve, while a 60% collapse in natural gas prices in the last week of the year saw the UK's 10-year breakeven (implied) inflation rate close the quarter 23bps lower at 3.94%. Overall, five-year UK real yields rose by 59bps in the quarter closing 2021 at -3.32%, around 0.5% below where they began the year; 10-year and 30-year real yields rose by 39bps and 31bps respectively to close the year at -2.97% and -2.28%, more or less returning to where they been at the beginning of 2021.

- Credit market returns were more pedestrian with sterling investment grade credit returning 0.34%, as the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened from 0.87% to 0.98%. For the year as a whole, the rise in gilt yields (from 0.20% to 0.97% for the 10-year gilt) led gilts to return -5.16% – by way of context, 2021 was the worst year for global sovereign bonds since 1999. Sterling investment grade credit returned -3.09%, with the credit spread tightening by one basis point to 0.98%.
- Currency movements were muted in the fourth quarter. Sterling was one of the stronger global currencies, strengthening against the US dollar and euro to reach a two-year high as the Bank of England raised the UK base rate. The yen was a notable outlier, weakening 3.3% against the US dollar and falling to its lowest level since 2017.
- Commodities delivered mixed returns after rising strongly earlier in the year. Brent crude oil trod water, falling back to below $80 a barrel after weakness in November. However, it still enjoyed a remarkable year after being particularly weak in the initial aftermath of Covid-19 – for 2021 as a whole, the price of Brent crude increased by over 50%. Copper futures resumed their upward trend (+7.7%) after retrenching in the third quarter: prices rose nearly 27% for the full year. The gold spot price rose +2.2% to just below $1,800/oz.

Performance and activity

- Wary of spouts of potential volatility, the fund ran a relatively flat strategic duration position in the fourth quarter; duration therefore only had a small, albeit positive, impact on overall performance in the period. We instead favoured a tactical approach duration, trading duration volatility tactically, particularly around supply events and frequent central bank rhetoric. Duration ranged from 0.2 years long and -0.5 years short, ending the year around -0.2 years short. The portfolio was significantly underweight the UK versus global markets throughout the quarter, as UK inflation markets remained overvalued. The underweight was greatest during November with the fund moving as far as -1.5 years short in its home market relative to global markets.
- Cross market positions were a major driver of performance in the quarter. The fund built underweight UK positions towards the end of November after the BoE's failure to increase interest rates during November led to significant market strength. This was positive for performance, as global markets significantly outperformed the UK in December – by between 50 and 100 basis points – following the BoE decision to increase the base rate. The overweight position in global markets was pared back following this period of strong performance, ending the year around 0.5 years short the UK at the close of the year, including long positions in Australia, France and Japan.
- Curve positioning had a moderately positive impact on performance for within the fund in the fourth quarter. With the 2073 bond syndication expected at the end of November, the fund held an underweight in ultra-long UK index-linked bonds in the run up to the supply event. As the ultra-long end underperformed, adding to returns, the position was gradually reduced. During the quarter, 30-year bonds were also bought relative to the 20-year and 35-year sector after a period of underperformance. By the end of the year the fund held a flattening bias via an underweight in the 10-year sector relative to the longer end of the market.

Outlook

- We expect markets to remain volatile during 2022 as they come to terms with rising interest rates and the removal of central bank support as QE programmes end. Inflation prints will remain high in the first quarter, with RPI forecasted to be above 7% at its peak in April when utility bill prices rise. However, the combination of tighter monetary policy globally and inflation valuations falling from record high levels should see real yields rise in 2022.
- The UK remains expensive, but with only two index-linked gilt auctions in the first quarter the recent underperformance may stall. Any widening of real yield differentials is likely to lead to an increase in the weight of assets invested in global markets. A judicial review of the RPI reform decision may support the long end of the UK market, so we prefer to be in real curve flattening positions across funds at present. Breakeven rates sold off sharply in December but with little supply in the first quarter and a rebound possible in gas prices, we are looking for better entry levels to go underweight breakevens.

More on government bonds

- A record number of current and prospective clients and consultants joined us online for the 2021 RLAM Investment Series (our annual client conference) between 1 and 5 November 2021. Fund managers and other in-house specialists addressed the macroeconomic environment and prospects for different asset classes, and the issues that they consider in managing their funds. There were also sessions on responsible and

sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. All the sessions are available to watch on demand – please visit the RLAM Digital Insight Hub

- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2022 document, and regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk

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