ROYAL LONDON INDEX LINKED FUND

Quarterly Report 30 June 2021

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	0.1	0.0
Sterling index linked gilts	94.5	100.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	5.4	0.0
Derivatives	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	21.0 years	21.0 years
Real yield[4]	-2.28%	-2.39%
No. of stocks	37	31
Fund size	£518.7m	-

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 (%)
Q2 2021	**4.28**	**3.58**	**0.70**
Year-to-date	-2.23	-2.99	0.76
Rolling 12 months	-3.67	-3.96	0.29
3 years p.a.	5.56	4.87	0.69
5 years p.a.	5.29	4.62	0.67
10 years p.a.	7.62	7.17	0.45
Since inception p.a. 30.01.1990	6.93	6.96	-0.03

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.

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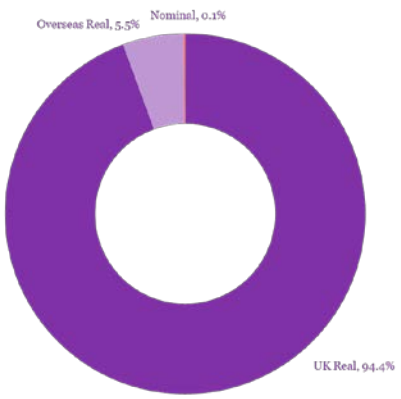
Ten Largest Holdings

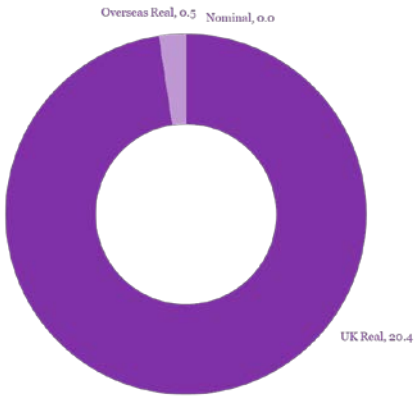
	Weighting (%)
UK Treasury 0.375% IL 2062	8.1
UK Treasury 1.125% IL 2037	6.4
UK Treasury 2.5% IL 2024	5.6
UK Treasury 0.75% IL 2047	5.5
UK Treasury 1.25% IL 2055	5.5
UK Treasury 0.125% IL 2046	5.2
UK Treasury 0.75% IL 2034	5.0
UK Treasury 1.25% IL 2032	4.8
UK Treasury 0.125% IL 2039	4.6
UK Treasury 4.125% IL 2030	4.2
Total	**54.9**

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

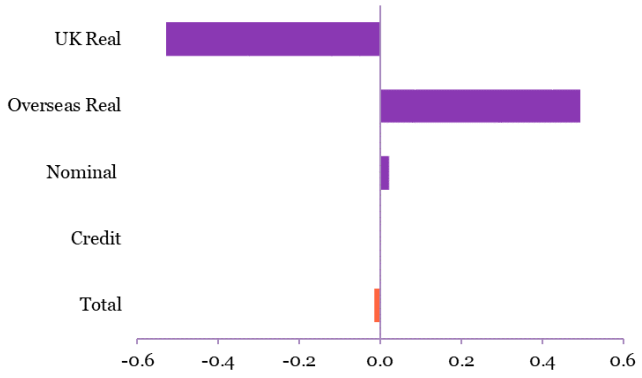
Asset split by percentage



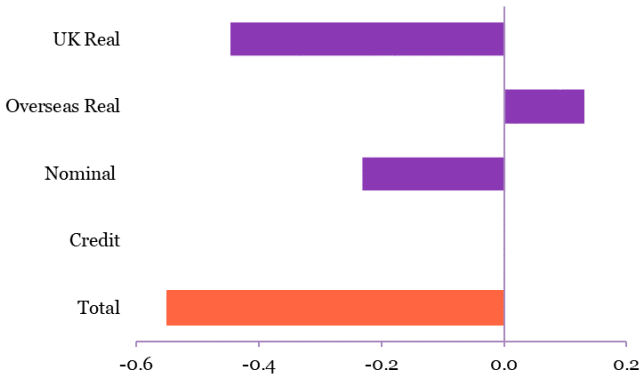
Asset split by duration



Asset allocation relative to benchmark (duration)



Asset allocation change on the quarter (duration)



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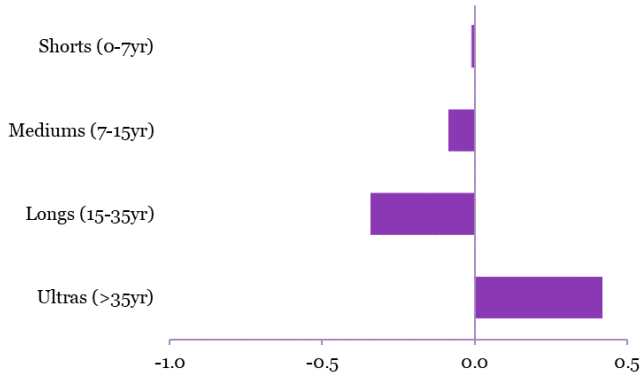
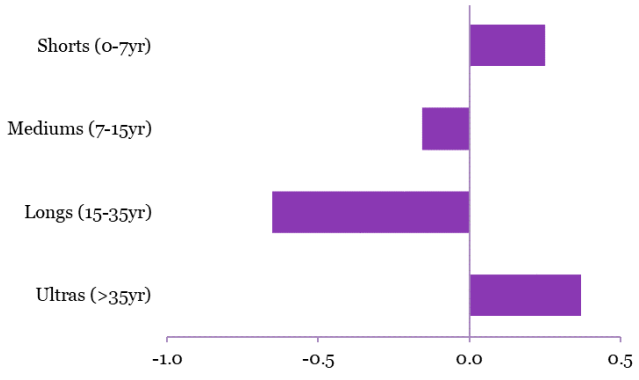
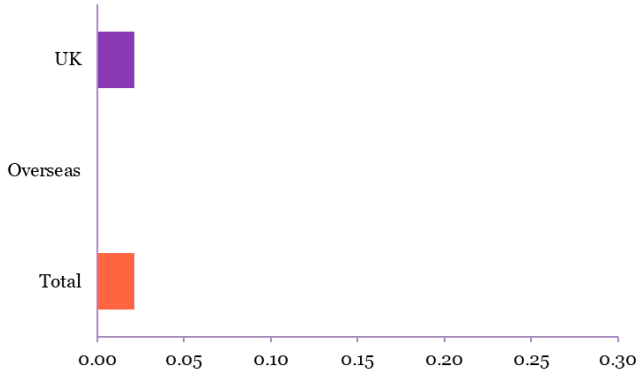
Yield curve relative to benchmark (duration)



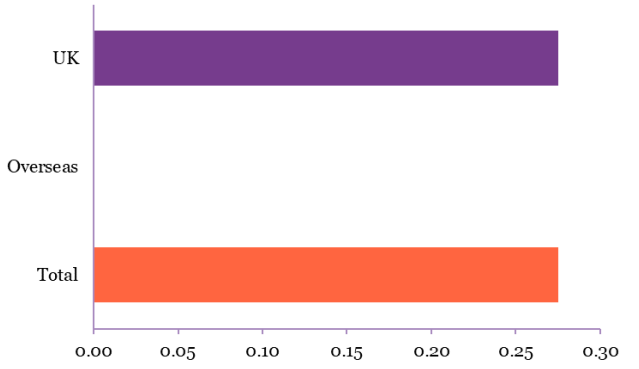
Yield curve change on the quarter (duration)



Inflation exposure (duration)



Inflation exposure change on the quarter (duration)



Executive summary

- Index-linked assets outperformed over the quarter, strongly supported by carry from higher inflation prints. Yields stabilised after the sell-off earlier in the year and the rise in breakevens led to fall in real yields leading to strong absolute performance and relative to nominal funds.
  - **RL Index Linked Fund**: 4.19%, benchmark 3.58%
  - **RL Global Index Linked Fund**: 3.05%, benchmark 2.80%
  - **RL Short Duration Global Index Linked Fund**: 1.73%, benchmark 1.70%
- 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 +6 basis points (bps), the **Global Index Linked Fund** outperformed by +27bps and the **Short Duration Global Index Linked Fund** outperformed by +12bps. On a 12-month rolling basis, outperformance for the funds, in the same order, is +0.31%, +0.50% and +0.51%.
- Although the Bank of England (BoE) began tapering in May by slowing the pace of its bond buying programme, and the Federal Reserve's June economic forecasts show a rase in base rates a year earlier (in 2022) that forecast in March, monetary support remained supportive in the quarter. This support helped government bonds settle down from highs in the previous quarter. The US 10-year treasury lead global markets, as its yield fell by 27 basis points (bps) over the quarter to 1.47%, while UK 10-year gilt yields down 13bps to 0.72%. Breakevens fell by less over the same period; the US 10-year breakeven was down 4bps and the UK down 9bps, pushing real yields lower and causing index-linked bonds to outperform on a relative basis.

Market overview

- Global government bond returns were mixed in the second quarter. The US 10-year treasury led global markets, as its yield fell by 27 basis points (bps) over the quarter to 1.47%. In the UK, 7- to 10-year gilts returned 1.1% for the quarter, with 10-year yields down 13bps to 0.72% – interestingly, the 10-year gilt market traded within a stable 15bps range throughout quarter,

having had a relatively volatile first three months of the year. Europe was the laggard of major global markets and core market yields were up for the quarter rather than down; the 10-year bund was up by 9bps to -0.21%. The underperformance in Europe compared to in the US and UK can partly be attributed to the delays in vaccine programmes. Rising yields have been closely linked to the success of vaccine programmes, which only began to make good progress in the second quarter.

- The second quarter of 2021 saw investors re-engage with global economic data. While data was broadly very strong and supported predictions of a sustained global economic recovery, a particularly strong US CPI print sent jitters through global markets on 12 May. As the US inflation measure hit 4.2%, the major global discussion point for the period turned to whether high inflation might be sustained rather than transitory. Although the Federal Reserve reassured markets that inflation would be transitory, and that they were not yet 'talking about talking about tapering', June Federal Open Market Committee (FOMC) meeting forecasts showed a more hawkish stance. Median committee forecasts showed rates at 0.6% at the start of 2023 – much closer to current market prices – pricing in two 25bps rate rises during 2022. In comparison, March forecasts had predicted no rate rises over the same period. The ECB followed a similar stance and stated it would not slow the pace of their asset purchasing programme as a response to strong data. Panetta, an economist and member of the ECB's executive board said; "only a sustained increase in inflationary pressure ... could justify a reduction in our purchases." At the close of the quarter, any decision by the ECB to roll back support for markets had been delayed to a later date.
- Most market events in the UK in the second quarter had little impact on market prices. In April, the Office for Budget Responsibility (OBR) revised down its borrowing forecasts which led to a £40bn reduction in issuance by the Debt Management Office (DMO), mainly across short and medium-dated gilts. Although this supported prices in those sectors, gilts were largely stable during the period. In May, the Bank of England (BoE) began tapering, slowing the pace of its quantitative easing programme – this had been broadly expected and was therefore already fully priced into gilt markets. However, surprisingly hawkish comments on interest rates from Gertjan Vlieghe, a Bank of England policymaker, pushed gilt yields up in the latter half of May, but only temporarily. In all, the UK economy remained strong in the quarter, against a backdrop of potential Brexit-related uncertainty over trade, and irrespective of the four-week delay to the exit from lockdown which was postponed until 19 July. At the end of the period, the BoE remained supportive of the UK economy. It was announced on 24 June that the Monetary Policy Committee (MPC) would leave interest rates unchanged at 0.1% and keep the total size of its bond-buying programme unchanged at £895bn, to be completed by the end of 2021.
- In the UK and the US, index-linked yield curves flattened, with rising shorter-dated yields and falling longer-dated yields. For example, the UK 5-year index linked gilt yield rose by 4bps, while the 10- and 30-year bond yields fell by 4bps and 13bps respectively. Over the period, the US 10-year index-linked bond yield fell by 24bps, while the bund equivalent rose by 2bps. After US breakevens had reached eight-year highs in the first quarter of the year, and UK breakevens reached their highest levels since the announcement of RPI reform, both were less volatile in the second quarter; the US 10-year breakeven was down 4bps to 2.56%, and the UK down 9bps to 3.64%.
- Major currencies were largely sedentary in the second quarter; the euro strengthened by 0.83% versus the dollar, while sterling saw no significant movement. The Australian dollar was the period's weakest currency, losing 1.61% against the US dollar for the quarter.
- Commodities extended their rally, leading cross-asset returns. Oil prices continued to recover strongly and were up 50% year-to-date, reaching their highest levels since October 2018 as the reopening trade sustained and blockages in supply chains continued to impact prices. The price of Brent crude oil rose by 18.2% to more than $76 a barrel in the quarter, while copper and gold also gained value; copper was up 7.2% for the quarter, and gold prices grew by 3.5% to $1,791/oz.

Performance and activity

- Index-linked assets outperformed over the quarter, strongly supported by carry. Furthermore, lower yields and higher inflation sent real yields lower, meaning inflation-linked government bonds in the UK and US outperformed conventional government bonds in both relative terms and on an absolute basis for the quarter. We avoided taking a strong strategic duration position in the quarter and instead favoured a tactical approach, trading intraday market volatility around market events. We traded 0.3 years either side of neutral through the quarter.
- We reduced duration during April when global markets rallied. We built duration on a cross-market basis through the remainder of the period. We especially favoured Europe as real yields looked better value than in the UK and US, particularly when hedging costs were taken into consideration. We also held long positions in the US and Canada– both outperformed versus the UK and we took profits on the latter in May. We sold UK into France again in June; the market looked to be underperforming in part due to political concerns but also due to the to the inaugural issuance of the EU's 'Next Generation EU' (NGEU) bonds. At quarter end, the fund remained exposed to long Italy, Germany, Japan and Australia. We increased the scale of the short UK position in the run up to the 2065 index-linked gilt auction in June, and then used the auction to cover the position, as we were wary of a limited number of UK supply events in the third quarter. Overall, cross-market activity added value in the quarter.

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- During May the Debt Management Office issued a new 2039 issue via a syndication that was met with very strong demand leading to a rally in long-dated index-linked bonds and breakevens. This was exacerbated when third quarter issuance was announced and did not include any ultra-long issues. We reduced duration and sold breakevens into this strength but overall this move curtailed relative performance.
- We traded breakevens tactically throughout the period; we sold 40-year UK breakevens into conventional gilts towards the end of May, which detracted from the funds as breakevens continued to rally, reaching highs not seen since the Brexit vote in 2016 (and this was despite the announcement of RPI reform in 2030). However, we then increased the scale of the position prior to the UK's 2065 index-linked gilt auction June, which added to performance as breakevens lost around 15bps in the lead up to the auction.
- Our UK curve steepening bias was broadly neutral for the quarter; the position marginally detracted from performance in April as the long-end of the curve flattened on further demand for LDI assets from pension funds, but added to performance in May as the curve steepened post supply of the 2039 index-linked gilt syndication.

Outlook

- After the strength in the end of the quarter, all funds ended the period marginally short duration. This position reflected a view that yields may creep higher as economies come out of lockdown. However, we expect yields to be largely range bound until monetary support is rolled back. This is not likely to happen until the end of the summer, when ECB policy makers next meet, or in August, at the Federal Reserve's policy meeting at Jackson Hole.
- Despite the announcement on RPI reform, long-dated UK breakevens remain elevated. These factors could be sustained for some time if pension industry technical factors continue to drive the market. We remain bearish on the UK relative to the global markets however, given the lack of UK index-linked supply in the third quarter – these positions have been pared back as we seek better opportunities.
- US 5-year breakevens traded at 3% after the higher May CPI reading. This is a level where we are comfortable selling breakevens, hence after the recent fall we will look to re-enter a short US position on any approach of 3%.

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 www.rlam.co.uk

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