ROYAL LONDON SHORT DURATION GILT 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]	5.5	0.0
Index linked credit bonds	0.0	0.0
Treasury bills	0.0	0.0
Sterling conventional gilts	91.9	100.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	2.6	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

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.

Fund data

	Fund	Benchmark[1]
Duration[3]	2.1 years	2.5 years
Gross redemption yield[4]	0.15%	0.14%
No. of stocks	36	14
Fund size	975.8m	-

Source: RLAM, based on the Z share class. Launch date: 07.11.2013.

[1]Benchmark: FTSE® Actuaries Gilt <5 years 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

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q2 2021	**0.12**	**0.08**	**0.04**
Year-to-date	-0.42	-0.72	0.30
Rolling 12 months	-0.16	-0.63	0.48
3 years p.a.	0.97	0.79	0.18
5 years p.a.	0.60	0.41	0.19
Since inception p.a. 07.11.2013	0.96	1.03	-0.07

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: FTSE® Actuaries Gilt <5 years Index.

Performance for the Royal London Short Duration Gilt Fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over 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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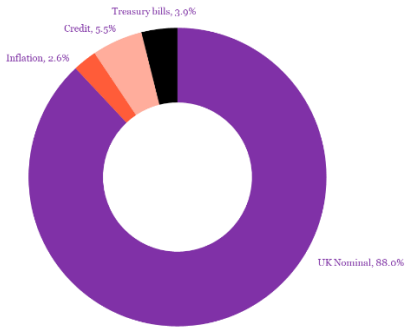
Ten Largest Holdings

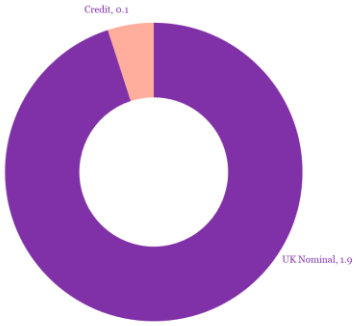
	Weighting (%)
UK Treasury 0.125% 2024	25.1
UK Treasury 0.125% 2023	20.7
UK Treasury 0.125% 2026	9.0
UK Treasury 4.0% 2022	8.7
UK Treasury 0.375% 2026	7.8
UK Treasury 1.75% 2022	6.5
UK Treasury 0.5% 2022	5.3
UK Treasury Bill 3.75% 2021	4.9
Deutschland 0.1% IL 2023	2.6
UK Treasury 0% 2021	1.6
Total	**92.2**

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

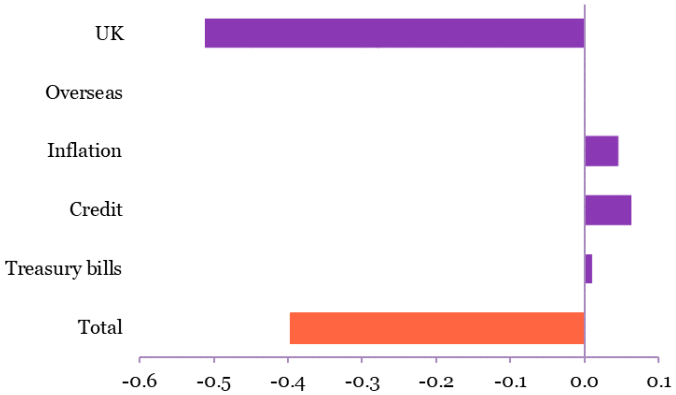
Asset split by percentage



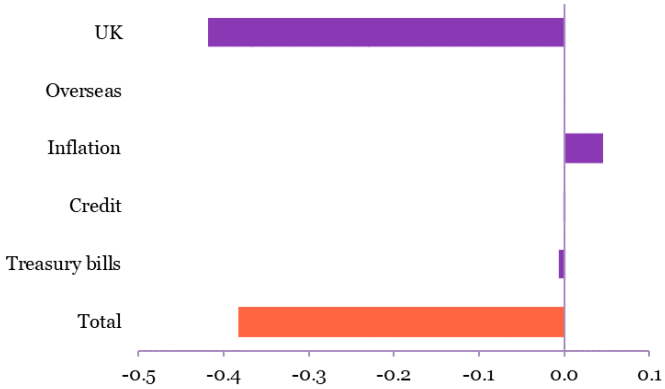
Asset split by duration



Asset allocation relative to benchmark (duration)



Asset allocation change on the quarter (duration)



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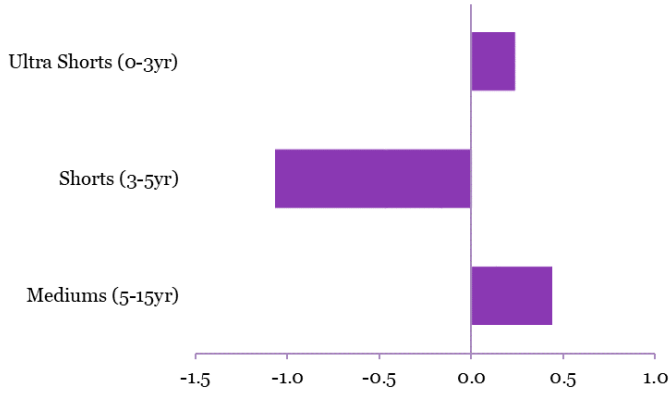
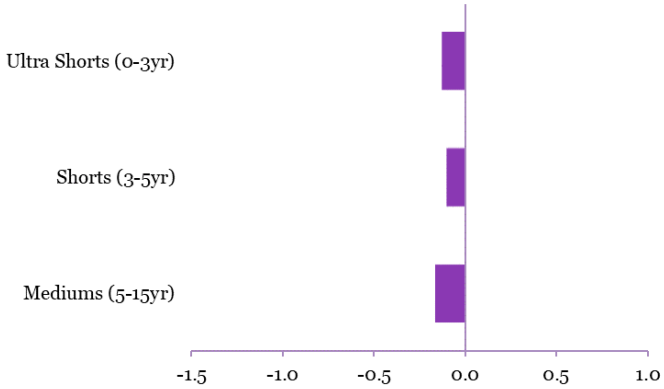
Yield curve relative to benchmark (duration)



Yield curve change on the quarter (duration)



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% – 10-year gilts 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 deviation in performance in Europe compared to in the US and UK can partly be attributed to the delays in its vaccine programme. Rising yields have been closely linked to the success of vaccine programmes, and as the US and UK made a flying start on vaccinations in 2021, which led to a rise in yields, while the EU only began to make good progress in the spring. Furthermore, substantial European government bond issuance in the first quarter, a traditional feature of the European market, added to the market's underperformance in this quarter.
- The second quarter saw investors re-engage with global economic data, and 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 quarter turned to whether high inflation might be sustained rather than pass as transitory. Although the Federal Reserve reassured markets that inflation would indeed be transitory, and that they were not yet 'talking about talking about tapering', taper talk begun at the June Federal Open Market Committee (FOMC) meeting and 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.
- In Europe, the ECB followed a similar stance to the US on inflation and vied not to 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.
- Market events in the UK in the quarter tended to have little impact on market prices. In April, the Office for Budget Responsibility (OBR) revised down its borrowing forecasts, leading 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 second quarter. 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 second 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.

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Portfolio commentary

- We began the quarter 0.25 years short relative to the benchmark (FTSE Actuaries UK Conventional Gilts up to 5 years index). We traded duration tactically through the period and increased the size of the short position to 0.4 years short at quarter end. Yields were largely pinned at the front-end of the curve during the second quarter, however gilts up to the 5-year sector posted a small positive return for the quarter (+0.08%) driven by a slight fall in yields during May. As such, the fund's short duration position marginally detracted from performance. Nonetheless, as strong global economic data has continued to flow, confidence of a sustained recovery in the second half of the year has been reinforced and central bank support has started to wane; we believe yields will rise in the short- to medium term as monetary policy makers will begin to temper support for markets.
- We held a small steepening bias during April, selling 5-year gilts into the 3-year maturities. The position had little impact on performance, as yields were relatively pinned across all sub 5-year maturity bonds during the month. The BoE then began to taper in May, and although this was broadly expected, it set a precedent for further hawkishness in the rest of 2021. This was reinforced by the surprisingly hawkish comment on interest rates by BoE policymaker Gertjan Vlieghe. With this in mind we sold 5-year gilts into the 2-year sector to build a strategic short duration position, building a steepening bias in the process.
- The fund was slightly underweight gilts on a cross-market at the end of the second quarter. The fund started to buy some inflation protection in May, buying German 2023 inflation-linked bonds. Although negative yielding, once the currency hedge and potential benefit of inflation are taken into account, these may offer a more attractive yield than short-dated gilts. No other cross-market positions were held in the period.
- With regards to security selection, the fund remains heavily overweight the lowest coupon bonds in each maturity bucket. The lowest coupon bonds were issued last year at a yield premium to surrounding bonds. With many of these bonds approaching the end of their issuance cycle, they have started to outperform.
- Late last year the fund bought T-bills, as these offered a better yield than very short-dated (less than one year) gilts. While T-bill yields have risen a little, very short-dated gilts have risen by more, so this has been beneficial to the fund. Overall, the fund has around 8.5% in T-bills, having built the allocation from 6% at the end of the first quarter.
- The fund's highly rated sterling credit exposure had no significant impact on performance in the quarter, as credit spreads (the average extra yield available from corporate bonds compared with government debt of equal maturity) tightened by 5 basis points to 0.91%. The fund's credit exposure remains focused in highly rated, covered, floating rate notes.

Outlook

- As the vaccination rates increase and confidence around vaccine efficacy heightens, the prospect of a return to more normal conditions draws closer. Optimism for the UK's economic is growing too, with data remaining strong despite the additional economic concerns related to Brexit. As such, central bank support is beginning to wane, and markets are changing focus to the potential for tapering and rises in base rates. The BoE slowed the pace of its purchases in May and the level of quantitative easing is likely to be further reduced over time, and other monetary policy makers are at least 'talking about talking about tapering'. We therefore expect yields to rise across the near to medium term and will look at increasing the strategic short into market rallies.
- Uncertainty remains high in markets, particularly regarding inflation and future rises in base rates. Investors are searching for evidence to decipher whether current inflationary pressures are indeed transitory, while simultaneously hanging on every word of central bankers in the lookout for signals offering insight into when rate rises will begin and how quickly each incremental rise will occur. With this in mind we will continue to employ a tactical investment approach in the fund, trading short-term market volatility to add to fund performance.

ROYAL LONDON
ASSET MANAGEMENT