ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND **3**

ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	0.0	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	4.6	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	91.1	100.0
Foreign index linked sovereign	4.3	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	8.0 years	8.0 years
Gross redemption yield[4]	0.58%	0.54%
No. of stocks	110	903
Fund size	£467.2m	-

Source: RLAM, based on the M share class. Launch date: 01.11.2011.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

[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 (%)
Q1 2021	**-2.74**	**-3.03**	**0.29**
Year-to-date	-2.74	-3.03	0.29
Rolling 12 months	-0.87	-1.96	1.09
3 years p.a.	3.27	2.97	0.30
5 years p.a.	2.08	1.83	0.26
Since inception p.a. 01.11.2011	3.06	3.07	-0.02

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 M share class.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

On 26th November 2012 the RL International Government Bond Fund (Class B) was renamed the RL International Government Bond Fund (Class M).In the above table, the fund returns in the first column are gross of fees and net of taxes. The fund returns in the second column are gross of fees and gross of taxes. Both include the impact of cash holdings over the period. The benchmark returns are gross of tax. Your tax situation may differ and as such your actual return may be less than the gross of tax fund return shown in this table.

Performance for the Royal London International 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 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.

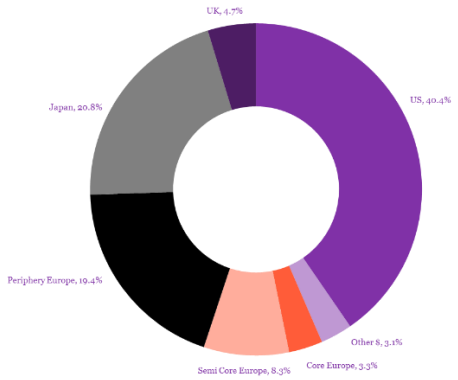
ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Ten largest holdings

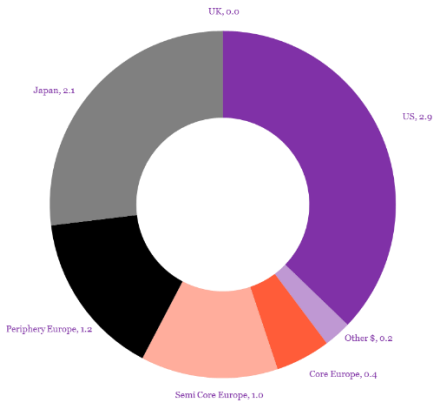
	Weighting (%)
BTP Italy 4.75% 2021	5.8
UK Treasury 3.75% 2021	4.6
US Treasury 2.25% 2024	4.2
US Treasury 0.625 2026	3.9
US Treasury Note 2% 2022	3.6
Japan (govt Of) 10yr Issue 0.8% 2022	3.3
Buoni Poliennali Del Tes 2.35% IL 2024	2.9
US Treasury 4.375% 2041	2.8
Japan (govt Of) 20yr Bond 0.4% 2039	2.8
US Treasury Note 2.5% 2023	2.6
Total	**36.5**

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

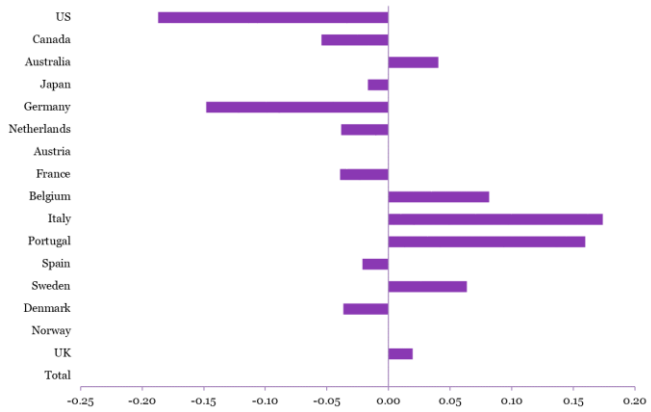
Geographic split by percentage



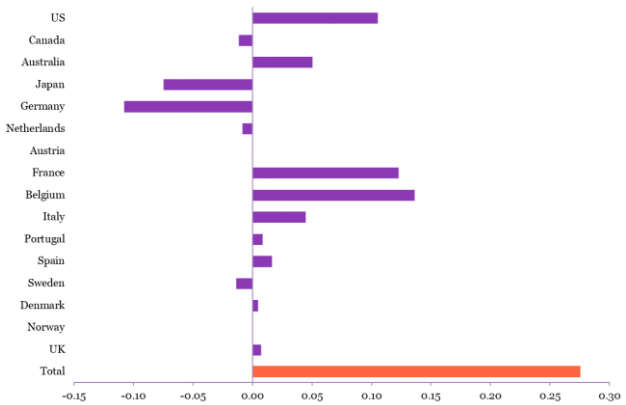
Geographic split by duration



Current position (by duration)



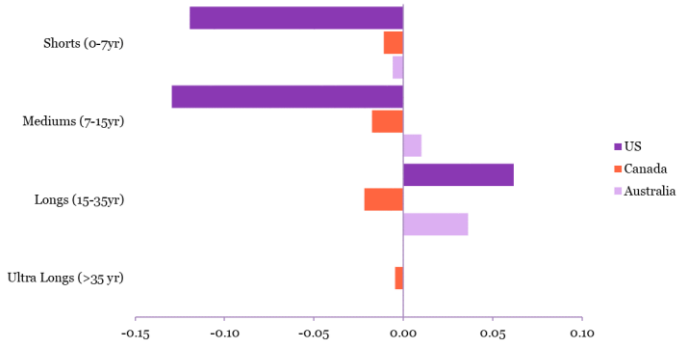
Change on the quarter by duration



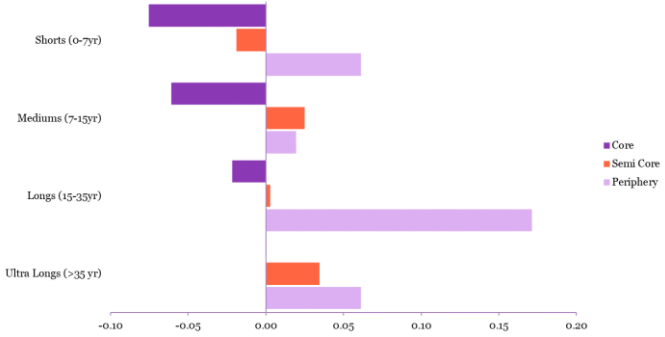
ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Yield Curve

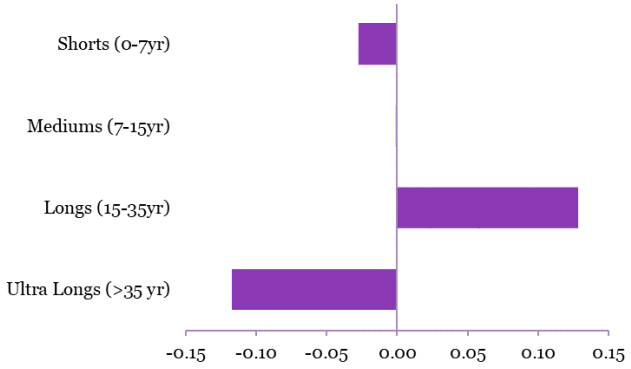
Dollar bloc



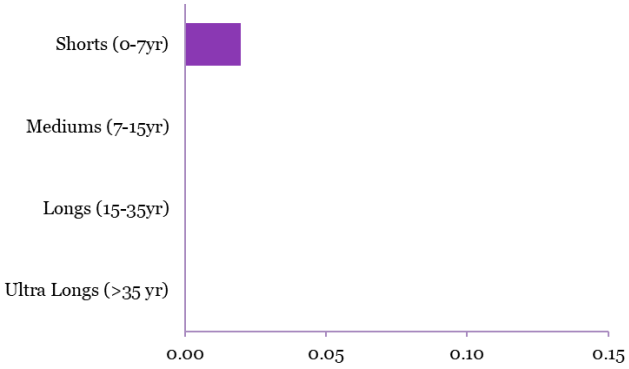
Euro bloc



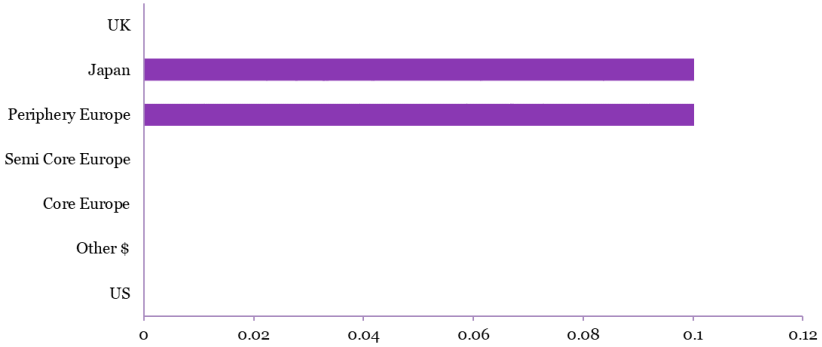
Japan



UK



Inflation breakeven



Market overview

- Global stock markets posted positive returns in the first quarter 2021 after a strong February and March (the MSCI World Index grew by 3.91% over the period), however, regional performance was mixed. Markets such as the UK and US, where vaccine programmes were particularly successful and sentiment for a recovery was greater, rotated more aggressively towards risk assets. As such, while these markets led global equity returns for the period, the equal and opposite was true for bond markets, which experienced a more pronounced increase in yields. The sector rotation caused bond yields to rise globally.

ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

- The election of President Biden, and the announcement of the vast $1.9trillion fiscal stimulus package, a sum at the top end of analysts' expectations, helped fuel positive sentiment for an economic recovery in 2021. The package underpinned the outlook for a long-term recovery and led the US 10-year treasury yield to rise by 0.83% in the quarter, the largest quarterly rise since 2016. Commentary from central bankers was also supportive for risk markets during the period, with all major central banks forecasting interest rates to remain at current levels for an extended period of time; the US Federal Reserve (the Fed) expects rates to be on hold until early 2023. Furthermore, the Fed, the Bank of England and European Central Banks have quantitative easing programs that will continue for the rest of 2021. With so much monetary and fiscal stimulus in the system, and with central banks expected to look through any short-term spikes in inflation, real yields remained well supported as nominal bond yields rose. With recovery in sight, the fear of tapering by the Fed added to the sell-off in government bonds. In relative terms, Japan was the strongest market in the quarter, where yields rose the least; the Japan 10-year rose by just 7bps. European markets followed, with Italian and Portuguese 10-year government bond yields rising 13bps and 20bps respectively through the period.
- Breakevens continued their surge from the previous quarter driven by the loose fiscal and monetary policy mentioned previously, and the rising sentiment around the potential re-opening of economies; 10-year breakeven in the US, UK and Germany rose by 39bps, 56bps, and 41bps respectively. US breakeven rates finished the quarter at eight-year highs.

Portfolio commentary

- As expected, global government bond markets faced significant cyclical pressures in the quarter, as investors turned to more risk-on assets, buoyed by the potential for a sustained economic recovery. However, markets also failed to show the traditional strength seen in previous maiden quarters. While the period was customarily busy for government debt issuance, discounts on debt were not as heavy as in the past, with huge sums of heavily discounted issuances during 2020 being the main cause (required to finance economies through lockdown). While demand was healthy, less significant discounting added to the underperformance of new issuances in the secondary market relative to the first quarter in previous years. The fund participated in new issues from Ireland, Italy, Spain, Portugal, France, Belgium and the EU, with mixed results. On balance, participation in new issues cost the fund a small amount of performance over the quarter, as yields rose. However, the fund performed well overall and posted returns of -2.74% gross of fees for the quarter, outperforming its benchmark by +0.29%.
- We avoided putting on large directional or structural duration positions during the quarter, conscious that coronavirus newsflow and fiscal and monetary policy announcements would greatly impact market movements. However, the slight short duration position held coming into the quarter, 0.2 years short of the benchmark, was a key driver of the fund's outperformance. The fund benefitted from sharp rises in global government bond yields in February especially. We closed the short position through March and into quarter-end to lock in returns, as markets began to consolidate at these higher yields.
- The underweight exposure to US treasuries was a key contributor to outperformance in the quarter; we expected that Joe Biden becoming president would mean greater government spending, and his pursuit of $1.9tn in stimulus through the quarter – which passed through congress in March – vilified this position. Although the US underweight was marginally tempered in the quarter it remained the fund's most significant bias versus the benchmark at quarter-end. The second strongest bias was our overweight in Italy, which we added to slightly in the quarter. Italian government bonds were relative outperformers in the quarter, as the instatement of Mario Draghi as Prime Minister in February bolstered confidence in the strength of Italian finances; Italy's 10-year yield rose by just +13bps, compared to +28bps in Germany and +83bps in the US. We also benefited from a long view on Portugal, another relative outperformer in the period, as peripheral spreads vs semi core European bonds continued to tighten. Overall, we were broadly neutral core markets in the quarter, short semi-core markets and the US, and long periphery markets, which was beneficial to performance.
- The continued surge in global breakevens remained a major theme, and our long breakeven position was the second key contributor to the fund's outperformance in the quarter. Breakevens continued to reach post Covid-19 highs, driven not just by massive fiscal stimulus (the $1.9tn US stimulus in particular) but also bottle-necks in global supply chains and continued loose monetary policy. Through the quarter, central banks globally signalled a willingness to let inflation run past targets to allow for growth. As such we added to our breakeven position at the beginning of the quarter, buying Italian and Australian breakevens. We sold Australia and long-dated Italy before quarter-end into continued breakeven strength. We remained invested in short-dated Italian breakevens and Japanese breakevens going into the Spring.
- We bought duration tactically during periods of particular stress in the quarter. Our main tactical trade was the purchase of 30-year Australian bonds, which reached a yield close to 3% in the quarter. While the asset looked very cheap later in the quarter, especially versus core market equivalents, a number of large holders of the bond were forced to sell, forcing its yield higher still. We decided to buy at this point in anticipation that the yield will fall through the coming months.

ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Outlook

- In the first quarter, as vaccine distribution picked up picked up and economic activity increased, the majority of major central banks prioritised economic growth, announcing their intention to let inflation overrun and keep base rates unchanged for at least the next six months. With this in mind, the surge in breakevens seen at the end of 2020 continued into 2021; US breakeven rates are now at eight-year highs and could move marginally higher in the short term, as CPI is expected to move above 3% in the summer. We held long breakeven positions throughout the surge, which proved a boon to performance, however as the run continues it becomes more difficult to judge the scope for yet more inflation to be priced in by markets. Therefore, while have, we still hold a long breakeven view in the fund via exposure to Italian and Japanese breakevens, we have reduced our exposure as we anticipate the surge in breakevens is nearing its peak.
- We expect volatility to dampen over the next few months yet still present. Given virus variants and regions vaccinating at very different paces, virus risks are not totally gone yet, so we expect the flow of global headlines to generate further volatility. With this in mind, we will maintain a relatively neutral strategic position in the fund and instead trade market volatility tactically to generate outperformance relative to the benchmark.
- As vaccine distribution stumbled early in 2021 in the EU, the bloc will be slower to open up and exit states of lockdown. With a potentially curtailed tourist season coming up, it could be a tough period for Europe, bolstering the requirement for continued loose monetary policy. We remain broadly neutral in Europe and anticipate only a longer-term short, as larger portions of the bloc are vaccinated, and the economy opens up more widely. We continue to favour peripheral markets due to the positive yields we can find in them, in the context of an environment where yields are widely negative in core markets. Peripheral bonds also benefit from the ample support provided by the ECB, preventing spreads from blowing out even when there is divergence between valuations and underlying fundamentals. We anticipate little change in stance from the ECB until its June meeting, when the path of recovery may become clearer, and the results of its strategic review (scheduled in Q3) are closer to release.
- While coronavirus concerns will remain critical through 2021, more traditional political risks will also come into play with the French and German elections on the horizon. We anticipate potential market uncertainty around these events, though these are unlikely to see manifest itself until later in the year.

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ASSET MANAGEMENT