ROYAL LONDON SHORT DURATION GILT FUND

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

CONTENTS

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	5.3	0.0
Index linked credit bonds	0.0	0.0
Treasury bills	0.0	0.0
Sterling conventional gilts	94.7	100.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	0.0	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]	2.6 years	2.6 years
Gross redemption yield[4]	0.20%	0.14%
No. of stocks	33	15
Fund size	£833.3m	-

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 (%)
Q1 2021	**-0.53**	**-0.80**	**0.26**
Year-to-date	-0.53	-0.80	0.26
Rolling 12 months	0.29	-0.15	0.44
3 years p.a.	1.06	0.90	0.15
5 years p.a	0.75	0.61	0.14
Since inception p.a. 07.11.2013	0.98	1.05	-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.

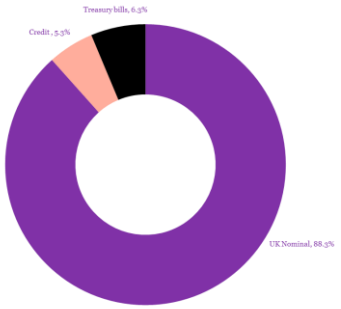
ROYAL LONDON SHORT DURATION GILT FUND

Ten Largest Holdings

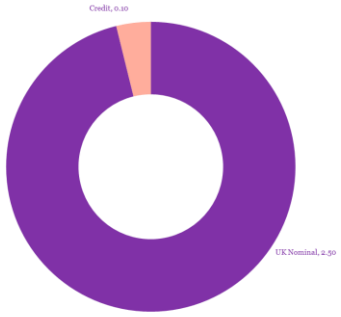
	Weighting (%)
UK Treasury 0.125% 2023	25.3
UK Treasury 0.125% 2024	20.1
UK Treasury 0.125% 2026	13.2
UK Treasury 4.0% 2022	7.1
UK Treasury 0.375% 2026	6.4
UK Treasury 0.5% 2022	5.4
UK Treasury 3.75% 2021	5.0
UK Treasury Bill 0.0% 2021	4.9
UK Treasury 0.625% 2025	3.1
UK Treasury 0.25% 2031	2.0
Total	**92.3**

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

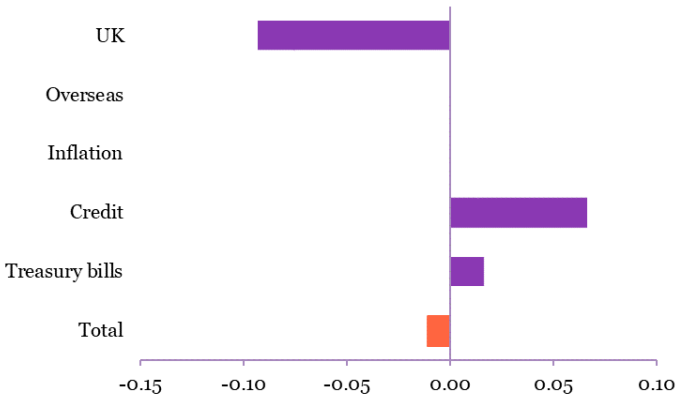
Asset split by percentage



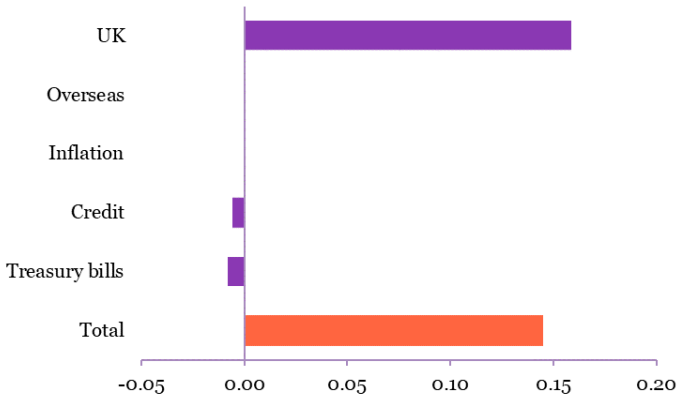
Asset split by duration



Asset allocation relative to benchmark (duration)

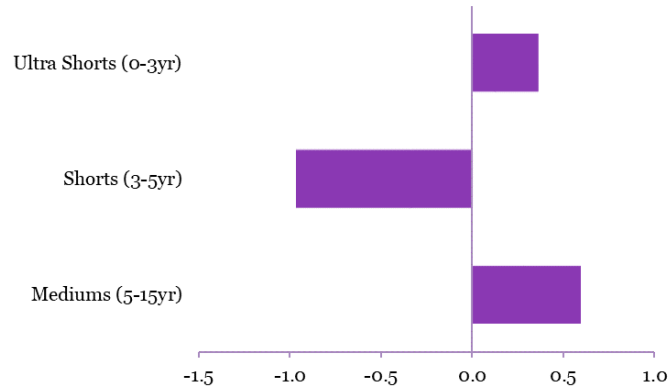


Asset allocation change on the quarter (duration)

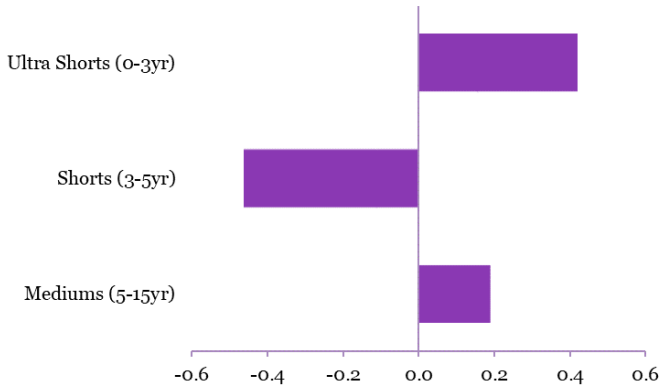


ROYAL LONDON SHORT DURATION GILT FUND

Yield curve relative to benchmark (duration)



Yield curve change on the quarter (duration)



Market overview

- Global stock markets posted positive returns in the first quarter 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.
- Yields rose most significantly in the UK and US. The 10-year gilt yield rose by 0.49% in February, the biggest increase of all leading markets in the month, finishing 0.65% higher for the quarter. The average sterling investment grade spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) ended the quarter 3bps tighter at 0.96%. This is remarkable considering that the average spread was as wide as 2.25% at the peak of the market sell-off in March last year. The Markit iBoxx Sterling Non-Gilt All Maturities index delivered total returns of -4.11% for the quarter, significantly outperforming gilts through the period. Long-dated bond yields were hit most significantly; the Merrill Lynch UK Gilts 15+ Years Index returned -12.4% over the period compared to -6.86% for its sister 10-15 years index.
- Concerns about potential future inflation were heightened in the period by the vast $1.9trillion of additional stimulus secured by President Biden, a sum at the top end of analysts' expectations. The package underpinned the outlook for a long-term recovery and led US 10-year treasury yields to rise by 0.83% in the quarter, the largest quarterly rise since 2016. With recovery in sight, the fear of tapering by the Federal Reserve (the Fed) added to the sell-off in government bonds.
- Dovish monetary policy through the period added to concerns about potential future inflation, as most central banks signalled a preference for growth rather than targeting inflation; the Bank of England's (BoE) Monetary Policy Committee (MPC) announced in January that no rate rise would come for at least six-months, while Chair Powell consistently played down concerns around yield rises in relation to inflation. Both central banks continued to neutralise government debt issuance through quantitative easing programmes. The European Central Bank (ECB) showed more concern for rising yields. Although its interest rate remained unchanged, it opted to increase the speed of its buying programme (the PEPP) to support the market. This added to the relative performance of European government bonds.

Portfolio commentary

- Into the start of the first quarter we continued to run a short duration position in the fund by 0.25 years relative to the benchmark index. We built on this position into February, moving 0.35 years short of the benchmark. We were sure that central banks would continue to prioritise growth over inflation control, even if governments extended further fiscal support to economies in lockdown. We were proven correct; the BoE signalled in February that it would be at least six months before interest rates could rise, as banks would need time to prepare for the change. We ended the period long duration, as we felt that markets were overestimating inflationary pressures.
- The front end of the gilt curved remained broadly pinned through most of the period, especially in January and March. However, a more potent rise in gilt yields in February had a more significant impact on short duration gilts. The Merrill Lynch 1-3 Gilt Index posted marginally negative returns of -0.07% in January, versus negative returns of -0.34% in February, and marginally positive returns of 0.06% in March. Our strategic duration positioning throughout the period proved beneficial to fund performance.

ROYAL LONDON SHORT DURATION GILT FUND

- We switched from a long held flattening position in the previous quarter into a 2s/5s steepener (i.e. underweight 5-year and overweight 2-year maturity bonds), which we built into a large bias by mid-February. This was positive for performance, as long-dated bonds rose more sharply than shorter-dated bonds. We moved into a 5s/10s flattener in March, anticipating a settle in the 10-year yield due to the market over-estimating inflation. However, the 10-year gilt yield continued to rise in March, albeit marginally by just 3bps, which was negative for performance. We negated negative return by tactically selling 10-year gilts in favour of the five-year, exiting our flattening bias by the close of the month.
- The fund was slightly underweight gilts on a cross-market basis through parts of the first quarter. We bought 10-year Spain against five-year gilts in January before selling in February after the MPC meeting. We also bought and sold Australian 30-year bonds, as it offers a greater yield to the UK 30-year equivalent even though base rates in the countries are the same, providing a greater real yield to investors. in March to the benefit of fund performance. No other cross-market positions were held in the period and we closed the quarter fully invested in the UK.
- Late last year the fund bought T-bills, as they offered a better yield than very short-dated (less than one year) gilts. While T-bills have risen a little in yield, very short-dated gilts have risen by more, so this has been beneficial to the fund. Overall the fund has around 6% in T-bills.
- The fund's modest, highly rated sterling credit exposure added slightly to returns during the quarter as credit spreads continued to contract as several key market risks subsided. The average sterling investment grade credit spread tightened from 0.99 % to 0.96% during the quarter, helping corporate bonds to outperform gilts.

Outlook

- The BoE's ongoing quantitative easing program should remain relatively supportive for bond markets in 2021. Nevertheless, the level of quantitative easing is likely to be reduced over time, and we expect yields to rise as economies return to more normal conditions as the Covid-19 vaccine rollout contains the spread of the virus. We consequently favour short duration strategies and curve steepening trades over the medium term.
- We think that real yields are too low and will rise over time, but only very gradually. Despite the announcement on RPI reform, long dated breakevens remain elevated as a consequence of buying at the end of the year. Conversely, inflation protection, on a global basis, looks undervalued. This is not because we expect a surge in inflation, but due to the asymmetry of risk in an environment with a high level of uncertainty. Central banks and governments may be happy for inflation to overrun as they prioritise economic growth.
- Sterling appreciated over the quarter, reflecting the relative success of vaccine roll outs. However, continued strength is unlikely as other economies catch up with the UK. We expect a gradual rise in European government bonds yields as the year progresses, and vaccination rates increase; the EU expects to receive 100mn vaccine doses per month from April.
- You can read more of our thoughts on the opportunities and risks at www.rlam.co.uk

ROYAL LONDON
ASSET MANAGEMENT

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