ROYAL LONDON SHORT DURATION GLOBAL INDEX LINKED 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]	0.0	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	5.2	0.0
Sterling index linked gilts	24.9	30.0
Foreign conventional sovereign	0.0	0.0
Foreign index linked sovereign	69.8	70.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	5.3 years	5.1 years
Real yield[4]	-1.80%	-2.14%
No. of stocks	68	96
Fund size	£563.0m	-

Source: RLAM, based on the Z share class. Launch date: 23.02.2016.

[1]Benchmark: 30% Barclays UK Government Inflation Linked Bond 1-10 year index,70% Barclays World Government Inflation Linked Bond (ex UK) 1-10 year index (GBP hedged).

[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 (%)
Q1 2021	**0.05**	**0.05**	**0.00**
Year-to-date	0.05	0.05	0.00
Rolling 12 months	5.69	5.00	0.69
3 years p.a	3.24	2.78	0.46
5 years p.a	2.55	2.39	0.16
Since inception p.a. 23.02.2016	2.78	2.56	0.22

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: 30% Barclays UK Government Inflation Linked Bond 1-10 year index, 70% Barclays World Government Inflation Linked Bond (ex UK) 1-10 year index (GBP hedged).

Performance for the Royal London Global 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 greater for shorter measurement periods.

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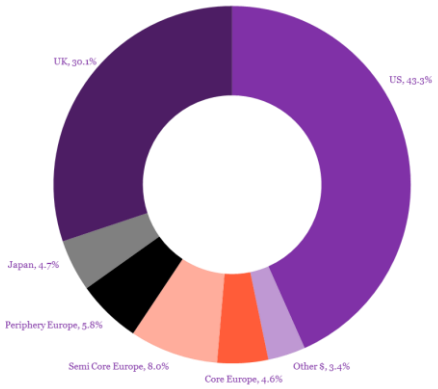
Ten Largest Holdings

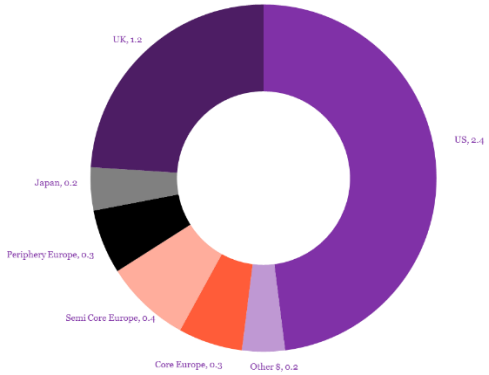
	Weighting (%)
US Treasury 0.125% IL 2030	7.5
UK Treasury 1.875% IL 2022	7.1
UK Treasury 0.125% IL 2029	4.6
UK Treasury 0.125% IL 2024	4.4
UK Treasury 3.75% IL 2021	3.7
US Treasury 0.25% IL 2029	3.3
US Treasury 0.875% IL 2029	3.1
UK Treasury 0.125% IL 2036	3.0
US Treasury 1.75% IL 2028	2.9
US Treasury 0.125% IL 2022	2.9
Total	**42.4**

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

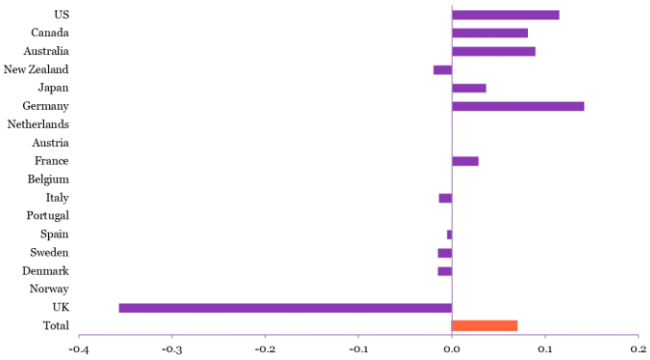
Geographic split by percentage



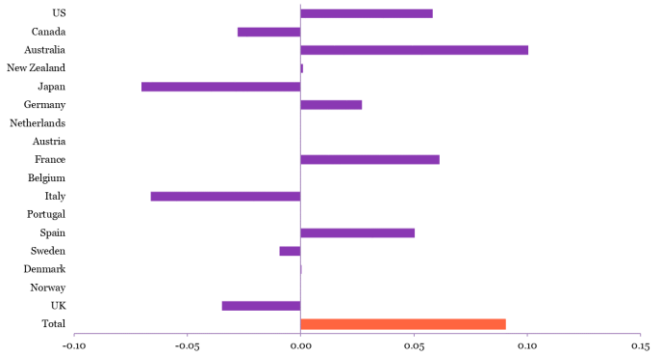
Geographic split by duration



Current position (by duration)



Change on the quarter by duration



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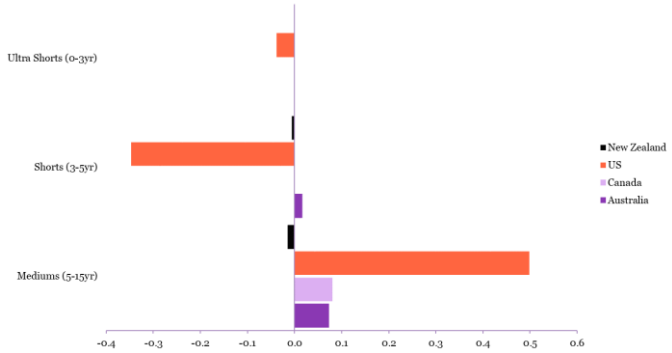
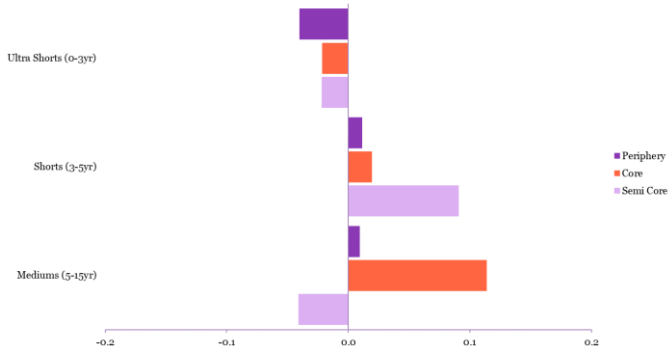
Yield Curve

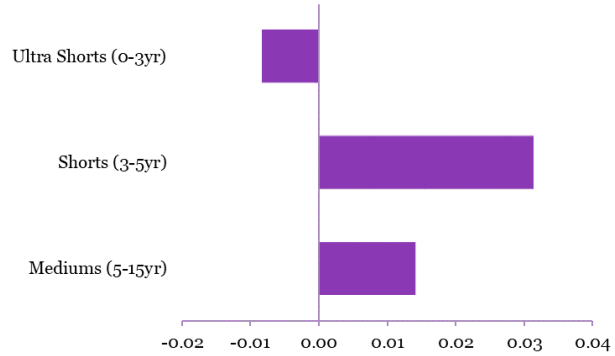
Dollar bloc



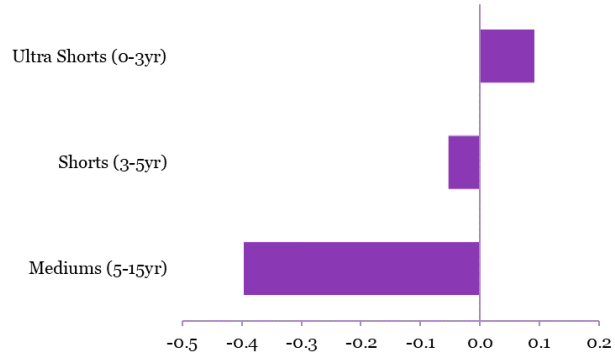
Euro bloc



Japan



UK



Executive summary

- The first quarter was tough for index linked funds, especially for those with longer strategic duration targets. While our shorter funds posted just marginally negative returns, we managed to outperform the benchmark in our longer, global funds.
  - **RL Index Linked Fund**: -6.33%, benchmark -6.35%
  - **RL Global Index Linked Fund**: -2.66%, benchmark -2.61%
  - **RL Short Duration Global Index Linked Fund**: 0.00%, benchmark +0.05%
- These figures (all M share classes, net of fees), however, 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** underperformed by +12bps and the **Short Duration Global Index Linked Fund** underperformed by +10bps. On a 12-month rolling basis, outperformance for the funds, in the same order, is +0.41%, +0.23% and +0.94%.
- Funds posted negative returns in during the quarter, as sentiment regarding a sustained economic recovery grew, driving a rotation from bonds into equities. Particularly successful vaccine programmes in the US and UK were reflected in sharp yield rises through February, although markets settled in March. The two shorter duration global funds fared better in absolute terms; the global reflation thematic which continued to hit headlines triggered a stronger sell-off in longer-dated bonds, meaning shorter dated index linked bonds performed better on a relative basis. However, due to strong demand for inflation protection, shorter dated real yields fell over the quarter. Our short duration positions held across the funds at the start of the quarter were beneficial to performance.

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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.
- The Bank of England (BoE) and the Federal Reserve (the Fed) continued to neutralise government debt issuance via their QE programmes, which were left consciously unaltered in the face of yield rises. The ECB was the main policy outlier and opted to increase the speed of its QE bond purchases to stabilise the market. This added to the relative performance of European bonds. Furthermore, new US President Biden's vast $1.9 trillion stimulus cheque added to concern about potential future inflation, although central banks remained dovish. The BoE's Monetary Policy Committee (MPC) had announced in January that a rate rise would be unlikely for at least six months, and as more central banks reinforced this stance towards the end of the quarter, bond yields settled slightly.
- The 10-year gilt yield rose by 0.49 basis points in February, the largest increase across leading markets, and ended the quarter 65bps higher at a yield of +0.85%. The US 10-year treasury yield rose by 83bps in the quarter to +1.74%, the largest quarterly rise since 2016. The strongest market was Japan, where yields rose the least; the Japan 10-year rose by just 7bps. European markets followed, with yields Italian and Portuguese 10-year government bonds rising 13bps and 20bps respectively through the period. Yield curves in the US steepened particularly sharply, as five-year bonds drew strong support with no supply over the quarter. In the UK, a lack of long-dated supply and LDI demand led to a flattening of the 10s/30s curve in February, however this was reversed in anticipation of supply in Q2, and the curve ended the period steeper. The 20-year government bonds sector performed particularly badly, while 10-year and ultra-long bonds were the best performers.
- In the UK, index linked yields fell slightly at the shorter end and increased at the long end, resulting in a steepening of the curve. The five-year UK index linked gilt yield fell by 15bps in the quarter, while the 10-year and 30-year rose by 31bps and 39bps respectively. Breakevens globally were heavily impacted by the reflation thematic, with US break-evens reaching eight-year highs and UK breakevens reaching their highest levels since the announcement of RPI reform. The market is anticipating a sharp rebound in inflation data as base effects from last year's collapse in oil price is unwound. However, recent inflation data has been soft, indicating that markets are slightly exuberant on inflation.
- Credit spreads tightened marginally upon extended government support packages. 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 when considering 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.
- Sterling remained among the stronger major currencies over the quarter, rising +1.1% against the US dollar, as the trade deal with the EU began to reduce Brexit uncertainties. It strengthened more significantly against the euro and the yen. This strength tempered the returns for sterling investors in global government debt.
- Commodities rallied to thirteen-year highs, leading cross-asset returns. Oil prices continued to recover strongly, reaching their highest levels since October 2018 in March following a surprise decision by OPEC+ to keep supply cuts fully in place at current levels. The price of Brent crude oil rose by +22.7% to almost $63 a barrel. Copper continued to strengthen as economic activity strengthened in China, rising +13.4% over the quarter. Gold fell -9.6% to $1,713/oz.

Performance and activity

- As vaccination programmes gained momentum, particularly in the UK and US, the improved outlook for a sustained economic recovery drove bond yields higher, generating negative returns for government bond funds. Long funds performed worst due to the increasing risk posed by rising inflation; as inflation is more damaging to long-duration assets, long dated government bonds experienced a more aggressive sell-off, increasing yields of long duration bonds more significantly.
- As yields rose, the short duration position held at the beginning of the quarter proved beneficial to performance. Furthermore, our tactical trading of duration, where we traded 0.2 years either side of neutral, added to performance in February when bond yields rose particularly sharply. We ended the quarter marginally long duration, which provided positive returns as yields settled down for the month.
- We entered a flattening bias across 5s/10s in the quarter. While this was negative for performance, we believe that the five-year section of the market is currently on loose footing, particularly as supply picks up in the second quarter with two five-year auctions planned in the period. Furthermore, ETFs with exposure to US TIPS experienced large inflows in the period as

retail investors sought to protect themselves against inflation. However, US TIPS offer exposure to real yield, not inflation. As the economy recovers, if real yields rise and erode returns, this may prompt investors to sell and lead to flattening of the curve.

- Positions in the dollar bloc, including the US, Canada and Australia where real yields were in excess of 200 basis points, looked very attractive. We added to dollar bloc positions during the quarter as a result, slightly detracting from performance, as spreads widened further into quarter-end. In addition, after strong performance in long positions held in Italian and French bonds, we sold our holdings to lock in positive returns. We maintained a long Germany position at quarter end.
- We held a short position on UK breakevens through the quarter, which proved detrimental to fund performance. However, we increased our short position into quarter end in anticipation of breakevens settling, as the market seems to have got ahead of itself on inflation at present, particularly in the UK where the currency has strengthened significantly over the past year.

Outlook

- After the weakness into the end of the quarter, the fund ended the month marginally long duration. The sell-off in yields has been warranted by the improved economic outlook, but uncertainty remains around how consumers will behave and how economies will fair once lockdowns have ended. With short term interest rates on hold for the foreseeable future, we expect bond markets to consolidate around current yields.
- Despite the announcement on RPI reform, long dated breakevens elevated as a consequence of buying at the end of the end of the period, which is year-end for many pension funds. 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 and have increased global positions as a result. Dollar markets still yield in excess of 200 basis points over the UK, and with supply in the UK picking up after limited linker supply last year, we would expect the UK to underperform again in the second quarter.
- US breakeven rates are now at eight-year highs and we expect they could move marginally higher in the short term, as CPI is expected to move above 3% in the summer. Further breakeven strength will see us move underweight US TIPS in favour of treasuries on a breakeven basis.
- Whether inflation will be sustained in the long term is up for debate. However, in the UK at least, we do not expect wage growth to pick up and therefore expect inflation to remain at or below target. As such, we believe the current UK breakeven rate is elevated despite sterling recovering sharply – a legacy from fears of a Brexit no-deal.

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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