Royal London Short Term Fixed Income Fund

Quarterly Report 30 June 2022

Fund data

	Fund
Gross redemption yield¹	2.46%
No. of issuers	56
Fund size	£6,594.3m
Weighted average maturity	0.3 years
Weighted average life	1.5 years
Duration	0.3 years

Source: RLAM, based on the Z share class. Launch date: 20.06.2011.¹The 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 (%) (income)	Fund (%) (accumulation)	Benchmark¹ (%)	Relative² (%)
Q2 2022	**0.15**	**0.15**	**0.22**	**-0.06**
Year-to-date	-0.08	-0.08	0.31	-0.39
Rolling 12 months	0.00	0.00	0.34	-0.34
3 years p.a.	0.56	0.56	0.31	0.26
5 year p.a.	0.65	0.65	0.35	0.30
10 year p.a	0.83	0.82	0.34	0.48
Since inception p.a. 22.05.2012 (income)	0.84	-	-	-
Since inception p.a. 20.06.2011 (accumulation)	-	0.83	0.36	0.47

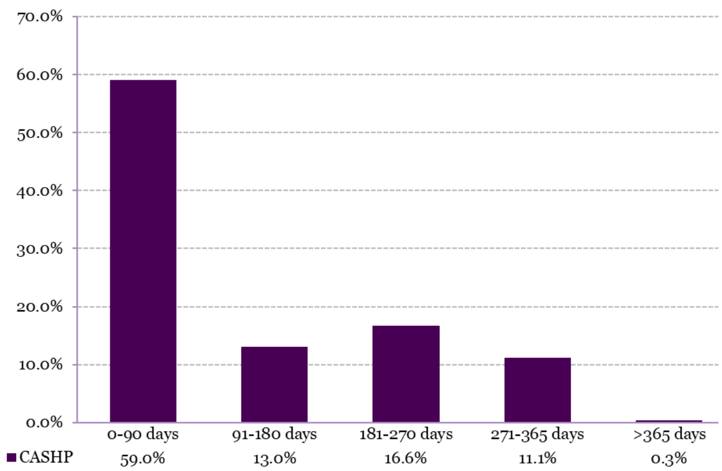
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. *All performance figures stated gross of fees and tax unless otherwise stated. As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax. ¹Benchmark: SONIA. Please note that this changed from 3-month LIBOR, effective 20 May 2019, and is reflected in the returns shown above. ²All commentary within this report is based on comparison with the Z accumulation units which have a longer track record.*

Top ten issuers

	Weighting (%)
Toronto Dominion Bank	5.7
Bank of Nova Scotia	4.7
National Australia Bank	4.4
Canadian Imperial Bank of Commerce	4.3
Commonwealth Bank of Australia	4.3
Royal Bank of Canada	4.1
Bank of Montreal	3.7
Rabobank Group	3.7
Goldman Sachs	3.6
Macquarie Bank	3.6
Total	**42.0**

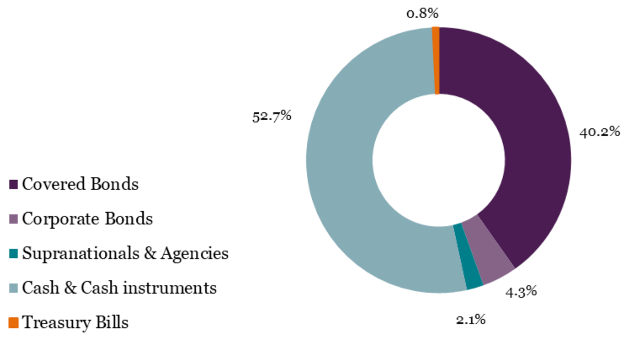
Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

Duration profile

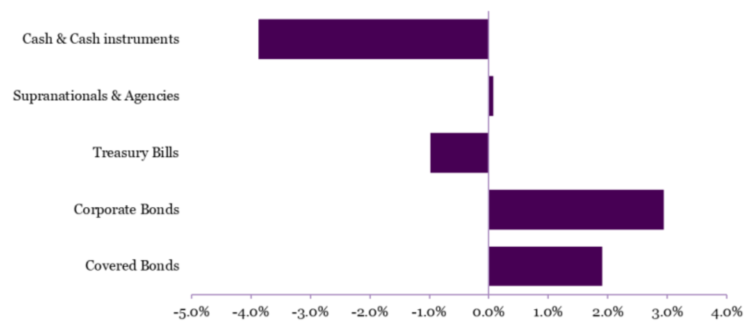


ROYAL LONDON
ASSET MANAGEMENT

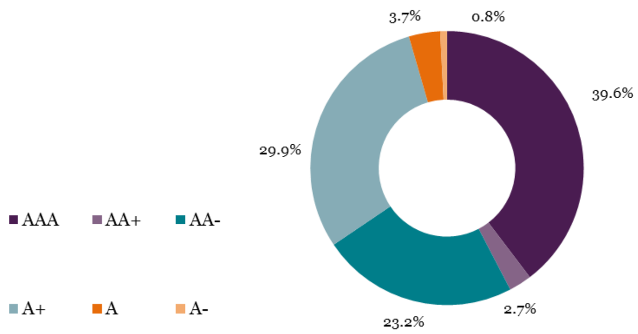
Asset allocation profile Q2 2022



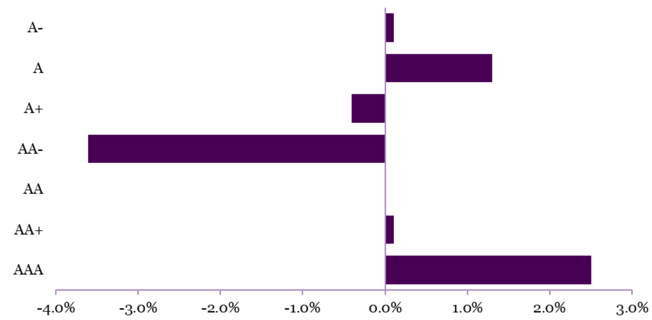
Change since last quarter



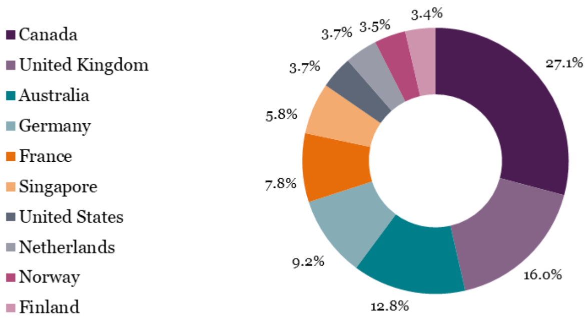
Credit rating profile Q2 2022



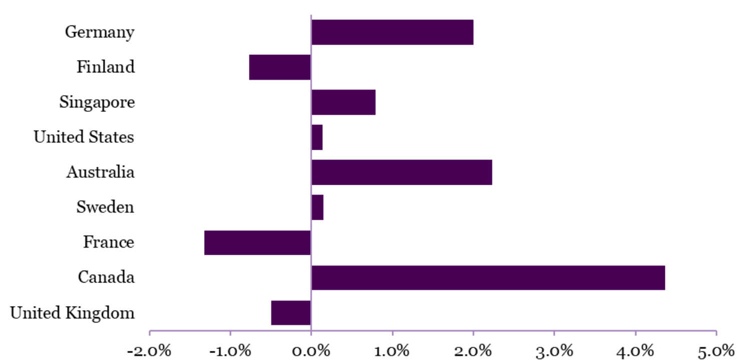
Change since last quarter



Top ten geographic allocation (ex gilts) Q2 2022



Change since last quarter



Market overview

- Inflation has been the headline macroeconomic market influence over the quarter. Increasing energy and commodity prices have added to the natural increase seen as the global economy continued to emerge from its Covid-induced slowdown of 2020 and 2021. Geopolitical events continued to weigh on sentiment as well, as Ukrainian resistance to the Russian invasion continued.
- Central banks have responded to rising inflation by tightening monetary policy and indicating that there is more to come. The US Federal Reserve has led the way, increasing rates by 1.25% over the quarter and its clear threat to do more leading markets to price in a further 2% of hikes in 2022. The European Central Bank was less aggressive – partly due to a more fragmented backdrop with the gap between German and 'peripheral' bonds widening in recent months – but confirmed that it was end its bond buying programme in July and signalled that a 25bps hike in July and even another 50bps in September were both possible. The Bank of England (BoE) has increased rates by 25bps at every meeting since December 2021 and this continued through the quarter, with the fifth consecutive increase in June taking the UK Base Rate to 1.25%.
- In the UK, economic data generally indicated that growth was slowing, while inflation rose each month, CPI for May hitting 9.1% and the BoE suggesting it could reach 11% by the autumn. Growth indicators were weak, with composite PMI indicators deteriorating, consumer confidence still below pre-pandemic levels, and GDP underwhelming. A government £15bn fiscal package was designed to alleviate some concerns for consumers.
- In UK bond markets, the benchmark 10-year gilt yield rose from 1.61% to 2.23%, leading gilts to return -7.42% on an all-maturities basis (FTSE Actuaries) and just over 14% lower for the first half of 2022, with index linked gilts performing even worse as real yields continued to rise. Although broad sterling credit indices outperformed government bonds, returns for the period were still negative with the iBoxx Sterling Non-Gilt index returning -6.79%. Investment grade spreads (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 22bps, from 129bps to 174bps. In an environment of rising rates, short-dated maturities outperformed longer-dated.
- UK money markets therefore unsurprisingly saw yields rise as well. After some 20 months trading at or just over 0.05%, SONIA had jumped to 0.69% by the end of the first quarter, and rose to 1.19% by the end of June, while ICE Term SONIA three-month rates rose from 0.92% to 1.55% over the quarter. Two-year gilts, often seen as a proxy for market expectations of BoE rates, rose from 1.35% to 1.97%. Reverse repo rates also increased over the quarter, ending at around 1.15% for high quality names, although this dipped slightly late in the quarter reflecting the quarter end.

Performance and activity

- Our cash funds are standalone vehicles. However, we know that many clients use a combination of these as part of a cash laddering strategy – using short maturity funds for more immediate liquidity needs and using other strategies for cash needs beyond six months or so. The return profiles of these funds will differ, but all are underpinned by a common philosophy and process. We focus on creating diversified portfolios that with high credit quality in the underlying banks. These portfolios also screen out tobacco, fossil fuel and armaments, but also factoring in ESG considerations when considering the banks that make up the majority of the portfolios. In this way we believe we create portfolios that meet client needs.
- Money market exposure was generally a modest positive over the quarter. Although rising yields are a headwind for money market funds (as these yields often rise faster than a portfolio can rotate into those higher yielding securities), we have been cautious when adding to long-dated paper to avoid having a significant part of our exposure locked into paper that looks attractive when purchased but poor value a few months later if rates have risen fast. With the market pricing in what we see as very aggressive rate rises, we believe this provides a safety net to any overall portfolio maturity extension: with money market rates pricing in those rate hikes, longer paper only becomes poor value if rates rise even faster.
- The Short Term Fixed Income Fund and Short Term Fixed Income Enhanced Fund (formerly named Cash Plus and Enhanced Cash Plus respectively) look to provide cash investors with returns over and above those on more traditional liquidity funds, by adding targeted exposure to non-money market instruments. Both use covered floating rate notes as part of this strategy, while the Enhanced fund also adds limited exposure to very short-dated investment grade credit and secured bonds such as mortgage-backed securities. These all contain limited interest rate and credit risk.
- During the quarter, fears of inflation and slowing growth pushed yields and credit spreads higher. This was negative for the instruments held in the portfolios that contained interest rate and credit risk. Our focus on very short-dated and high quality instruments meant that the negative

impact was far lower than seen in traditional credit markets, but was nonetheless worse than that seen on 'riskless' assets such as treasury bills.

- For the Short Term Fixed Income Fund (formerly Cash Plus fund) , covered bonds still account for the majority of non-money market exposure. These were negative for performance due to the widening of credit spreads over the quarter, although the floating rate nature of these bonds meant that there was a minimal effect from rising yields. However, the increase in spreads meant that we added to exposure over the quarter. We had reduced total exposure late in 2021 when we felt spreads had got too tight – with a typical three / four-year bond paying around 15bps over SONIA at the time. During the quarter we were able to add covered yielding around 50bps over SONIA – which we feel is good value, locking in additional return and helping over fund yield – examples including **Santander** and **National Bank of Canada** in the secondary market and new issues from **Toronto Dominion** and **Canadian Imperial Bank of Commerce**.
- The yields on our funds have now risen materially – the Short Term Fixed Income Fund is yielding around 2.5% (or 50bps over SONIA on a forward-looking basis, and a significant premium to current SONIA levels), while Short Term Fixed Income Enhanced yields around 3% (or 1% over forward-looking SONIA. While overall yields have increased, selective activity over the period has helped protect and add to the premium over SONIA.

Outlook

- At the end of March, we wrote that the market was pricing in further rate hikes this year which would take base rates to 1.75%. Over the past three months, we have already reached 1.25%, and the market now has the Base Rate priced at 3% at year end, with many calling for 50bps hikes in the remaining meetings of the year.
- We question whether the BoE can deliver this many rate increases. On the hawkish side, as well as CPI hitting a high 9.1% for May, there is evidence of strong wage growth; this reflects employee pressure for cost-of-living increases, as well as tighter supply, and suggest that current inflation is not solely driven by energy prices but could be more persistent. However, for the doves, with at least a material proportion of current inflation driven by energy, will the use of monetary policy for a non-monetary phenomenon be effective? With four further MPC meetings this year, the Bank will need to deliver rate increases averaging above 25bps for each of these to reach 3%, while also being aware of the cost-of-living issue and the potential, given already low growth, of pushing the economy into recession and possibly stagflation.
- As managers of liquidity and short-term fixed income strategies, we take views on market pricing of future interest rates. At present, we feel the risks to the market's view of BoE policy are asymmetrical – that is more likely the Bank hikes less than expected, rather than more. In general, this gives us comfort that in general, extending the maturity profile of our funds is the right course of action. However, we also recognise that markets can (and often have) underestimated what central banks may or may not do. In addition, the nature of these strategies is that they are lower risk, and have objectives that are broader than simply generating return: we need to do this while providing our investors with secure, liquid vehicles that they can use for their liquidity management. This therefore tempers that extension in maturity profile.
- Going into the second half of the year, we believe that there is value in the market – through both extending exposure to money market instruments and adding to the likes of covered bonds and short-dated credit where appropriate to the strategy. However, we will do this on a selective, limited basis.

Additional information

- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars and other mediums. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.com. This includes regular updates from Head of Fixed Income Jonathan Platt as well as Head of Rates & Cash Craig Inches.

IMPORTANT INFORMATION