Royal London Short Duration Gilt Fund

Quarterly Report 31 March 2022

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	4.1	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	92.0	100.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	3.9	0.0
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	2.1 years	2.4 years
Gross redemption yield[4]	1.40%	1.28%
No. of stocks	25	15
Fund size	£1,087.9m	-

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

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 2022	-1.16	-1.42	0.26
Year-to-date	-1.16	-1.42	0.26
Rolling 12 months	-1.60	-2.26	0.66
3 years p.a.	0.10	-0.32	0.42
5 years p.a.	0.17	-0.12	0.29
Since inception p.a. 07.11.2013	0.67	0.65	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.

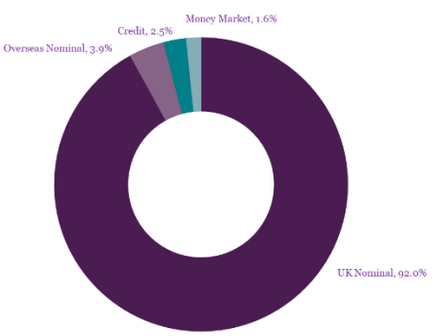
Source: RLAM, [1]Benchmark: FTSE® Actuaries UK Index Linked Gilts over 5 years.

Ten Largest Holdings

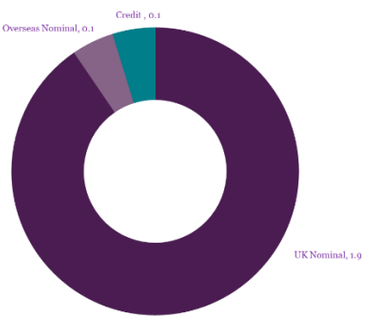
	Weighting (%)
UK Treasury 0.125% 2023	24.2
UK Treasury 2.25% 2023	17.8
UK Treasury 0.125% 2024	17.4
UK Treasury 0.25% 2025	14.4
UK Treasury 0.375% 2026	14.2
UK Treasury 5.0% 2025	3.9
Canadian Government Bond 0.75% 2024	3.9
PRS Finance 2026	0.6
Leeds Building Society 1.375% 2027	0.3
Royal Bank Of Canada 1.0% 2026	0.3
Total	**97.1**

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

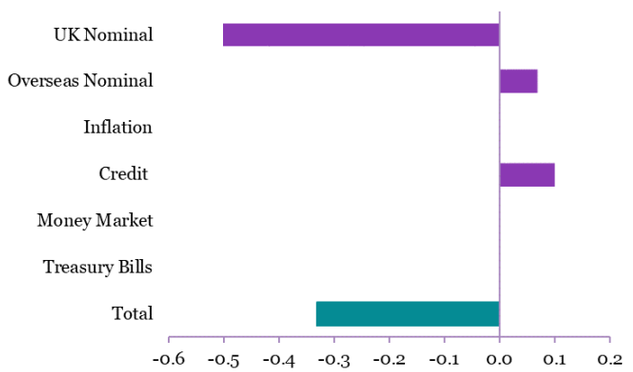
Asset split by percentage



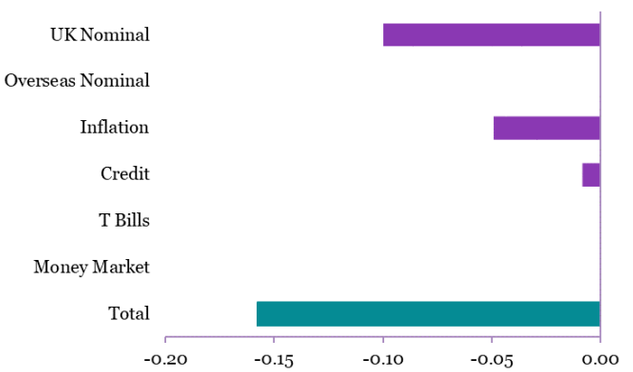
Asset split by duration



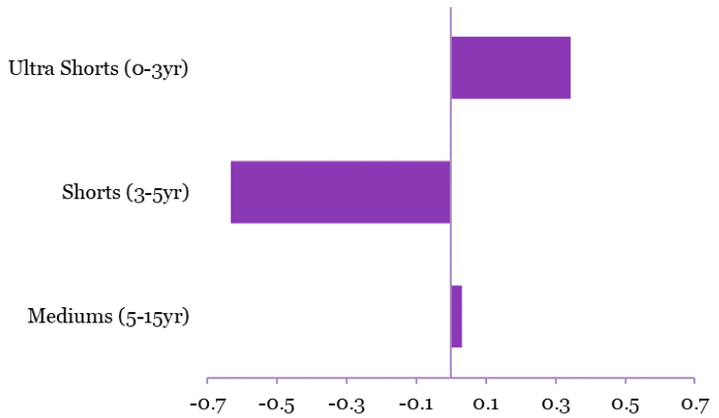
Asset allocation relative to benchmark (duration)



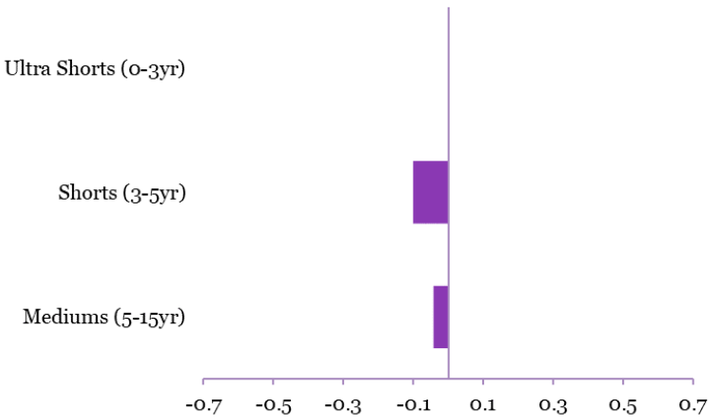
Asset allocation change on the quarter (duration)



Yield curve relative to benchmark (duration)



Yield curve change on the quarter (duration)



Market overview

- Russia's invasion of Ukraine in late February shocked the world, triggering a humanitarian crisis in Europe on a scale not seen since the Second World War. War has been met by a unified response from Western powers, enforcing far reaching sanctions upon Russia. Shockwaves have reverberated through global financial markets following these events, and although a sense of calm had returned to markets by mid-March, the unpredictability of war means that stability is fragile.
- After the relatively benign impact of the Omicron variant of Covid-19, central banks globally maintained their hawkish pivot into the turn of the year, as they focused on tackling persistently higher than expected inflation rates. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and delivered extremely negative returns to investors on a global basis as a result. The UK government bond market underperformed on a global basis due to its longer duration (longer-maturity assets are more sensitive to increases in interest rates).
- War in Ukraine has exacerbated inflationary pressures, leading to some opposing dynamics with respect to monetary policy: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident – rising commodity prices are driving up the cost of energy, food, and materials, leading to concerns around what potential impact the withdrawal of monetary support might have on general financial conditions and growth. Bank of England (BoE) Governor Bailey cited such concerns during the March Monetary Policy Committee (MPC) meeting, but increased the interest rate nonetheless – the UK base rate stood at 0.75% at the end of the reporting period, after consecutive 25bps hikes in February and March.
- The UK's Spring Budget Statement drew more attention than usual in 2022 due to the potential for more significant policy manoeuvres being taken to help relieve consumers from the rising costs of living. Chancellor Rishi Sunak took some small measures with regard to limiting the impact of forthcoming tax rises, mitigating around one third of impact of rising costs on consumers. Markets are still pricing in a further 5 rate hikes in the UK this year, taking the base rate to 2%.
- In the US, where the economy is better insulated from rising commodity prices (it is a net energy exporter) the Federal Reserve (the Fed) doubled down on its hawkish stance on inflation, highlighting the potential for a diversion in monetary policy between central banks going forward. The Fed ended its quantitative easing (QE) programme at the end of March as planned, and markets are now pricing 8 more rate hikes in 2022, raising the Fed Funds Rate to 2.5% or higher by the end of the year.
- In the UK, government bond markets returned -7.49% to investors for the quarter (ICE BoAML >1 year), slightly more negative than in the US (-5.56%) and the Germany (-5.11%), as a result of the longer duration of the market. The benchmark 10-year gilt yield rose from 0.97% to 1.61%, an increase of 64bps – it was a similar story across maturities, as yields rose to a similar extent across the curve. The Russian invasion of Ukraine drove a significant if only temporary dip in yields in the period: 10-year gilt yields reached around 1.55% in late February, fell to around 1.20% following the onset of war – the flight to safety proved only temporary as yields again trended higher from the second week of March. The same pattern is visible in the US and Germany, where yields rose throughout the period but temporarily dipped following the onset

of war in Ukraine: in the US, the benchmark 10-year US treasury yield rose from 1.51% to 2.34% in the quarter, while the German 10-year bund yield rose from 0.14% to 0.55%.

Portfolio commentary

- The fund opened the fourth quarter -0.15 years short duration relative to its index, the FTSE Actuaries UK Conventional Gilts up to 5 years index. The duration short was tactically traded between neutral and -0.5 years short relative to the benchmark, and closed the period -0.3 years short duration. As gilt yields rose across the curve, the fund's duration short added to fund performance. The fund's strategic short is held via an underweight in five-year gilts, the longest duration bonds in the benchmark – a bi-product of this underweight position is a steepening bias in the fund.
- The fund's cross market position in two-year Canadian bonds versus gilts was neutral to fund performance. We took profits on the original position in February after gilt yields rose aggressively following the UK rate hike. The fund re-entered a long position in Canada versus gilts during March, since when Canada has underperformed UK gilts.
- The fund held no exposure to UK or global inflation markets in the period.
- The fund's highly rated sterling credit exposure had no significant impact on performance in the quarter. Credit spreads (the average extra yield available from corporate bonds compared with government debt of equal maturity) widened by 22bps. The fund's credit exposure remains focused in highly rated fixed rate credit, and CDs

Outlook

- There is considerable uncertainty about the year ahead. The war in Ukraine has worsened existing trends and has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal, which is possible given that US investors are positioned for eight further rate hikes this year, taking the Fed Funds target rate above 2.5% (from 0.50% at present). In the UK the picture is only marginally different: five further hikes and a rate of 2%. In the eurozone there has been a significant shift, with tightening now expected in the second half of the year. Although we expect a slowdown in medium term, we believe that market pricing may be too aggressive at present. However, we must highlight the uncertainty of any market forecasts at present, given the unpredictability of war in Ukraine.
- Once the UK base rate reaches 1% the use of active quantitative tightening (QT) becomes an option for the Bank of England (active QT refers to the active sale of balance sheet holdings; passive QT is when the proceeds of maturing bonds are not reinvested). Currently, the BoE holds £850bn in gilts, or around a third of the gilt market. The BoE has noted concern for the size of its balance sheet, which makes the use of QT a distinct possibility. This would certainly aid the smooth running of the gilt market, where a lack of liquidity during periods over the past six months has led to some sharp swings in prices. However, as the £125bn in gilt issuance announced by the Office for Budget Responsibility (OBR) for the coming financial year was slightly below consensus market expectations, the likelihood that QT might impact market prices is reduced

Find out more

- RLAM recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March.
- 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.co.uk for further information.

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