



Royal London Short Term Fixed Income Fund

Quarterly Report 30 September 2022



Fund data

	Fund
Gross redemption yield ¹	4.78%
No. of issuers	50
Fund size	£5,602.6m
Weighted average maturity	0.2 years
Weighted average life	1.7 years
Duration	0.2 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)	Benchmark ¹ (%)	Relative ² (%)
Q3 2022	0.13	0.13	0.39	-0.26
Year-to-date	0.05	0.05	0.71	-0.66
Rolling 12 months	0.08	0.08	0.72	-0.64
3 years p.a.	0.52	0.51	0.38	0.14
5 year p.a.	0.66	0.66	0.42	0.24
10 year p.a.	0.79	0.79	0.37	0.42
Since inception p.a. 22.05.2012 (income)	0.83	-	-	-
Since inception p.a. 20.06.2011 (accumulation)	-	0.83	0.39	0.44

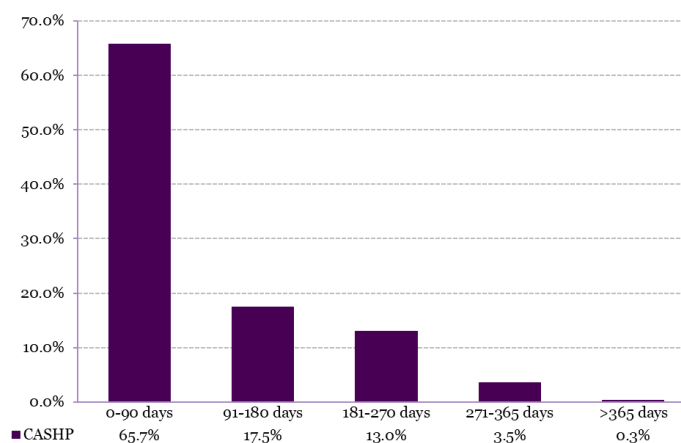
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. All performance figures stated gross of fees and tax unless otherwise stated. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return. 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

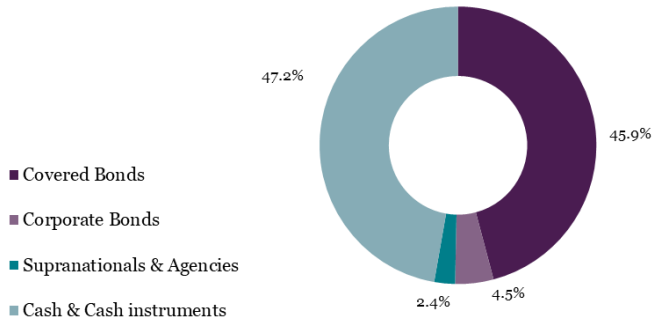
	Weighting (%)
Toronto Dominion Bank	6.7
Bank of Nova Scotia	5.5
Canadian Imperial Bank of Commerce	5.3
National Australia Bank	5.1
Royal Bank of Canada	4.8
Bank of Montreal	4.6
Commonwealth Bank of Australia	4.5
Macquarie Bank	4.2
Rabobank Group	4.1
United Overseas Bank Limited	3.5
Total	48.2

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

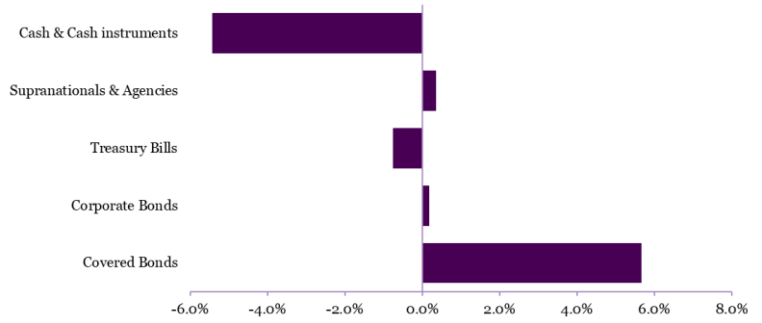
Duration profile



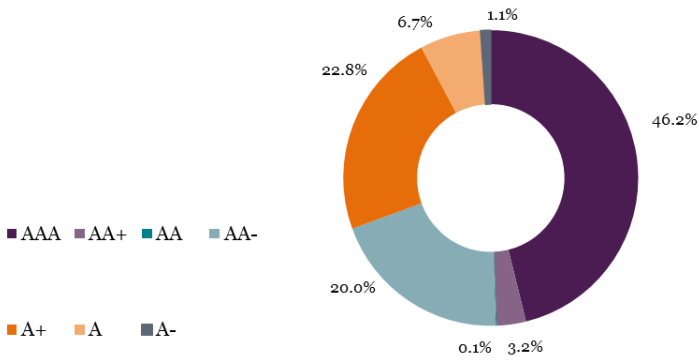
Asset allocation profile Q3 2022



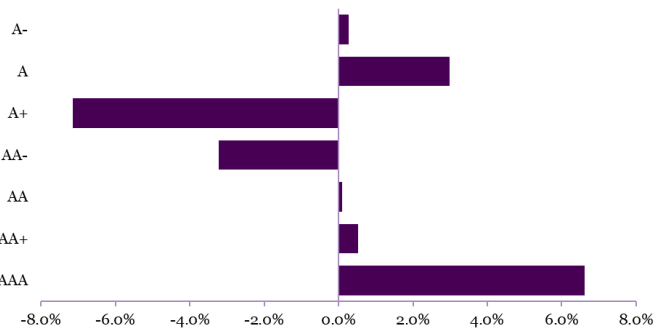
Change since last quarter



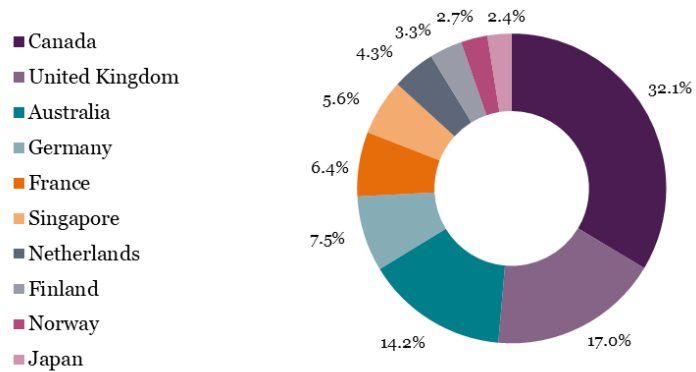
Credit rating profile Q3 2022



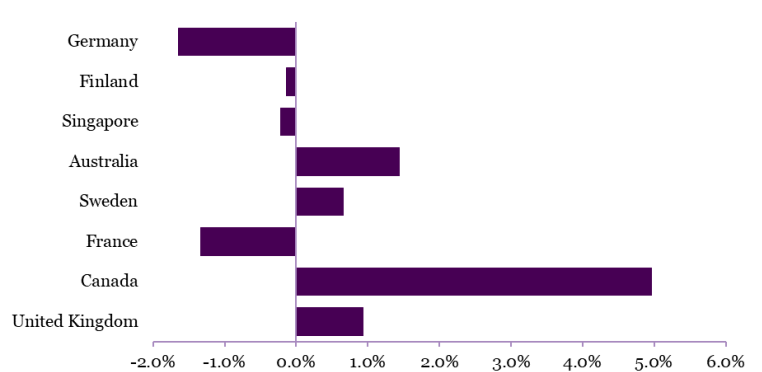
Change since last quarter



Top ten geographic allocation (ex gilts) Q3 2022



Change since last quarter





Market overview

- The macroeconomic factors that disrupted financial markets in the first half of 2022 continued to dominate in the third quarter – higher-than-expected inflation and interest rate increases were the key macroeconomic influences, along with growing fears of recession in the UK, Europe and the US. Inflation first surfaced in the aftermath of the Covid-19 pandemic, but was exacerbated by the Russian invasion of Ukraine in February and retaliatory sanctions which sharply increased the prices of oil & gas and other commodities. Although they have fallen back slightly, energy prices remain high and geopolitical events continue to affect sentiment as winter approaches. The apparent sabotage of the Nordstream gas pipelines from Russia to Germany suggests that energy will remain a key pawn in relations between NATO countries and Russia.
- Central banks have responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The US Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. Since March, the Fed has raised rates five times by an aggregate of 3% - its 0.75% increases in June, July and September were the biggest increases for nearly 30 years. Its commitment to do more has led markets to price in a further 2.75% of hikes in 2022. The European Central Bank (ECB) has so far been slower to react, partly due to a more fragmented backdrop with a gap between Germany and ‘peripheral’ economies. However, ended its bond buying programme in July and increased rates by 0.75% (it’s first increase in 11 years and a bigger increase than the 0.50% expected by economists). A further increase of 0.75% followed in September with a clear commitment of further increases to follow. The Bank of England (BoE) increased rates by 1.00% over the quarter to 2.25%, taking its tally to six increases so far in 2022 and seven in this cycle.
- The level of activity in the UK economy is still only slightly above where it was pre-pandemic. Although GDP growth was robust in the first quarter, the second quarter saw a small contraction in activity. The composite PMI business survey indicator of activity in the economy deteriorated between March and August 2022 and by August signalled only relatively weak rates of activity growth in the economy and, as with the eurozone, it continues to deteriorate as does consumer confidence.
- UK economic policy is in a state of flux following the new Chancellor’s ‘mini Budget’ in late September. As expected, he outlined details of programmes to limit domestic and corporate energy bills as well as the reversal of his predecessor’s increases in corporation tax and National Insurance. However, other measures such as scrapping the top rate of income tax (since abandoned) and the cap on bankers’ bonuses came as a surprise, leading to further weakness in gilts and sterling. In the last week of the quarter, after comments to support the currency, the BoE was forced to intervene in the gilt market as problems with levels of collateral in the ‘liquidity-driven investing’ (LDI) part of the pensions industry pushed down the prices of long-dated gilts in a vicious spiral. Having said the previous week that it would reduce its holdings of gilts and corporate bonds, the BoE announced that it would potentially buy £65bn of long-dated gilts over the following two weeks.
- The UK gilt market was the worst performing major government bond market over the quarter, delivering a return of -12.85% as the benchmark 10-year gilt yield rose by 129 basis points (bps) from 2.80% to 4.09%. However, all major government bond markets were impacted as the ongoing interest rate rises and hawkish commentary from central banks drove bond yields higher globally. These gilt market returns took a heavy toll on the sterling investment grade credit market, which returned -11.01%, with the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widening by 25bps to 1.99% (iBoxx).
- 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, 1.19% by the end of June, and ended September at 2.19%, while ICE Term SONIA three-month rates rose from 1.55% to 3.23% over the quarter. Two-year gilts, often seen as a proxy for market expectations of BoE rates, rose from 1.97% to 3.92%. Reverse repo rates also increased over the quarter, ending at around 2.17% for high quality names, although this dipped slightly late in the quarter reflecting the increased demand for ‘near cash’ late on.

Performance and activity

- Although this report covers the past three months, for many investors, the focus is very much on the final two weeks of September, and the impact of the new UK Government’s ‘mini-budget’ and subsequent intervention from the Bank of England. The uncertainty in markets, and particularly the need for cash to meet collateral calls, meant that our funds saw outflows over the quarter. The nature of these outflows was unexpected, but the way that we structure the funds reflect the expectation that events like this are possible, and the need for liquidity sits alongside our goals to provide a high degree of security and yield.
- Pleasingly, this liquidity event did not impact the funds. Very liquid funds such as our Sterling Liquidity and Short Term Money Market funds have high daily / weekly liquidity as a matter of course. Our Short Term Fixed Income Fund and Short Term Fixed Income Enhanced Fund



(formerly named Cash Plus and Enhanced Cash Plus respectively) usually run with a lower degree of immediate liquidity, reflecting their longer-term investment target. However, the funds also place an emphasis on high quality exposure – in covered bonds, ABS and short-term credit. This meant that as we needed to increase liquidity within those funds, we were able to do so in an orderly fashion, the nature of paper we were selling meant that we were able to execute trades efficiently and without having to sell at distressed prices or focus our sales on one particular part of the market and hence changing the shape of the portfolios and thus disadvantaging other investors. In addition, where we needed to raise funds, we aimed to sell paper with 2022 maturities, keeping 2023 maturity instruments to minimise year end issues as we come into the final months of the year.

- 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.
- Money market exposure was generally a modest positive over the quarter, as the additional yield on paper bought in previous months outpaced the rise in SONIA. For most of the quarter, we were happy to add slightly longer paper – maturities of up to one year. This reflected our view that the market was pricing in too much tightening, too fast from the BoE. This was positive for returns as the yields on these instruments outstripped the rise in SONIA over the quarter.
- During the third quarter, we saw the same market themes as in Q2, with fears of inflation, rising interest rates and slow growth pushing yields and credit spreads higher. This was negative for the instruments held in the portfolios that contained interest rate and credit risk. As in the second quarter, 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.
- Covered bonds still account for the majority of the fund’s 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. We were active in this area over the quarter. We were able to pick up attractive bonds in both primary market (**Clydesdale** and **Leeds Building Society**) and secondary market (**Nationwide** and **Westpac**), focusing on three and four year bonds offering a premium of 50-60bps over SONIA. Later in the quarter we reduced very short-dated covered bonds – typically those with around six months to maturity – where spreads remained compressed and where liquidity was higher.
- The yields on our funds have now risen materially – the Short Term Fixed Income Fund is yielding around 4.8%, a significant premium to current SONIA levels, while Short Term Fixed Income Enhanced yields around 5.6%. While overall yields have increased, selective activity over the period has helped protect and add to the premium over SONIA.

Outlook

- The perception of the third quarter was skewed by the market reaction to the mini-budget. However, we see those events as more ‘one-off’ in nature – the market was taken by surprise by the approach taken by the Government, and is unlikely to be surprised once more. Beyond this, we continued to see the trends of 2022 continue. Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, interest rate increases are already showing signs of slowing down activity and, despite more aggressive market expectations, we believe that inflation will peak in major economies during the second half of 2022. Weaker GDP growth and recession in some areas will impact the corporate sector.
- It is too early to say whether the UK government will be forced into further U-turns in economic policy, either by its backbenchers or financial markets, but its reputation has undoubtedly been affected by recent events. The goal of boosting UK economic growth is laudable, but would require a wider programme of measures over a sustained period of five to 10 years. Also, despite the ambitious scope of the mini-Budget, it would have been more effective had the Chancellor also detailed a fiscal framework and package of supply-side reforms. Furthermore, having sacked key advisers on assuming office, the new Prime Minister and Chancellor didn’t communicate their plans well: even if events subsequently play out in their favour, they cannot afford to take the gilt market for granted at a time of such economic strain.
- Rate expectations swung wildly in the final two weeks of the quarter, but ended with the market pricing in BoE rates of around 5.5% in 12 months’ time. While the Bank is still insisting that it will focus on inflation, rate rises of that magnitude would have a significant impact on the economy, making it difficult to achieve. The increasing expectation of rate hikes means that there are attractive opportunities across our investment spectrum, notably in short-dated credit, where yields of 6-7% are now attainable. We will aim to add selectively to these areas over



the coming months. In the very short term, we may see downward pressure on shortest paper, as some of the money called in the wake of the uncertainty around the mini-budget returns to money market funds. .

Additional information

- As we highlighted in our Annual Report, RLAM has ambitious targets for the next few years, notably in international growth as well as investment in infrastructure and people. This investment is to make sure that we continue to provide clients with the service they need and positioning us to for future regulation changes and market development.
- As part of that ambition, we are pleased to announce that we are moving to a new investment platform and have selected the industry leading 'Aladdin' platform. This decision has followed months of analysis and pre-implementation planning with the vendor BlackRock. Aladdin will help us improve our service offerings to our clients, as well as delivering operational efficiencies.
- As you would expect, implementation is an extended task, and the project is expected to complete in 2024, but we believe it is important to be transparent about such projects with our clients. Throughout the implementation, the project and management of your client portfolios will be closely monitored by our Board and Risk functions to ensure that this transition is achieved smoothly, and we will keep you updated on our progress. This is an important part of our long-term strategic goal to ensure that we continue to meet your needs today and into the future.
- We are experiencing unprecedented times in markets. Inflation is at multi-decade highs, energy prices are rising and the latest Bank of England announcement created further uncertainty. Following on from the unsettling fixed income and currency markets of late September, RLAM hosted a webinar for RLAM's Head of Fixed Income Jonathan Platt, and Craig Inches, Head of Rates and Cash to discuss the situation and how central banks and policymakers might react. Investors can listen again via the Our Views section of www.rlam.com, which also contains includes regular updates from Head of Fixed Income Jonathan Platt, Head of equities Peter Rutter, and Head of Sustainable Mike Fox.



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