Royal London UK Government Bond Fund

Quarterly Report 30 September 2022

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	5.8	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	93.7	100.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	5.0	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]	9.3 years	9.6 years
Gross redemption yield[4]	4.18%	4.07%
No. of stocks	55	56
Fund size	£830.0m	-

Source: RLAM, based on the Z share class. Launch date: 30.01.1990.

[1]Benchmark: FTSE® Actuaries All Stock Gilts 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 (%)
Q3 2022	**-11.16**	**-12.85**	**1.68**
Year-to-date	-23.69	-25.10	1.41
Rolling 12 months	-22.18	-23.29	1.11
3 years p.a.	-8.48	-9.58	1.10
5 years p.a.	-2.69	-3.35	0.67
10 years p.a.	0.53	0.15	0.38
Since inception p.a. 30.04.2010	3.13	2.70	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.

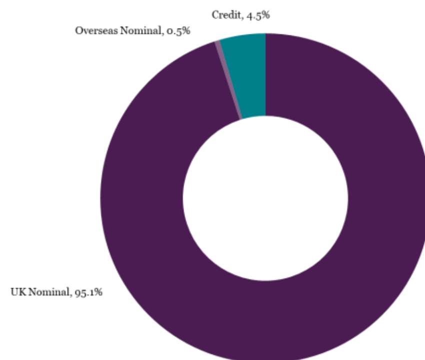
All performance figures stated gross of fees and tax unless otherwise stated. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.
Source: RLAM, based on the Z share class.
[1]Benchmark: FTSE® Actuaries All Stock Gilts Index.
On 1 May 2012, the Royal London UK Government Bond Fund (Class B) was renamed the Royal London UK Government Bond Fund (Class Z). The Z share class was launched on 30 April 2010. All performance after this date is for the Z share class. All performance for periods prior to 30 April 2010 is for the Royal London UK Government Bond Fund (Class A).Therefore the performance shown in this table is a merged return which includes the historical 'A' share return for the periods to 30 April 2010, before the Z share existed. If you were invested in the fund prior to this, your investment was in the A shares. If you require separate performance solely for the Z shares since 30 April 2010, please contact your Client Account Manager.
Performance for the Royal London UK Government Bond 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.
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Ten Largest Holdings

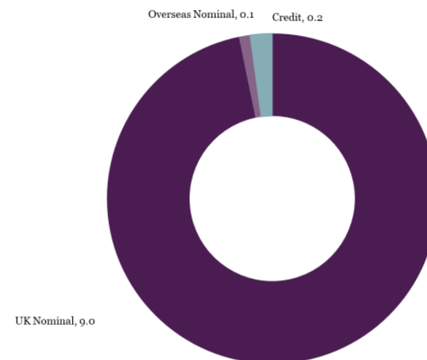
	Weighting (%)
UK Treasury 0.25% 2025	11.3
UK Treasury 0.375% 2026	10.7
UK Treasury 1.25% 2024	9.4
UK Treasury 4.5% 2034	4.7
UK Treasury 0.5% 2029	3.6
UK Treasury 1.5% 2053	3.6
UK Treasury 4.5% 2042	3.6
UK Treasury 0.375% 2030	3.5
UK Treasury 0.175%2037	3.2
UK Treasury 1.0%2024	3.1
Total	**56.8**

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

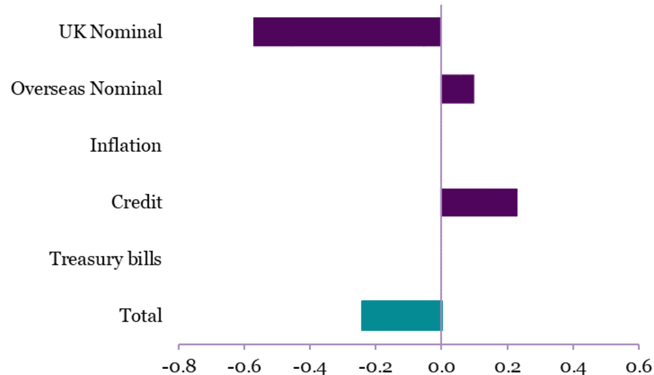
Asset split by percentage



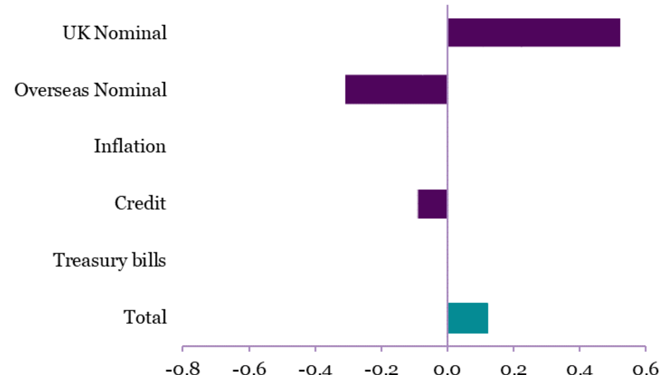
Asset split by duration



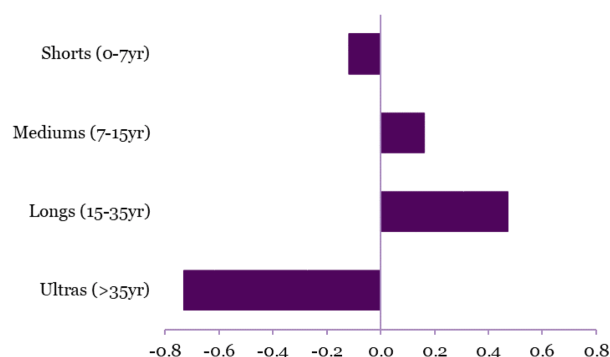
Asset allocation relative to benchmark (duration)



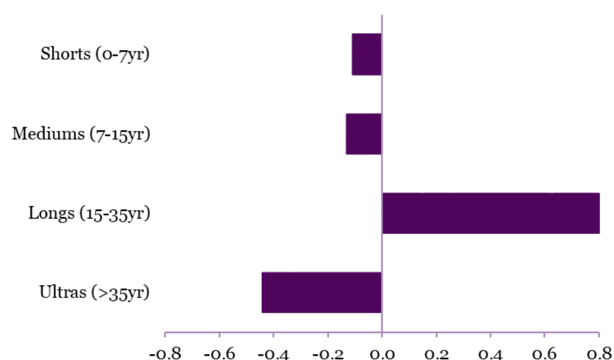
Asset allocation change on the quarter (duration)



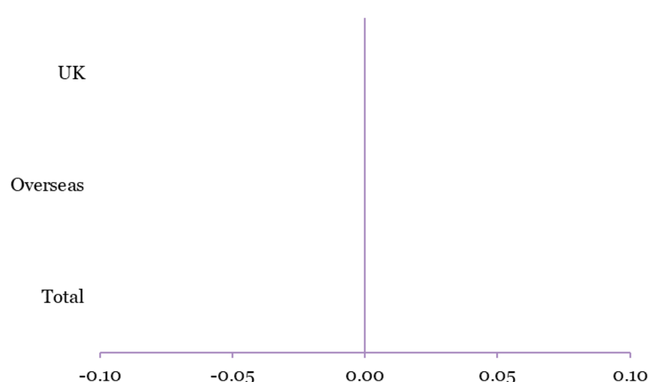
Yield curve relative to benchmark (duration)



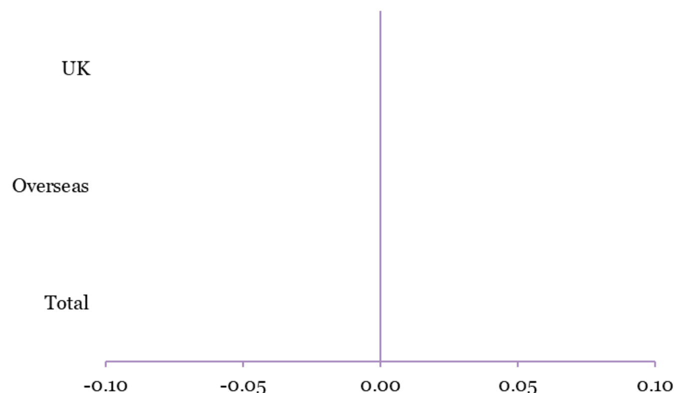
Yield curve change on the quarter (duration)



Inflation exposure (duration)



Inflation exposure change on the quarter (duration)



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 further 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.
- 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 186 basis points (bps) from 2.23% 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 (prices move inversely to yields): the 10-year US treasury yield rose by 82bps to 3.83%; and the 10-year German bund yield rose by 77bps to 2.11%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, for example, gilts with five years to maturity or less provided negative returns of just -4.93%, whereas the 15 years or more to maturity segment returned -18.77%.

Portfolio commentary

- The fund began the second quarter around 0.3 year short duration versus the benchmark. We covered some of this position, moving closer to neutral for the end of the quarter, locking in the positive relative returns provided by the position after yields rose aggressively across the curve. We remain marginally short as we expect yields to continue trending upwards through 2022, albeit at a slower pace, as monetary support unwinds.
- The fund held a steepening bias across the curve during the first part of the quarter. Most notable was a long-held steepening bias within longer maturity bonds (over 15-year), and particularly in ultra-long dated (50-year) bonds where the fund was overweight 30-year maturity bonds versus the longest dated bonds on the curve. This had a positive impact on performance, particularly during July. With the curve at its steepest levels in 12 months, the fund took profits, and neutralised its curve bias within longs. Shorter down the curve, the fund was underweight 10-year maturity bonds versus sub 5-year bonds and 15-year maturity bonds.
- Cross market exposures added significantly to performance during Q2, as the UK underperformed global bond markets. With Boris Johnson's term as prime minister coming to an end, investors took fright at the prospect of a Liz Truss led government, and the likelihood of significant increases to spending which would weigh on the UK debt profile. By the end of the quarter the fund had exited its long-held position in 30-year Australian bonds, and took profits on both 30-year US and two-year Canada, by selling those assets back into the UK.
- The fund's highly rated sterling credit exposure was slightly detrimental to performance in the quarter, as credit spreads (the average extra yield available from corporate bonds compared with government debt of equal maturity) widened by 45bps to 1.74 (iBoxx). The fund's credit exposure remains focused in highly rated fixed rate credit, and CDs.

Outlook

- The perception of the third quarter was skewed by the market reaction to the mini-budget. Beyond this, we expect to see the trends of 2022 continuing for the rest of the year. Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, The Bank of England has been raising interest rates all year, and there are signs that this is starting to impact demand. It is likely inflation will peak at some point during Q4, but the key for central banks will be where inflation settles, and that remains a big unknown for markets.
- 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. But that may be exactly what is needed to get inflation back to target.
- With base rates now above 1%, the BoE can employ active quantitative tightening (QT) – i.e., selling bonds back into the market to reduce the size of its balance sheet holdings. Currently, the BoE holds around £850bn in gilts, or around a third of the entire gilt market. In our view QT would help alleviate some of the liquidity issues and aid the smooth running of the gilt market, and we expect QT to start in Q4 2022.

Find out more

- 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 regular updates from Head of Fixed Income Jonathan Platt, Head of equities Peter Rutter, and Head of Sustainable Mike Fox.

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.

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