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Royal London Absolute Return Government Bond Fund

Quarterly Investment Report

30 September 2023

ROYAL LONDON
ASSET MANAGEMENT

Quarterly Report

The fund as at 30 September 2023

The purpose of this report is to provide an update on the Royal London Absolute Return Government Bond Fund. The report has been produced by Royal London Asset Management. The report starts with a summary dashboard showing key information about the fund. A glossary is located at the end of the report covering the description of some of the more technical terms used within the report. All data is as at the report date unless otherwise stated.

Contents

The fund

Fund performance objective and benchmark

The investment objective of the fund is to target absolute positive capital growth.
The fund seeks to achieve its investment objective by outperforming its benchmark, the Sterling Overnight Index ("SONIA") on an annual basis by 2.5% over rolling three year periods and aims to provide positive performance over 12 month periods.

Benchmark: SONIA (Sterling Overnight Index Average)

Fund value

	Total £m
30 September 2023	1,320.02

Fund analytics

	Fund
Fund launch date	17 November 2014
Base currency	GBP

Performance and activity

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	2.71	1.25	1.47
YTD	3.85	3.27	0.59
1 Year	7.54	3.97	3.57
3 Years (p.a.)	2.77	1.57	1.20
5 Years (p.a.)	2.33	1.15	1.18
10 Years (p.a.)	-	-	-
Since inception (p.a.)	1.65	0.82	0.83

Past performance is not a guide to future performance. Please refer to the Glossary for the basis of calculation and impact of fees. Performance and since inception date based on RL Absolute Return Government Bond Fund (Z Acc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 17 November 2014.

Performance commentary

The fund posted a strong positive return of 2.71% on the quarter, compared to 1.25% for the benchmark (SONIA). Over the past year the fund has returned 7.54% over 250 basis points ahead of benchmark. This has been a 12-month period where we have faced war, an LDI crisis and multiple bank failures. Government bond indices have delivered double digit losses over the same period as central banks raised short-term rates to combat the highest level of global inflation for decades.

The largest contributor to performance was the holdings of highly rated FRNs and money market instruments. We added to money market instruments with yields approaching 7% and benefited as yields fell later in the quarter.

A key theme over the quarter was the underperformance of the gilt market as inflation data continued to surprise to the upside, leading to higher rate expectations, flatter curves and higher breakeven rates. Into this weakness we moved to an overweight position in the UK and as inflation data improved and base rate hike expectations diminished this overweight position added value

As we believed we were nearing the peak in interest rates and curves were very flat, steepening positions in the UK and US added value as the market began to price lower rates in 2024. The major curve position within the fund remains this US curve steepener, with the fund being underweight the 30-year part of the curve and overweight the five-year area. We held this position over the past couple of quarters as we believed the US curve would further struggle to remain inverted, given the actions and rhetoric of the Fed. This has proved to be the case from the end of the second quarter to the end of the third quarter. Within the period, however, there was large volatility in curve positioning as the market reacted to data prints, policy rate changes and central bank commentary. Overall, the US curve positioning added to performance, but we maintain that there is still scope for additional steepening in the coming months, whilst recognising the path to this is unlikely to be particularly smooth.

The long breakeven position in Japan added significant value as inflation remained sticky, whilst the short position in both the UK and Europe added value as inflation expectations began to fall. Cross market positions added value, the long in UK 1y1y vs the US and long Spain relative to Italy being the notable contributors to performance.

We lengthened duration during the quarter, particularly in Australia and Canada. This was detrimental to performance as yields reached new highs. Tactical duration positioning around supply events mitigated some of the losses from outright long positions..

Performance and activity

Return Contribution

	Quarter	1 year	Target return (of live trades)
Inflation	62.00	189.00	46.00
Curve	72.00	224.00	25.00
Duration	(30.00)	(22.00)	45.00
Relative Value	(4.00)	12.00	0.00
Cross Market	28.00	66.00	10.00
FX Hedges	0.00	0.00	0.00
Cash	126.00	328.00	490.00
Total	**254.00**	**797.00**	**616.00**

Top Contributors

	Strategy	Q3 Contribution (bps)
CASH	CASH	139.00
Curve	US	42.00
Inflation	Japan	38.00
Curve	UK	34.00
Inflation	UK	25.00

Bottom Contributors

	Strategy	Q3 Contribution (bps)
Duration	Aus	(19.00)
Duration	Canada	(18.00)
Duration	France	(11.00)
Duration	US	(7.00)
RV	UK	(4.00)

Performance and activity

Portfolio Exposure

Trades	Position size	Net duration exposure	Market beta	Target return (bps)
Inflation				
Long Japanese Breakeven	0.60	0.00	(0.10)	10.00
Short UK 10 and 20 year Rpi	0.80	0.00	0.10	16.00
Short Euro Hicp 20 year	0.80	0.00	0.10	15.00
Long US Cpi vs Euro Hicp 30 yr	0.20	0.00	0.00	5.00
Curve				
US 5/30 Steepener	1.00	0.00	0.00	20.00
UK 5/10 Steepener	0.20	0.00	0.00	5.00
Cross Market				
Long Spain vs Italy 10y	0.20	0.00	0.00	5.00
Long UK vs Europe	0.10	-	0.00	5.00
Duration				
Long Can Real Yield	0.10	0.10	0.10	5.00
Long France 20y Real yield	0.20	0.20	0.10	5.00
Long US Real Yield	0.20	0.20	0.10	5.00
Long Australia 20 and 30 Year	0.60	0.60	0.30	25.00
Long Japan	0.10	0.10	0.00	5.00
Cash				
Cash	0.20	0.20	-	490.00

Performance and activity

Portfolio Exposure

Trades	Position size	Net duration exposure	Market beta	Target return (bps)
Cash				
Overall Net Duration Position	**-**	**1.40**	**0.70**	**616.00**

Performance and activity

Asset allocation – duration

	0 -2 yrs	2 -7 yrs	7 - 12 yrs	12 - 17 yrs	17 -22 yrs	22 -27 yrs	>27 yrs	Total
UK	0.08	0.21	0.32	(0.47)	0.03	0.05	(0.21)	0.01
Japan	0.02	0.11	(0.08)	0.00	(0.00)	0.00	0.08	0.12
US	(0.05)	1.03	(0.00)	0.06	(0.03)	(0.74)	0.01	0.30
Canada	0.02	0.03	0.00	0.06	0.00	0.07	(0.00)	0.18
Singapore	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Australia	0.00	(0.03)	0.59	0.00	0.00	0.00	0.00	0.56
Belgium	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Europe	(0.00)	0.09	(0.20)	(0.00)	(0.02)	0.00	(0.01)	(0.14)
France	0.01	0.01	(0.01)	(0.02)	(0.02)	(0.01)	0.20	0.17
Germany	(0.00)	0.04	0.13	0.01	0.01	(0.16)	0.00	0.01
Italy	0.00	0.00	(0.11)	(0.04)	0.00	0.00	0.00	(0.14)
Netherlands	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.02
Norway	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.01
Spain	0.00	0.00	0.12	0.01	0.00	0.00	0.00	0.14
Portugal	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Sweden	0.01	0.02	0.00	0.00	0.00	0.00	0.00	0.03
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total								1.25

Performance and activity

Asset allocation - inflation

	0 -2 yrs	2 -7 yrs	7 - 12 yrs	12 - 17 yrs	17 -22 yrs	22 -27 yrs	>27 yrs	Total
UK	0.02	0.74	(1.03)	(0.25)	(0.26)	0.00	0.00	(0.79)
Japan	0.00	0.46	0.00	0.00	0.00	0.00	0.00	0.46
US	0.00	(0.00)	0.00	(0.01)	0.17	0.01	0.13	0.30
Canada	0.00	(0.00)	(0.00)	(0.00)	(0.00)	0.06	0.00	0.06
Singapore	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Australia	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Belgium	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Europe	0.00	0.00	0.00	(0.07)	(0.42)	(0.01)	(0.14)	(0.65)
France	0.00	0.00	0.00	0.00	(0.00)	0.15	0.00	0.15
Germany	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.01
Italy	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Netherlands	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Norway	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Spain	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Portugal	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Sweden	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total								(0.47)

Performance and activity

Stand alone risk contribution

	Quarterly Vol (%)	Annual Vol (%)
Inflation	0.36	0.73
Curve	0.39	0.78
Duration	0.35	0.70
Relative Value	0.06	0.13
Cross Market	0.35	0.69
FX Hedges	0.27	0.55
Cash	0.19	0.39
Total stand alone vol	**1.97**	**3.97**
Diversification	1.34	2.71
Overall Volatility	**0.63**	**1.26**

Performance and activity

Fund activity

During the quarter we added duration, favouring real yields in dollar markets where US longer dated real yields are now close to 2.5%. The range in duration was between 1 and 2.5 years long, ending the quarter at about 1.5 years long.

In inflation we reduced the overall short position buying back UK RPI forwards as they fell back. We also reduced the short inflation exposure, buying real yields across the globe including the US,France and short dated UK bonds.

Curve steepening positions were increased in the UK and the US, adding to the 5-10 steepeners in the UK and 5-30 steepeners in the US. These positions ranged from 0.25 to 1 year as markets remain volatile around data events.

During the quarter we added to cross market risk, buying gilts vs bunds as spreads reached multi-year highs, selling US 1y1y versus the UK, picking up 160 basis points. These positions were closed as the UK outperformed in September as wage and inflation data began to improve.

With markets pricing in still further rate hikes and yields having risen from the lows of the banking crisis we are running a slightly long duration position predominantly in the UK and Australia. Germany and Japan are our least favoured markets where we continue to run short positions.

The fund participated in a number of auctions and syndications during the quarter..

Market commentary

Market Overview

The third quarter was characterised by mixed data around the world, with central banks coming towards the end of their rate hiking path, but with cuts still seemingly a while away. The global economic picture is rosier now than it was at the start of the year, but global growth is spluttering again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust.

Inflation has fallen significantly and, although higher energy prices threaten a widespread revival in headline inflation, other factors – including a weak economic activity backdrop – should pull inflation lower still. With taming inflation still the priority for central banks, there is still a possibility of further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but peak rates look to be near, with real rates now well into positive territory.

The outlook is still lacklustre in the UK. A technical recession is still assumed for the UK in the next 12 months, but a modest one. There are still risks from the housing sector and consumer spending has yet to respond fully to tighter monetary policy. GDP growth has been weak since late 2021 and PMI business surveys point to deterioration, falling into recessionary territory over the summer. Inflation should fall significantly at headline level, but domestically driven inflation continues to look strong, despite higher interest rates. The labour market is starting to look less tight and lead indicators of wage growth suggest some slowing ahead but so far, pay growth remains much too strong to be consistent with hitting a 2% inflation target.

In the US, the real economy has been surprisingly resilient in the face of tighter credit conditions. However, the fourth quarter looks set to see a few growth challenges, monetary policy is restrictive and employment growth has slowed. A number of recession indicators are still flashing. Business survey data paints a mixed picture, with PMIs consistent with flattish growth while ISM surveys look more upbeat. Employment gains have slowed on the non-farm payrolls data and job openings have fallen a long way from their highs consistent with a less tight labour market. Housing-related activity remain subdued.

The euro area economy may already be in mild recession and forecasts continue to pencil one in. Business surveys have deteriorated and look consistent with falling private sector output. Tighter monetary policy will still be feeding through to the real economy. Bank lending conditions have tightened and loan growth has slowed. High domestically driven inflation continues to point to the balance of risks being in the direction of further hikes.

Global government bond markets continued to see yields move higher – a trend that started in mid-2020, reflecting market views that rising inflation would necessitate higher interest rates and that the central banks and governments would ultimately have to withdraw the support measures put in place during the global financial crisis and then used further to help mitigate the economic impact of Covid. With the end of the rate rising cycle possibly in sight, but issuance expected to remain high, markets have become more volatile.

UK government bonds struggled, being impacted by the higher-than-expected inflation print. Gilts delivered a -0.63% return (FTSE Actuaries) over the third quarter with the benchmark 10-year gilt yield rising to 4.44% from 4.39% but pulled back from a 4.75% high seen in mid-August. There was a marked difference in maturities, with short-dated bonds materially outperforming longer-dated bonds, as expectations that rates may be at a peak helped short-dated bonds start to anticipate cuts in late 2024, while longer-dated bonds remained weak due to concerns about the long-term inflation environment and significant gilt supply. In the US, 10-year treasury yields rose to 4.57% from 3.84%, hitting heights not seen in fifteen years, while in Germany the 10-year bund yield increased to 2.84% from 2.39%.

UK index-linked markets significantly underperformed on a global basis, returning -4.69% (FTSE Actuaries) in the third quarter. Real yields on UK 10-year bonds saw a rise over the period, ending the quarter at 0.60%, up from 0.52%. On longer-term bonds, 30-year real yields increased 53bps to 1.48%. Yields on US 10-year index-linked bonds increased to 2.23% from 1.61%, while its German counterpart saw yields rise to 0.45% from 0.07%.

Global corporate bond markets saw similar underlying influences over the third quarter, with differing overall results. All markets faced the headwind of rising government bond yields, but with this mitigated by ongoing additional carry, and tighter credit spreads as corporates continued to perform well in spite of the higher interest rate environment. In the US, the impact of higher government bond yields dominated returns, leading to a negative return over the quarter, the ICE BofAML US Corporate Index returning -2.70%, while in the euro zone and UK, larger spread tightening and smaller government bond yield increases meant positive returns, with the ICE BofAML Euro Corporate & Pfandbrief Index and iBOXX Sterling Non-Gilt indices returning 0.28% and 2.26% respectively.

Market commentary

Outlook

We expect the downward trend in inflation to continue through the rest of 2023, as energy and food price increases moderate and sluggish GDP weakens the labour market. Nonetheless, UK interest rates are likely to rise further as the BoE continues to focus on bringing inflation under control.

We believe that whilst inflation will fall sharply this year, its likely to remain well above target in most economies by the end of the year, and particularly so in the UK. Shallow recessions are possible but are unlikely to be deep enough at this stage to ease the excessive tightness seen in labour markets.

Central banks are faced with a dilemma as to when to stop tightening and all are pointing towards a greater emphasis on data prints in order to direct policy going forward. We are undoubtedly nearer the end of the tightening cycle than the start, and data has started to show signs of weakening as a result of policy tightening to date. However, the job may not yet be done and we may well see further hikes going forward, and we believe that the timeline for the banks to start cutting rates is longer that the market is currently pricing.

Despite the impact of supply, with the peak of interest rates near and with real yields have risen considerably in recent months across most major government bond markets, we believe that yields are beginning to offer long-term value. However, we expect to see All this adds up to the potential for further volatility in reaction to data points, and at the margin, we are therefore looking for opportunities to add duration to portfolios, using market volatility or weakness as attractive entry points.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

TCFD climate report

Find out more

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams. Notable publications in the third quarter include our annual Climate Report, as well as our annual Assessment of Value reports, available from the home page of www.rlam.com.

Disclaimers

Important information

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Issued in October 2023 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

The Fund is a sub-fund of Royal London Asset Management Funds plc, an open-ended investment company with variable capital (ICVC), with segregated liability between sub-funds.

Incorporated with limited liability under the laws of Ireland and authorised by the Central Bank of Ireland as a UCITS Fund. It is a recognised scheme under the Financial Services and Markets Act 2000.

The Management Company is FundRock Management Company SA, Registered office: 33 rue de Gasperich, L - 5826 Hesperange, Luxembourg and is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF).

The Investment Manager is Royal London Asset Management Limited.

For more information on the Fund or the risks of investing, please refer to the Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.com.

Most of the protections provided by the UK regulatory system, and the compensation under the Financial Services Compensation Scheme, will not be available.

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Risks and Warnings

Investment Risk

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk

Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative Risk

This fund may undertake transactions in derivatives and forward transactions (both on exchange and over the counter (OTC)). These may include interest rate swaps and interest rate futures for the purposes of meeting the investment objective, protecting the risk to capital, duration and credit management, as well as for hedging. While the discerning use of derivatives can be beneficial, derivatives also involve specific risks. These risks relate specifically to market risk, management risk, credit risk, liquidity risk, the risk of mispricing or improper valuation of derivatives and the risk that derivatives may not correlate perfectly with underlying assets, interest rates and indices. The use of derivative instruments may from time to time alter the economic exposure of the fund causing it to deviate significantly from the performance of the market as a whole. The use of these derivatives will be within the parameters allowed for linked funds by the Financial Conduct Authority and Prudential Regulation Authority.

EPM Techniques

The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Exchange Rate Risk

Changes in currency exchange rates may affect the value of your investment.

Interest Rate Risk

Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital. Unlike the income from a single fixed interest security, the level of income (yield) from a fund is not fixed and may go up and down. Bond yields (and as a consequence bond prices) are determined by market perception as to the appropriate level of yields given the economic background.

Liquidity Risk

In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Counterparty Risk

The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Performance to 30 September 2023

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years
Fund (gross)	2.71	2.69	7.54	8.53	12.21
Fund (net)	2.63	2.54	7.22	7.33	10.16

Annualised (%)

	3 Years (p.a.)	5 Years (p.a.)
Fund (gross)	2.77	2.33
Fund (net)	2.39	1.95

Year on year performance (%)

	30/09/2022 - 30/09/2023	30/09/2021 - 30/09/2022	30/09/2020 - 30/09/2021	30/09/2019 - 30/09/2020	30/09/2018 - 30/09/2019
Fund (gross)	7.54	(0.08)	1.01	3.61	(0.21)
Fund (net)	7.22	(0.48)	0.59	3.21	(0.56)

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.
Source: RLAM as at 30 September 2023. All figures are mid-price to mid-price in GBP for the RL Absolute Return Government Bond Fund (Z Acc).

Glossary

Fund value

Total value of the fund as of the last business day of the calendar month. The fund value is as at close of business and on a mid-price basis.

Performance

Performance is calculated using the daily end of day NAV per share produced by HSBC based on the mid price.

VaR

VaR is a statistical measure of the level of financial risk within the fund over a specific time.