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Royal London UK Government Bond Fund

Quarterly Investment Report

30 September 2023

Quarterly Report

The fund as at 30 September 2023

The purpose of this report is to provide an update on the Royal London UK 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.

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The fund

Fund performance objective and benchmark

The fund's investment objective is to achieve a total return over the medium term (3-5 years) by investing at least 80% in UK government bonds, also known as gilts. The fund's performance target is to outperform, after the deduction of charges, the FTSE Actuaries UK Conventional Gilts (All Stocks) Total Return GBP Index (the "Index") over rolling 5-year periods. For further information on the fund's index, please refer to the Prospectus.

Benchmark: FTSE Actuaries UK Conventional Gilts (All Stocks) Total Return GBP Index

Fund value

| | Total £m |
|-------------------|----------|
| 30 September 2023 | 741.80 |

Asset allocation

| | Fund (%) | Benchmark |
|--------------------------------|----------|-----------|
| Conventional gilts | 92.81% | 100.00% |
| Conventional foreign sovereign | 2.87% | - |
| Conventional credit bonds | 2.41% | - |
| Money market instruments | 1.92% | - |

Fund analytics

| | Fund | Benchmark |
|----------------------------|-----------------|-----------|
| Fund launch date | 30 January 1990 | |
| Base currency | GBP | |
| Duration (years) | 9.07 | 8.37 |
| Gross redemption yield (%) | 4.63 | 4.62 |
| Number of holdings | 42 | 60 |

Performance and activity

Performance

| | Fund (%) | Benchmark (%) | Relative (%) |
|------------------------|----------|---------------|--------------|
| Quarter | (0.14) | (0.63) | 0.49 |
| YTD | (3.46) | (4.09) | 0.63 |
| 1 Year | (1.13) | (2.47) | 1.34 |
| 3 Years (p.a.) | (10.37) | (11.33) | 0.96 |
| 5 Years (p.a.) | (3.08) | (3.95) | 0.87 |
| 10 Years (p.a.) | 0.44 | 0.21 | 0.23 |
| Since inception (p.a.) | 1.74 | 1.63 | 0.11 |

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 UK Government Bond Fund (Z Inc). Source: Royal London Asset Management; Gross performance; Since inception date of the shareclass is 30 April 2010.

Performance commentary

Despite posting a negative return, the fund was significantly ahead of its benchmark over the third quarter. The fund is also ahead of its benchmark year-to-date.

Government yields ended the quarter broadly flat, rising about 5bps over the three months, but this does not capture the volatility seen in the period. We have seen yields march higher since a stubbornly high inflation print spooked the market in May but fell into quarter-end as investors re-priced their expectations of where base rates should peak. This is best seen in the market's pricing for SONIA, which started the quarter around 6.1%, hit a high of 6.5% but ended the quarter around 5.2%.

We have seen two key themes play out over the quarter: deteriorating economic data – in particular, falling consumer inflation, rising unemployment, and weaker PMIs; and central bank speakers telling the market to readjust their peak rate expectations. The BoE's Chief Economist Huw Pill used a speech in South Africa to change the narrative and let the market know he favoured a lower peak but a more sustained period of higher rates. Pill re-iterated the commitment to get inflation back to 2%, but markets remain more sceptical with implied inflation, well above 3% at longer maturities.

As a result of these two factors, we saw 5-year gilt yields fall, as the market's peak rate expectations were too high, while the long end rose - resulting in a steeper curve.

The long end of the market remains nervous, however, due to concerns about the long-term inflation environment and significant gilt supply.

Performance and activity

Fund activity

Our strategic decision to take the fund long duration versus its benchmark was beneficial to performance but we have slowly reduced this position. The fund's long duration position remains concentrated in 5-year maturity bonds, which added to performance as 5-year yields fell.

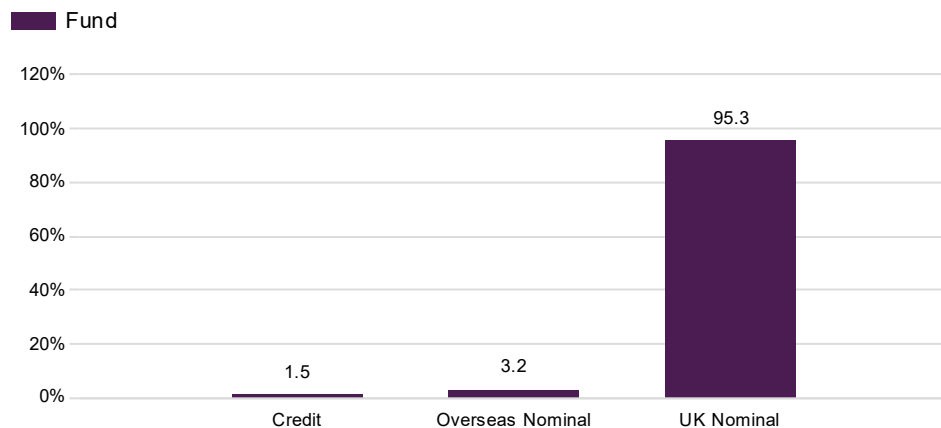
During the third quarter, UK gilts were a strong outperformer versus their overseas counterparts – which was beneficial to our performance as we did not hold much cross-market exposure during the quarter as we felt UK bonds looked good value in a global context.

Towards the end of the quarter, however, we picked up dollar market bonds, namely in the US and Australia – selling 5-year gilts into these markets as they offered additional yield, particularly in the US as yields are hitting multi-decade highs. We are now long US and Aussie bonds and also German bunds as we believe gilts no longer stand out as cheap.

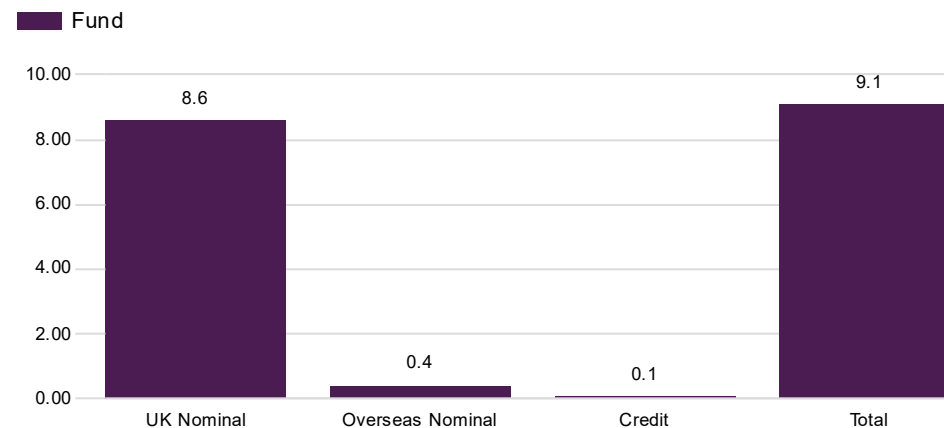
Our cross-market position was slightly negative for performance over the quarter as we had been overweight Aussie bonds which underperformed versus gilts. We added to our position in 20-year maturity Australian bonds, buying nominal bonds outright. Although this was detrimental to performance as yields on Australian bonds rose, we still view Australia as an attractive market to invest in at these yields levels, particularly in a global context.

Fund breakdown

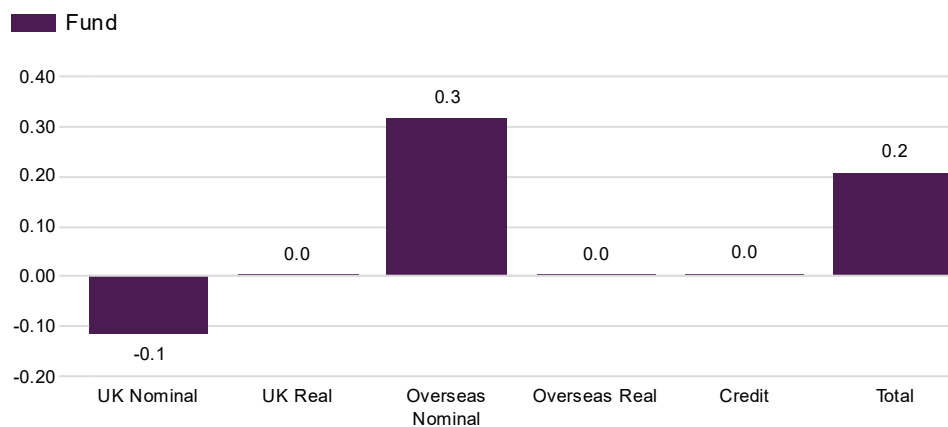
Asset split by percentage



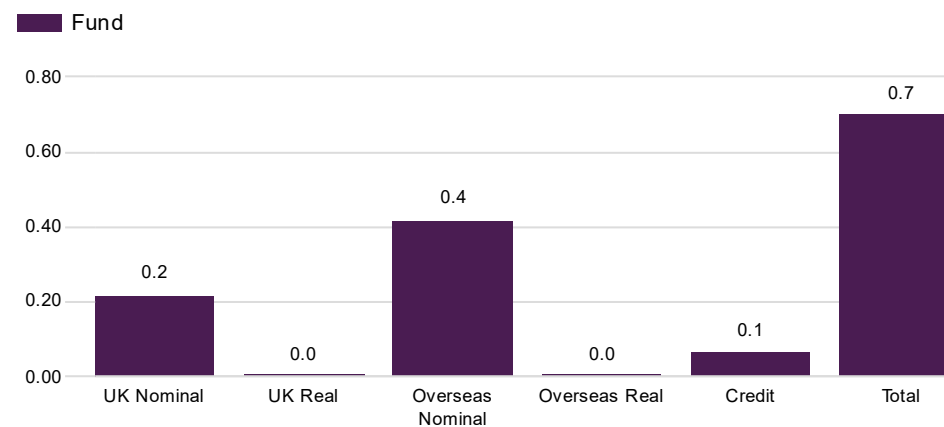
Asset split by duration



Asset split by duration change on quarter

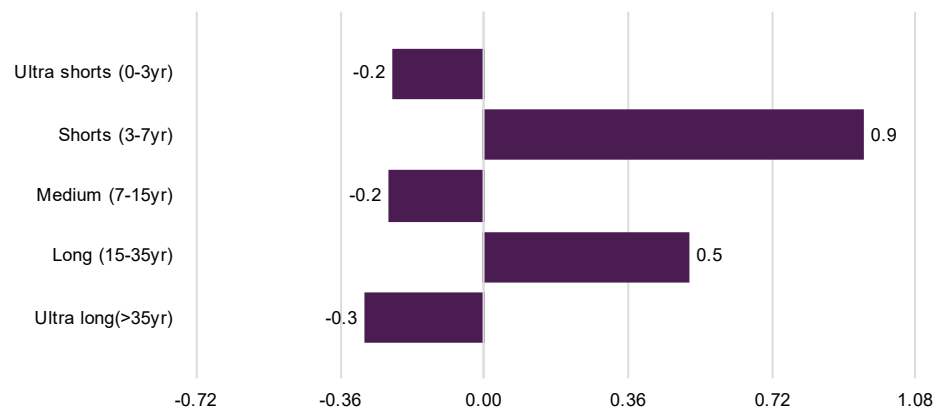


Asset allocation relative to benchmark (duration)

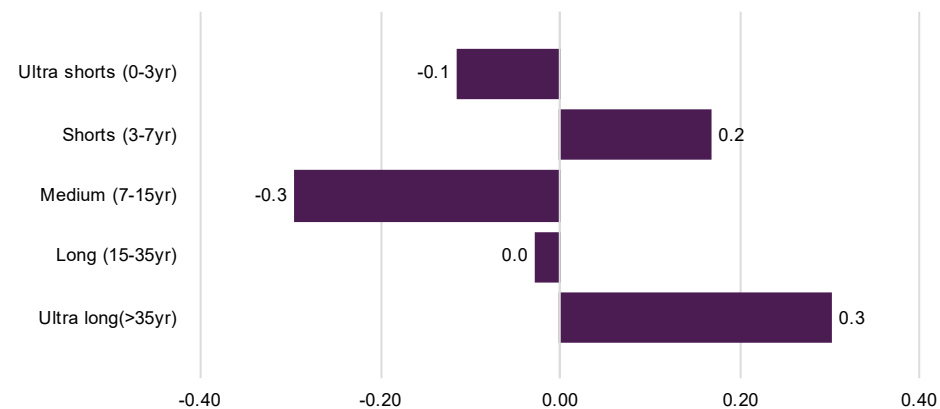


Fund breakdown

Maturity profile relative to benchmark



Maturity profile change on 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 soggy 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.

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 Fed continued to hike rates over the quarter against a still resilient labour market backdrop, to help ensure inflation returns sustainably to target. Over the third quarter, the Fed raised the Fed Funds target range by another 25bps to 5.25-5.50%. As of their September meeting, the mean forecast of participants still had one more rate increase in it for the rest of 2023, but removed some of the rate cuts that participants had pencilled in for 2024. Over the quarter, CPI inflation rose to 3.7% year-on-year by August, from 3.0% in June driven by higher energy inflation, but with core continuing to drift lower over the period. The core PCE measure of inflation fell over the quarter and month-on-month was only 0.1% in August. Second quarter GDP recorded a steady-ish 2.1% quarter-on-quarter annualised. More timely economic activity indicators were mixed over the quarter. The government shutdown stand-off was eventually resolved at the last minute, but with a stop-gap measure that will fund the government only through to mid-November 2023.

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.

Over the third quarter, the ECB again raised rates 50bps. At the September meeting, they signalled that current levels would potentially mark the peak, while leaving the door open for further rate hikes if necessary. Euro area CPI fell to 4.3% year-on-year in September from 5.5% in June. Core CPI fell over the same period too and showed a clearer downward trend than over the previous quarter. The euro area economy grew (only) 0.1% on a quarterly basis in the second quarter - the same outcome as seen in the first three months of the year. However, business surveys signalled a deterioration in activity into more recessionary territory by the end of the quarter.

UK data released in the third quarter painted a picture of slower economic activity, with high but falling inflation albeit featuring still-strong domestic inflationary pressure. Second quarter GDP grew 0.2% quarter-on-quarter in real terms. Upward back revisions to GDP over the quarter showed Q2 GDP as 1.8% above pre-pandemic levels (0.2% previously), with the bulk of revisions from before 2022. The data showed that the UK economy experienced a less-bad pandemic in GDP terms than first estimated. Meanwhile, inflation fell, and tended to surprise on the downside at headline level: year-on-year CPI inflation fell from 8.7% for the May release to 6.7% for the August release. Core inflation fell from 7.1% to 6.2% over the same period. Consistent with a somewhat looser-looking labour market and lower than expected inflation, the Bank of England raised rates another 25bps in August to 5.25% but chose to keep rates on hold at their September meeting.

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.

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.

Market commentary

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 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. 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%.

The sterling investment grade credit market (Non-gilt) returned 2.26% over the quarter, as the negative impact of higher government bond yields was offset by tighter credit spreads and the greater proportion of short-dated bonds (which performed well relatively to longer-dated equivalents) in credit indices. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightened from 1.48% to 1.38% (iBoxx). Banks and insurance bonds performed strongly in the quarter while senior insurance debt also enjoyed an impressive quarter. No sector saw negative returns, but real estate was broadly flat, and healthcare and transportation lagged other sectors. By rating, there was no standout performer in investment grade, with all bands posting returns between 1.8% and 2.5%. High yield bonds, however, saw a strong quarter, seeing returns of 3.7%. In duration terms, shorter-dated maturities performed significantly better than longer-dated equivalents.

Outlook

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. As a result, base rates will continue to trend higher, albeit at a much slower pace than over the last 18 months and are unlikely to be cut anytime soon.

In the UK, the market is now expecting base rates to peak around 5.4% later this year, before being cut in late 2024, and falling to a terminal level of around 4.25% by mid-2027. At one point in early July the market was pricing peak rates closer to 6.5%. We believe that gilt yields are well

priced for this base rate scenario and at around 4.5%, are attractive to investors. In particular, we see 5-year gilts as attractive.

Supply will be an issue for the market over the next few years, with around £200bn per annum forecast over each of the next five years. Alongside quantitative tightening (where the BoE is selling its gilt holdings back into the market), this will represent a headwind for gilts. However, when considering gilts in a global context, we believe the gilt market is somewhat priced for this.

Further Information

Please click on the links below for further information:



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 Bond Funds ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC000797.

The Authorised Corporate Director (ACD) is Royal London Unit Trust Managers Limited, authorised and regulated by the Financial Conduct Authority, with firm reference number 144037.

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.

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FTSE makes no claim, prediction, warranty or representation either as to the results to be obtained from the Fund or the suitability of the Index for the purpose to which it is being put by Royal London Asset Management.

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.

Concentration risk

The price of Funds that invest in a reduced number of holdings, sectors, or geographical areas may be more heavily affected by events that influence the stockmarket and therefore more volatile.

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.

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.

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.

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.

Government and Public Securities Risk

The Fund can invest more than 35% of net assets in different Transferable Securities and Money Market Instruments issued or guaranteed by any EEA State, its local authorities, a third country or public international bodies of which one or more EEA States are members.

Charges from Capital Risk

Charges are taken from the capital of the Fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.

Performance to 30 September 2023

Cumulative (%)

| | 3 Month | 6 Month | 1 Year | 3 Years | 5 Years | 3 Years (p.a.) | 5 Years (p.a.) |
|---------------------|---------|---------|--------|---------|---------|-------------------|-------------------|
| Fund (gross) | (0.14) | (5.62) | (1.13) | (27.99) | (14.49) | (10.37) | (3.08) |
| Fund (net) | (0.20) | (5.74) | (1.38) | (28.64) | (15.79) | (10.64) | (3.38) |

Annualised (%)

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) | (1.13) | (22.22) | (6.37) | 5.19 | 12.89 |
| Fund (net) | (1.38) | (22.45) | (6.70) | 4.83 | 12.57 |

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 UK Government Bond Fund (Z Inc).

Glossary

Asset allocation

Breakdown of the assets by asset classes. Based on RLAM asset classification scheme.

Duration

Measure of sensitivity of a Fixed Income instrument to changes in interest rates, indicating the potential impact of interest rate fluctuations on the value of the investment.

Fund Analytics

All figures exclude cash. Credit bonds include non-sterling bonds and CDs where held within the fund or benchmark.

This is applicable to the following sections: fund Asset Allocation, Duration, Yield curve, Sector breakdown, Financial holdings, Credit ratings.

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.

Gross redemption yield

Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the fund is the average for its individual holdings, weighted by their current value, net of relevant fund management costs and gross of tax.

Number of holdings

Total number of unique holdings of the Fund excluding cash, currency and derivatives.

Performance

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

Sector breakdown

Breakdown of the fixed income assets, excluding derivatives and cash by RLAM's internal industry sector classification scheme. Figures are subject to rounding.