ROYAL LONDON
ASSET MANAGEMENT

The case for active versus passive investing in sovereign bonds

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The old world of zero rates and deflation

The financial crisis in 2008 was the spark that set light to a 13-year bull market for bond investors. The resultant collapse of interest rates towards zero and diminished inflation expectations meant that bond yields were in perpetual decline over that period.

In the government bond universe, global central banks embarked on quantitative easing that pushed yields even lower and, in most cases, took sovereign yields close to zero or in several markets declined into negative yield territory – where investors essentially pay to hold a bond.

> **In this low yield environment, fund fees became a key factor in determining whether investors chose to pay for active management.**

Regular annual sovereign issuance was swallowed up by central banks buying via quantitative easing (QE) and the effect was a sovereign universe starved of volatility and therefore limited active relative value opportunities. In this low yield environment, fund fees (always important) became a key factor in determining whether investors chose to pay for active management. In a low volatility, low yield environment, many investors instead settled for an index tracking approach at a low fee.

A new world of rate moves, geopolitics and inflation fears

The Covid pandemic was a shock for us all, including global central banks. The initial reaction saw inflation expectations plummet as the world shut down. However, the global monetary easing response to pump money into the system (via excessive QE), combined with pent-up consumer demand and supply chain backlogs, resulted in an enormous inflationary pulse that rippled around the globe and has since seen interest rates skyrocket.

The addition of the Ukraine war and global sanctions (Russia and China) has seen many countries adopt an onshoring strategy that has continued to fuel labour shortages, pushing up domestic inflation and wages.

As well as raising interest rates, central bankers also decided to embark on quantitative tightening (QT) which will see them sell back their government debt (accumulated under QE) to the market over the course of the next few years. This comes at the same time as regular debt issuance is expected to remain very high.

These factors have been known for some time. More recently, we can add the rise of right leaning politics globally and the re-election of President Trump, which continues to put upward pressure on inflation and create more global uncertainty. We believe that the tariff policy and likely retaliatory tariffs will result in significant global bond volatility and could see a decoupling of interest rate expectations between key areas such as the US, euro area and UK.

The 'active versus passive' debate

Conventional wisdom says that government bond markets, both in the UK and overseas, are amongst the most efficient within the fixed income universe and thus passive investing is viewed as sufficient. In our view, the contrary is true. In recent years the Truss 'mini budget', subsequent pension fund liquidity crisis, high inflation, excess supply, and interest rate moves have all highlighted the extent of market volatility and corresponding inefficiencies which provide potential opportunities to nimble active investors.

In our view, this volatility is likely to persist as global markets now consider the next move in interest rates and grapple with further geopolitical tensions in the wake of elections. The official forecasts also show that supply and demand imbalances which create volatility will persist for the foreseeable future and as a result we can make the following observations:

- Persistent market inefficiencies in government bond markets can give rise to multiple active opportunities.
- These opportunities cannot be exploited by passive investors due to their requirement to track indices with low volatility.

Figure 1 is just one example of how volatility has returned to bond markets. The purple line is the average absolute move in 10-year US treasuries on the day that certain pieces of economic data are released in the US. These include factors such as the US Consumer Price Index (CPI), US nonfarm payrolls and US Initial Jobless Claims. What is clear is that bond market volatility was depressed between 2014 and 2021, when interest rates were low, and central banks supressed activity through large bond buying programs (QE). Bond market volatility has now, for the reasons outlined above, returned to pre global financial crisis levels, which is good for active managers.

The unfolding environment has never been better for an active manager in the sovereign bond space, and we see the following strategic and tactical opportunities persisting for several years:

Strategic (longer-term)

- Macro data surprises continuing to drive interest rate volatility and fiscal policy moves
- Geopolitical uncertainty impacting yield differentials and asset returns
- De-globalisation, supply chain disruption and tight labour markets keeping inflation expectations elevated

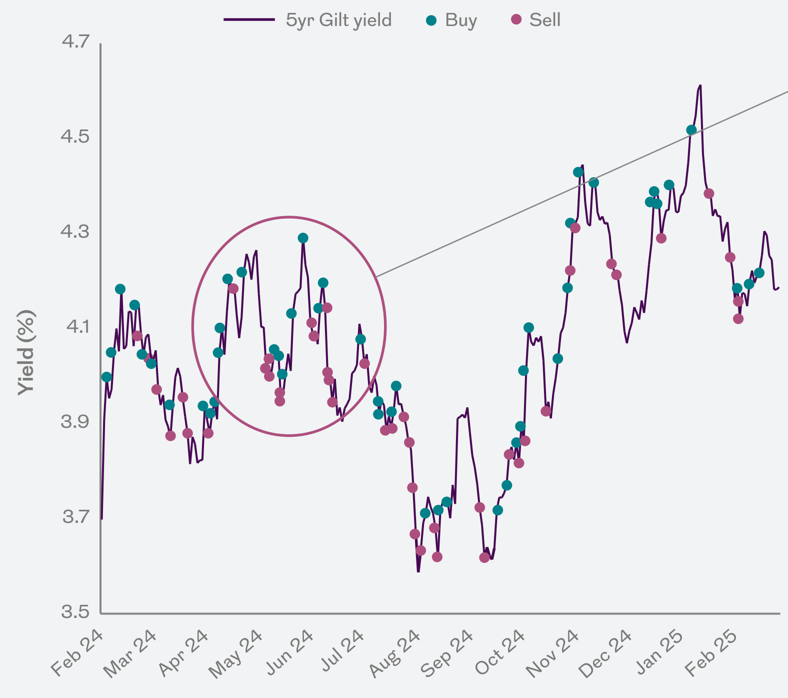
Tactical (shorter-term)

- Excess and frequent global bond supply and demand events (auctions and index changes)
- Central banks moving from buyers to sellers (QE to QT)
- Changes to pension fund strategy creating bond volatility via buy-out activity

Figure 1: Macroeconomic data is once again driving market volatility

Source: Bloomberg
For illustrative purposes only.

Figure 2: Gilt yield movements from February 2024 to February 2025



Date	Buy /sell	Trade size (Dur, yrs)	Yield Level	PnL for Fund (bps)
16/04/2024	Buy	0.05	4.23	0.47
18/04/2024	Sell	0.05	4.13	
24/04/2024	Buy	0.05	4.23	0.90
07/05/2024	Sell	0.05	4.05	
09/05/2024	Sell	0.05	4.00	0.24
14/05/2024	Buy	0.05	4.05	
10/05/2024	Sell	0.05	3.96	0.33
13/05/2024	Buy	0.05	4.03	
15/05/2024	Sell	0.05	4.00	0.71
22/05/2024	Buy	0.05	4.14	
16/05/2024	Sell	0.05	3.93	0.31
17/05/2024	Buy	0.05	3.99	
29/05/2024	Buy	0.05	4.23	0.51
03/06/2024	Sell	0.05	4.13	
04/06/2024	Sell	0.05	4.07	0.26
07/06/2024	Buy	0.05	4.12	
10/06/2024	Buy	0.05	4.19	0.25
11/06/2024	Sell	0.05	4.14	
			Total Contribution	3.97

Source: Bloomberg and RLAM.

The active manager's toolkit

Utilising multiple diversified active strategies, managed in a risk-aware style that accounts for volatility and market direction, the following active opportunities can be employed:

Duration: We anticipate that central banks are likely to remain more reactive and flexible with their monetary policy toolkit, leading to greater volatility in the level of yields. Active managers can take a long or short duration position relative to a benchmark in order to capitalise on these moves.

- Bond market volatility creates opportunities for active investors to tactically trade markets. In figure 2, the chart on the left shows five-year gilt yields, with tactical trades being denoted by teal dots (buys) and pink dots (sells).
- The table on the right in figure 2 pairs trades together to reflect the profit, or value add, that comes from trading five-year maturity bonds in a risk-adjusted manner.
- Between mid-April and early June last year, tactically trading market volatility added four basis points.

Curve: We expect greater monetary policy flexibility and changing supply/demand dynamics to lead to greater volatility in the shape of the yield curve. We can be overweight or underweight in certain parts of the yield curve relative to the benchmark dependent on these known outcomes.

Cross-market: Central banks' monetary policy and supply profiles may diverge more over the coming decade, creating numerous cross-market trading opportunities. We can be underweight bonds in one country versus another on a hedged basis to add value from spread moves.

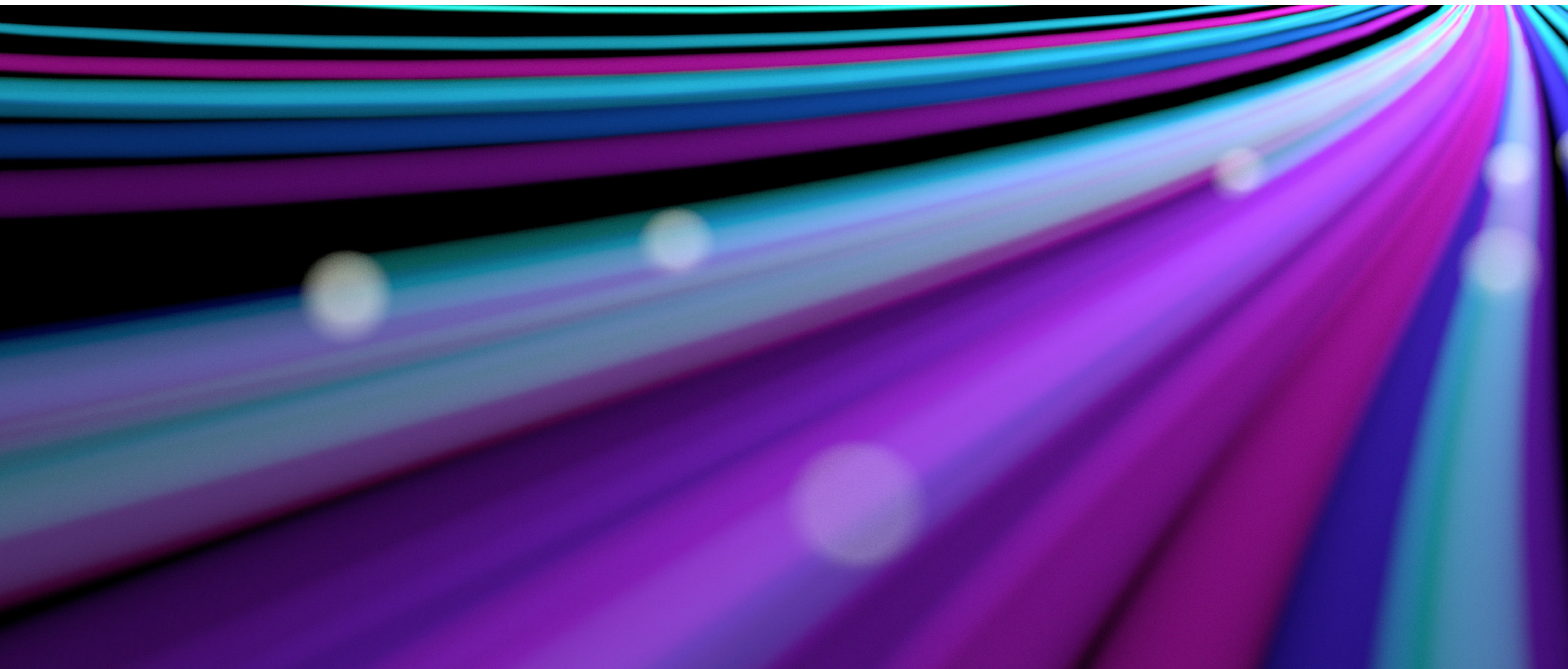
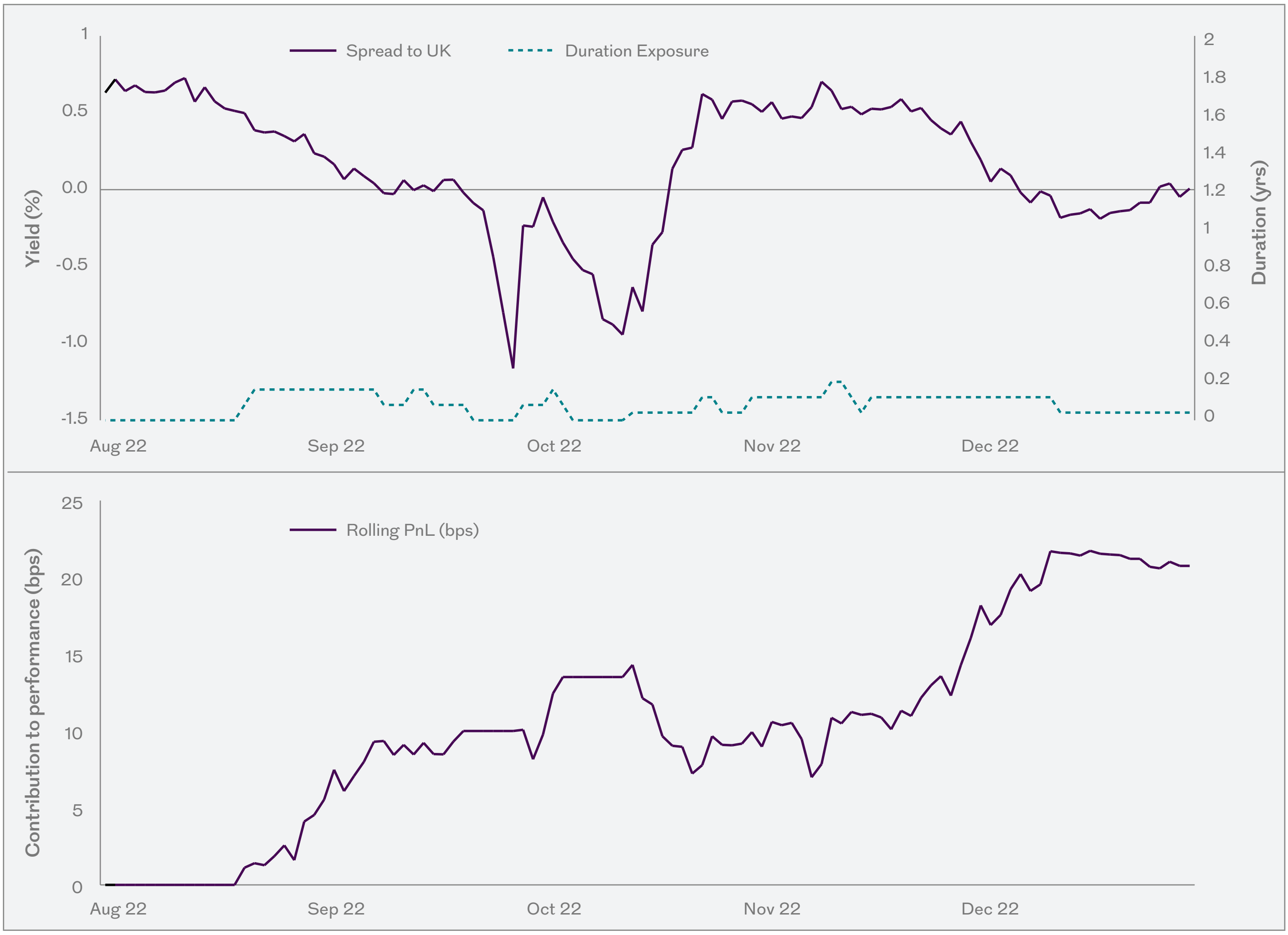


Figure 3: Relative positioning in US versus US/UK 30-year spread and cumulative P&L



Source: Bloomberg and RLAM.

Figure 3 is an example of how active managers can trade cross market spreads. The purple line in the top chart is the spread (yield differential) between 30-year maturity US and equivalent maturity UK government bonds (left-hand axis).

The teal line is the exposure to US bonds in duration terms (right-hand axis). In this example the exposure was relatively small, 0.2 years of duration contribution being the maximum size.

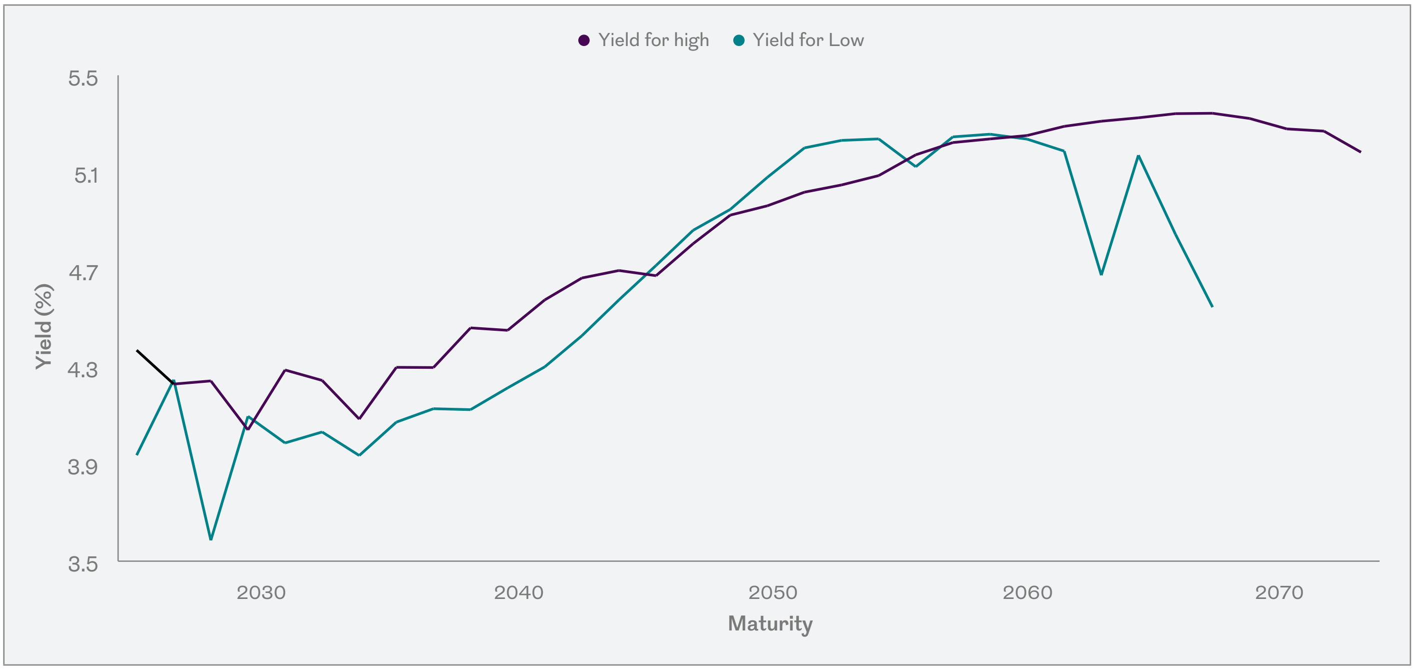
The bottom purple line is the contribution to performance from this cross-market position, which is both strategic, but also tactically traded around based on market moves.

The contribution to performance during the period shown was 20bps.

Inflation: The debate around hard versus soft landings, tight labour markets and geopolitical risks may lead to changing inflationary expectations and greater volatility in inflation break-evens. We can switch nominal bonds into index linked bonds or vice versa to reflect our inflation view.

Relative Value: QT sales and heightened volume of supply should increase the opportunities available to trade the relationship between specific bonds along the yield curve.

Figure 4: Trading bonds along the yield curve



Source: Bloomberg.

Figure 4 shows that in the UK there are two clearly defined curves – a low coupon curve consisting of bonds that were issued when interest rates were low (sub 1%), and a high coupon curve for very old, but also current 'on the run' bonds that are being issued in a higher interest rate environment.

The demand and supply dynamics for different bonds with different coupon, duration, and cash price dynamics creates opportunities for active investors to take advantage of mispricing's across the curve.

Credit: Utilising money market instruments, secured credit, and supranational bonds we can enhance portfolio yield by switching into these out of short dated low yielding sovereigns.

Why Royal London Asset Management

Our government bond team averages over 20 years' investment experience and has worked together through several market cycles including the Global Financial Crisis, Covid-19 pandemic, and the pension fund liquidity crisis.

We have developed a repeatable investment approach that combines research and portfolio construction to support strategic and tactical positioning across these multiple diversified opportunities in a risk-controlled manner.

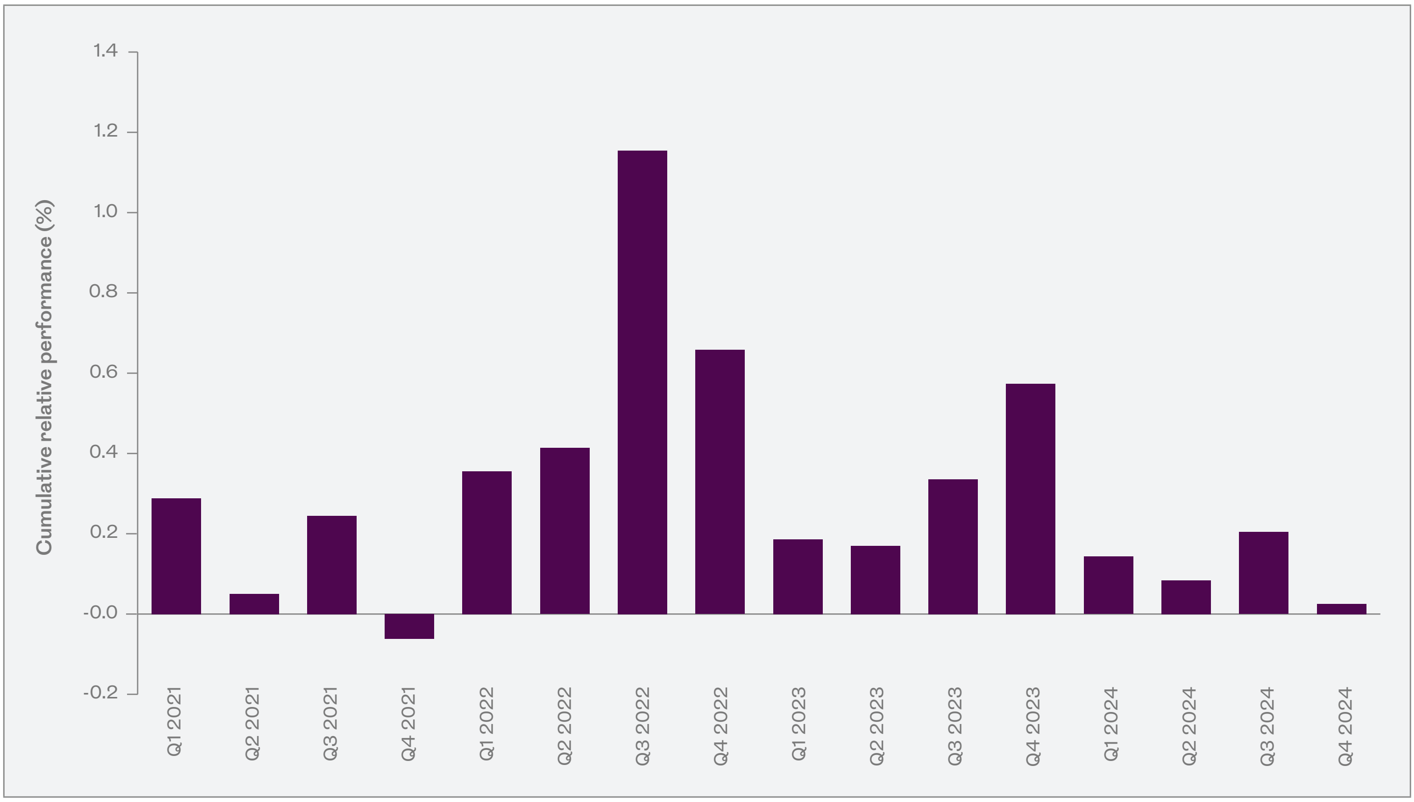
This has historically allowed us to successfully achieve the objective of strong, consistent performance across our range of funds.

Royal London UK Government Bond Fund overview

The fund aims to achieve a total return (combination of capital growth and income) 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 UK Gilts Government (All Stocks) Total Return GBP Index (the "Index") over rolling 5-year periods.

Figure 5 shows below the performance of the Royal London UK Government Bond fund relative to the benchmark, split into quarterly performance periods. We believe that bond market volatility provides active investors with that opportunity to take strategic and tactical positions in bond markets in a controlled and risk-adjusted manner.

Figure 5: Performance of the Royal London UK Government Bond fund versus the FTSE UK Gilts Government benchmark



Source: RLAM
Past performance is not a guide to 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.

Central to this performance is the active managers toolkit. Figure 6 depicts the contribution of each strategy to performance since the start of 2021. No single strategy dominates, but all have combined to deliver strong risk-adjusted diversified returns versus both the benchmark, but also relative to passive funds and our active peers.

Figure 6: Contribution of each toolkit strategy to performance since 2021

Strategy	2021	2022	2023	2024	YTD	Total
Duration	0.46	0.49	0.32	-0.26	0.02	1.04
Curve and RV	0.07	0.98	0.73	0.43	0.10	2.32
Cross Market	0.14	0.98	0.13	0.25	0.01	1.51
UK Inflation	-0.03	0.01	0.01	-0.01	0.00	-0.01
Credit	-0.04	0.14	0.08	0.04	0.00	0.23
Other	-0.07	-0.03	-0.01	0.00	0.00	-0.12
Total	**0.52**	**2.58**	**1.27**	**0.46**	**0.14**	**4.96**

Source: RLAM, subject to rounding.
For illustrative purpose only.

Fund risks

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.

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.

Contact us

For more information about our range of products and services, please contact us.

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