ROYAL LONDON EQUITIES

Fund Manager Commentary – December 2020

For professional clients only, not suitable for retail investors

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RLAM EQUITY PERFORMANCE

Fund Performance

	1 month (%)	Rolling 12 months (%)
RL UK Equity Income M Inc	**4.77**	**-14.89**
IA UK Equity Income Sector	3.53	-11.73
FTSE All Share Index	3.86	-9.82
RL UK Dividend Growth Fund M Acc	**4.57**	**-3.86**
IA UK All Companies Sector	4.24	-7.78
FTSE All Share Index	3.86	-9.82
RL UK Mid Cap Growth Fund M Acc	**6.75**	**-4.34**
IA UK All Companies Sector	4.24	-7.78
FTSE 250 ex-IT Index	6.54	-8.48
RL UK Opportunities Fund M Acc	**7.26**	**-5.46**
IA UK All Companies Sector	4.24	-7.78
FTSE All Share Index	3.86	-9.82
RL UK Smaller Companies Fund M Acc	**6.51**	**5.65**
IA UK Smaller Companies Sector	7.56	5.65
FTSE Small Cap ex-IT Index	6.69	1.65

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.

Source: RLAM and FE, correct as of 31 December 2020. Returns quoted are net of fees.

ROYAL LONDON UK EQUITY INCOME FUND

Portfolio Commentary

- During December, the fund was ahead of both the FTSE All Share index and competitor funds. Performance benefitted from a number of stocks including **Signature Aviation**, **Paragon** and **Imperial Brands**. There were no material detractors from performance, with the largest negatives being **Dunelm** and **Severn Trent**. Signature Aviation received two bid approaches during the month at a significant premium to the prevailing share price. We continue to hold the position, awaiting developments.
- We sold out of the fund's remaining holding in **McCarthy & Stone**, after the takeover had been voted through by shareholders, at a very small discount to the bid price. While the bid was an opportunistic one by private equity, the company is currently not paying a dividend and its most recent trading statement confirmed the challenging trading conditions that are resulting from the Covid-19 lockdown. We also added modestly to the fund's **British American Tobacco** holding.

Investment Outlook

- Covid-19 means we are facing a challenging start to 2021, with further lockdowns and tightening restrictions. The good news is that effective vaccines have now arrived and these are set to be rolled out in the UK during the first half of 2021 at speed. In addition, a Brexit deal has been agreed which provides a platform for future cooperation and partnership between two sovereign entities. It also gives clarity and certainty for businesses about future trading arrangements. We will continue to target those companies that we believe have good medium- and longer-term dividend paying capacity, without chasing dividend in the short term, and will retain a breadth and depth of industry exposure. We are very much sticking to our investment process and using this to guide us through the crisis.

Martin Cholwill

Head of UK Income Equities

ROYAL LONDON UK DIVIDEND GROWTH FUND

Portfolio Commentary

- December was a strong month for the UK equity market, with positive news of a Brexit trade deal with the EU outweighing worsening Covid-19 news. The Brexit news caused sterling to strengthen a little against other currencies, prompting the more domestically-focused FTSE 250 index of mid-sized companies to outpace the FTSE 100's larger stocks. The fund performed better than the benchmark index and its peer group in the month, returning 4.57% and ranking in the 44th percentile. The biggest driver of outperformance was the fund's holding in **Signature Aviation**, a company that provides services for small aircraft at US airports and airfields. During the month Signature announced that it had received a number of takeover approaches, causing its share price to rise significantly.
- For 2020, the fund was down by 3.86%, a significantly better return than the FTSE All-Share index which was down 9.82%. The fund ranked 31st percentile in its peer group.
- During the month, we sold the holding in **Signature Aviation** into the takeover-induced share price strength and eliminated the holding in healthcare company **UDG** after a strong run in its shares. We added to positions in **Sage** and **Diageo** and initiated a new holding in **Avon Rubber**, a specialist engineering company which provides breathing equipment and body armour to the military and emergency services. Avon's shares were hit by the announcement of teething issues with one of its newer contracts, but we felt this weakness was a good opportunity to start a position in a unique and well-financed company.

Investment Outlook

- The current news about the resurgence of Covid-19 in the UK is concerning, but there is some cause for optimism as the mass vaccination programme begins. The speed and effectiveness of the vaccine programme is likely to be a key driver of investor sentiment in the coming months. As consistently stated, we look to invest in a range of companies which are in control of their own fates, irrespective of market conditions. The Covid-19 shock is proving a stern test of this process and the resilience of those companies, but we continue to believe that the approach is serving investors well. As well as looking for durable businesses, a willingness to look through short-term extremes of sentiment and buy stocks when they are out of favour, or take profits when sentiment becomes exuberant, should drive longer-term performance.

Richard Marwood

Senior Fund Manager

Niko De Walden

Fund Manager

ROYAL LONDON UK MID CAP GROWTH FUND

Portfolio Commentary

- UK equity markets ended 2020 on an optimistic note, with Covid-19 vaccination programs underway and the agreement of a trade deal between the UK and the EU. The fund returned 6.8%, ahead of both the benchmark (the FTSE 250 ex-IT index) return of 6.5% and the peer group median return of 4.2%. This meant that, after a tumultuous twelve months, the fund ended the year -4.3%, ahead of its benchmark return of -8.5%. During December, stock selection provided the outperformance relative to the benchmark, while sector allocation, in particular the overweight to the healthcare sector, was a headwind as pro-cyclical sectors such as industrials and consumer goods led the way.
- **Applegreen**, the service station owner and operator, was the top contributor to returns after Blackstone private equity agreed to take it private with the management team, at a 50% premium. **Paragon**, the speciality lender, and **Watches of Switzerland**, the luxury goods retailer, were also among the top positive contributors. Paragon posted better-than-forecast results, demonstrating resiliency during an extraordinary period for lenders, and reinstated its dividend payments. Watches of Switzerland raised its earnings guidance for the year after strong trading during November and the first weeks of December. This marks its third upgrade since the initial pandemic downgrades, and again demonstrates how successfully the business has transitioned its model to operating remotely.

Investment Outlook

- December's macroeconomic headlines focussed on the last-gasp trade negotiations between the UK and the EU, and the initial Covid-19 vaccinations. The former is important for sentiment as much as limiting friction on goods traded across the border. More will need to be done for the UK's valuable services exports, but this is likely a better starting point than may have been the case in "no deal" scenarios. More critically for GDP and corporate profit growth, Covid-19 vaccinations started taking place across the UK during December. An accelerating rollout should enable a return to near normality by the summer months, if not earlier, and provide an end to the cycle of restrictions and disruption. This provides greater confidence in our expectations for a period of synchronised global growth, accelerating consumer spending and industrial inventory restocking through 2021 and into 2022.
- We continue to focus our efforts on investing in cash-generative small- and medium-sized companies, with strong balance sheets, structural earnings growth opportunities and valuation optionality.

Henry Lowson

Head of UK Alpha Equities

FE ALPHA MANAGER 2018 HENRY LOWSON citywire AA

ROYAL LONDON UK OPPORTUNITIES FUND

Portfolio Commentary

- The positive momentum in equity markets that was generated by the news of successful vaccine trials continued to influence sentiment in December. Markets across the globe increased as regulatory bodies approved the use of these vaccines and the rollout to the most vulnerable people began. In the UK, the FTSE All-Share index rose 3.9% as it became clear that a trade deal with Europe was likely to occur, and this duly arrived on Christmas Eve. The strongest performing sectors during the month were those which play into economic recovery, such as industrials, mining and chemicals. We remain optimistic that corporate earnings can recover after the pandemic and this, coupled with ongoing stimulus from central banks, gives the potential for the UK equity market to recover some, if not all, of the falls experienced in 2020.
- During December, the UK Opportunities Fund outperformed its benchmark, the FTSE All-Share Index (Total Return), returning 7.3% versus 3.9%. The fund has a mixture of high quality growth names, together with more cyclical stocks and some special situations names. This combination proved beneficial for performance. The strongest performers over the month included **Applegreen**, up 56% after the founders announced they wished to take the business private, **MJ Gleeson**, 19% higher, and **Victrex**, which increased 18%. Other notable performers included **Restore**, **Melrose** and **Prudential**.
- During the month we sold **GlaxoSmithKline** and purchased **AstraZeneca**. We think that AstraZeneca has a much stronger earnings-growth trajectory. Its shares fell when it announced that it will buy US biotech company Alexion. This gave us the opportunity to invest in a high quality story on a very reasonable multiple. In addition, we continued to add to the fund's position in **Tesco** and reduced the weighting in **Applegreen** following its bid, together with **Fevertree**.

Investment Outlook

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Craig Yeaman

Senior Fund Manager

ROYAL LONDON UK SMALLER COMPANIES FUND

Portfolio Commentary

- UK equity markets ended 2020 on an optimistic note, with Covid-19 vaccination programs underway and the agreement of a trade deal between the UK and the EU. The fund returned 6.5%, behind the benchmark (the FTSE Small Cap ex-IT index) return of 6.7% and the peer group median return of 7.6%. After a tumultuous twelve months, the fund ended the year making a return of 5.7%, significantly ahead of its benchmark return of 1.7%. Unusually, stock selection was a detractor from relative returns during December, in particular within industrials due to **Avon Rubber**. Offsetting this, sector selection was beneficial, in particular the overweight allocations to the technology and healthcare sectors.
- M&A was a feature of the month, with both **Codemasters**, the video games developer, and **Applegreen**, the service station owner and operator, receiving takeover bids. Codemasters became the subject of a competitive process after EA Games trumped Take Two Interactive's existing offer by 16%, with the shares rallying ahead of the new offer price in anticipation of a further approach by Take Two. Applegreen management proposed to take the group private, funded by Blackstone, at a 50% premium to the prevailing share price. **Kin + Carta**, the digital transformation consultancy, was also among the top contributors after agreeing the sale of its (non-core) healthcare communications business and the acquisition of US-based Cascade Data Labs. The divestment effectively completes its transformation from a communications and consultancy mini conglomerate to a streamlined, integrated, digital consultancy operating in a rapidly growing market, while Cascade Data Lads will enable it to accelerate growth with US West Coast clients.
- **Avon Rubber**, the specialist engineering group, was the largest detractor after issuing a profits warning due to delaying production on one of its contracts with the US Department of Defence. The issue is limited to one product rather than a technology or production facility, and management is confident that it will be able to rectify it in time to enter production in the next financial year, with no penalties to the total contract value.

Investment Outlook

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- We continue to focus our efforts on investing in cash-generative smaller companies with strong balance sheets, structural earnings growth opportunities and valuation optionality.

FE ALPHA MANAGER 2018 HENRY LOWSON citywire AA

Henry Lowson

Head of UK Alpha Equities

Henry Burrell

Fund Manager

ROYAL LONDON GLOBAL EQUITY INCOME FUND

Portfolio commentary

- It was a pleasing month for the fund, with performance driven by stock selection across a range of sectors, in particular IT, materials and healthcare. **Samsung** and **TSMC** were both up strongly as hopes for a prolonged semiconductor cycle continued to grow. **Adidas** was strong on positive numbers across the athleisure industry, while **Eli Lilly** was up double digits on the back of a positive pipeline update.
- Areas which were ignored by the market at any valuation pre-vaccine, namely financials and materials, are now areas of significant capital allocation as hopes of an economic recovery and fears of inflation started to drive behavioural decisions in the market. Having added significantly earlier on in 2020, we still like the balance of risk and reward in the stocks we hold in these sectors, but took some profits in **US Bancorp** after all of our US banks continued rallying strongly.
- We initiated a position in **CME**, a derivatives exchange with a strong market position and capital-light business model. Its trading should positively inflect if there is any upward move in bond yields because it is a market leader in interest rate hedging for corporates. We continued increasing our stake in **Gilead Sciences**, thinking its valuation looks far too low given its stable cashflow generation from HIV franchises, combined with an exciting pipeline of cancer drugs. This pipeline was acquired at huge expense from a variety of other companies, but that is done now and our focus is purely on the potential cashflow it may generate in the coming decade. These trades were funded by reducing our **Apple** position, which currently yields 0.6% and has more balanced risk and reward dynamics following a rally of more than 70% in its shares over the year. We also sold the small holding in **Home Depot**. While it is a strong business that has managed to compound consistently, it was boosted by Covid-19 as people spent more on DIY and it has a mature store footprint in the US. We see better long-term opportunities elsewhere.

Investment outlook

- The fund's diversification by sector, country and stage of lifecycle has borne fruit in recent months. Despite a complete change in market leadership, performance has remained strong. Its balance is crucial in the highly uncertain macro environment because it makes the fund less dependent on macro factors and more dependent on stock selection.

Niko De Walden

Fund Manager

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