ROYAL LONDON GLOBAL EQUITY DIVERSIFIED

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Top 10 holdings

	Fund (%)
Apple Inc	4.8
Microsoft	3.6
Amazon	3.2
JP Morgan Chase and Company	1.8
Visa	1.3
Alphabet	1.3
Facebook	1.2
Alphabet	1.2
Johnson & Johnson	1.2
Exxon Mobil	1.2
Total	**20.8**

Source: RLAM, based on the M Acc share class.

Fund data

	Fund
No. of stocks	184
Fund size	£2,871.8m
Launch date	10.10.2017
Active share	64.6%
Tracking error	1.5%

Performance

	Fund* (%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**7.79**	**7.78**	**0.01**
Year-to-date	11.41	12.32	-0.92
1 year p.a	11.41	12.32	-0.92
3 year p.a	10.51	10.16	0.35
Since inception p.a. 10.10.2017	10.75	10.08	0.67

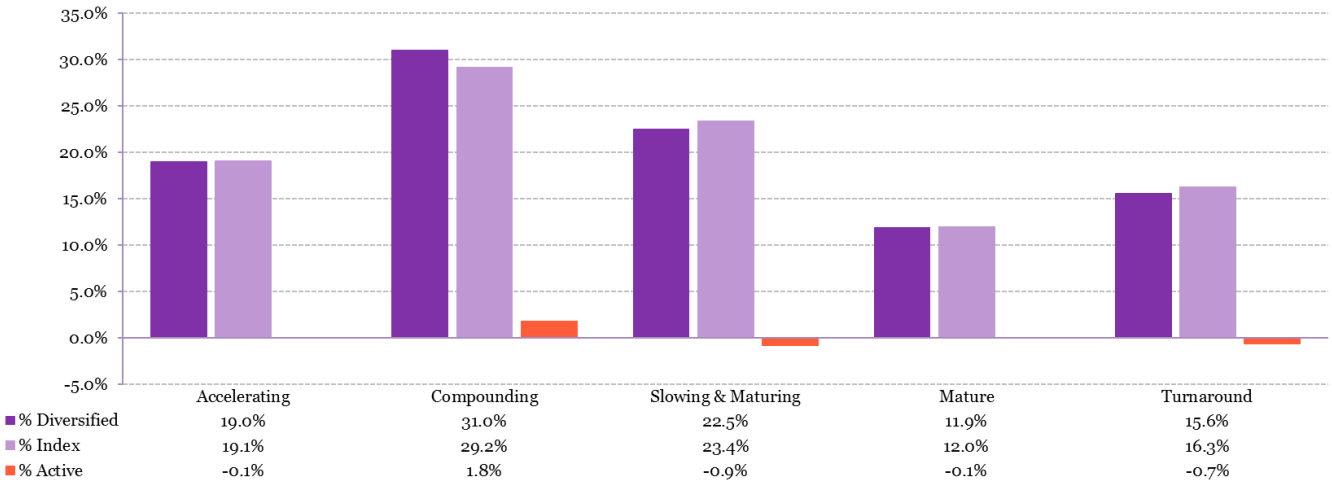
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Source: RLAM. All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.

[1]Benchmark: MSCI World NDR Index.

**Performance refers to R Acc share class unless otherwise stated. M Acc share class launched on 05.03.2018. Initial share class at fund launch was R Acc.*

Holdings and Weights



Source: RLAM as at 31 December 2020.

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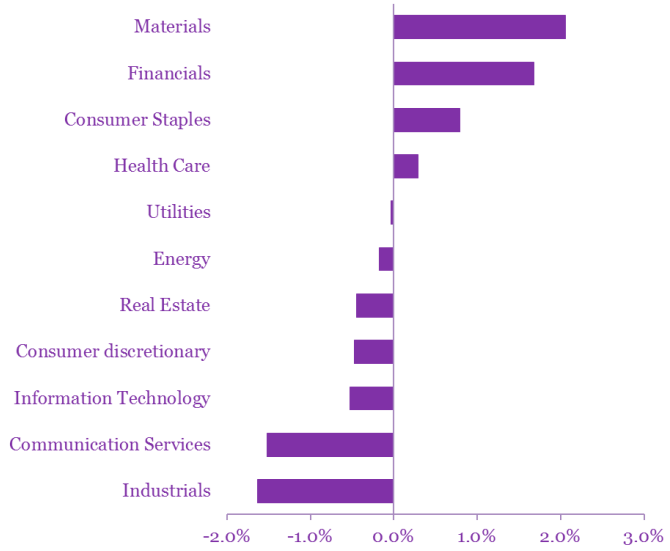
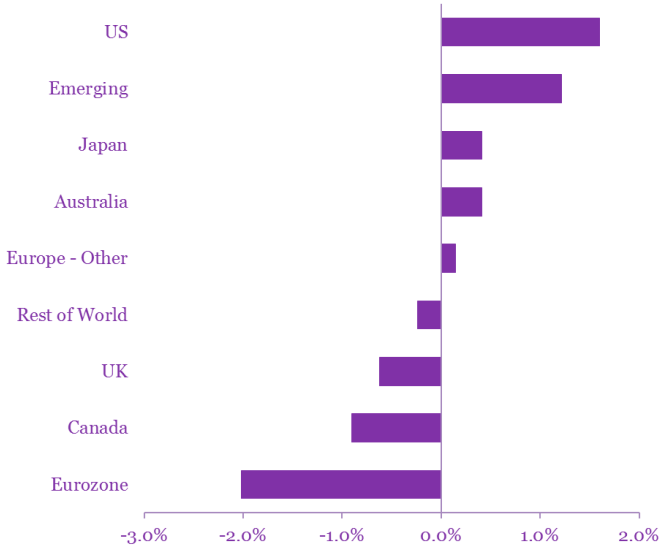
Sector weights



Regional weights



Source: RLAM as of 31 December 2020. Shows weight relative to index.

Executive summary

- The global equity strategies delivered good performance in the fourth quarter as equity markets pushed on from regaining the ground lost in February and March to reach new highs for the year as a whole. Our pooled funds delivered net returns of +9.29% for the **RL Global Equity Select Fund** and +7.66% for the **RL Global Equity Diversified Fund**, compared to +7.78% for the benchmark (MSCI World Net Total Return in sterling). For the 12-month period, the funds have returned +16.51% and +10.86%, respectively, against +12.32% for the benchmark (fund returns net of fees, for M Acc share classes).
- Covid-19 cases generally increased over the quarter with a more transmissible variant spreading quickly in parts of the UK, South Africa and other countries, leading to tighter restrictions. However, strong efficacy data in early November and subsequent regulatory approval allowed vaccination programmes to start. As a result, investors looked through the short-term challenges to the possibility of a strong economic recovery in the second half of 2021. Political issues were also prominent. Financial markets responded positively to the expected combination of a Biden presidency with a Republican Senate, even though two seats in Georgia required a runoff in early January. Congress finally agreed a $900bn (4% GDP) fiscal deal. The UK also agreed a trade deal with the European Union.
- As with previous quarters, the market recovery may seem surprising given the ongoing Covid-19 crisis and the economic impacts of lockdowns and other restrictions. Indeed, the pandemic has had clear negative impacts on corporate performance, which in some cases look to be structural rather than a shorter, cyclical hit. However, the monetary and fiscal responses have been equally dramatic, and have driven down fixed income yields to very low levels and equity discount rates to over 20-year lows. Although positive vaccines developments helped global markets, most were already up year-to-date before that news broke. While more transmittable strains of Covid-19 represent a near-term challenge with the need for tighter lockdowns, a number of other risks have lifted, including whether vaccines could be developed, US political risks and the UK-EU trade talks. While the first half of 2021 could be particularly volatile, governments and central banks remain committed to supportive monetary and fiscal policies, and we believe that equities will outperform bonds over the year with a strong economic recovery in the second half.
- We are conscious, however, that following the remarkable recovery of global equity markets from their lows in late March, valuations are less compelling. Using some valuation metrics, equities are the most expensive for several decades, and are approaching valuation peaks reached in the dotcom boom in 1999/2000. Nonetheless, relative to bonds, while clearly more expensive than at points in 2020, equity valuations are still not extreme and are actually lower than in 2018. We also believe earnings momentum will remain favourable. We believe sectors will be a key point of volatility risk, with the rotation into more cyclical/Covid-recovery stocks in the autumn showing the potential for positive and negative effects on performance. We are addressing this risk by minimising factor exposure to sectors and focusing on stock-specific risk.
- Our preference is to own wealth creating companies with suitable balance sheets for their underlying business and a conservative approach to credit diversified across regions, countries, industries and Corporate Life Cycle categories. No single model or analysis is a magic bullet for investing, but our Corporate Life Cycle model helps us to understand the world

as management teams see it and identify those that are actively responding to the crisis. Owning companies that merely survive the pandemic won't deliver significant outperformance. We are looking for the 'Accelerators' that are increasing investment to take full advantage of the current environment, and 'Slowing & Maturing' or 'Turnaround' companies that are doubling down on restructuring with an attractive valuation pay-off opportunity.

Market overview

- Major global stock markets delivered a strong fourth quarter. The MSCI World Index rose +7.8% in sterling terms. Remarkably, despite the pandemic, 2020 as a whole posted positive returns (+12.3%). All major markets rose during the quarter with the dispersion in returns resulting more from sector rotation. Among the major regions, emerging markets, Asia Pacific excluding Japan and the UK were the stronger markets, whereas Japan, Europe excluding the UK and the US were slightly more pedestrian.
- Companies that had been struggling because of Covid-19 tended to perform well on the Pfizer vaccine news, while several sectors rose on the prospect of a more traditional US president and gridlock in the legislative bodies preventing extreme policy decisions. Unlike prior quarters, it was not technology that led sectors (+6.8% in sterling terms during quarter), but a strong recovery in energy (+20.3%) and financials (+17.4%), which had previously underperformed. For the full year, however, energy was still down -36.3%.
- The Bank of England (BoE) has continued to neutralise the impact of government bond issuance through asset purchases, which were extended in the quarter. The Federal Reserve (Fed) and European Central Bank (ECB) are operating similar quantitative easing programmes. In addition, the removal of roadblocks to the dispersal of the €750bn EU Recovery Fund was a significant positive for European economies.
- With renewed lockdowns in many countries and activity remaining below normal levels, yields on benchmark 10-year government bonds fell over the quarter in most major developed markets, apart from the US, Canada, Sweden and Japan. The yield on 10-year gilts decreased 3 basis points (bps) to 0.20% and shorter-dated government bond yields remained negative, although the BoE continued to eschew the policy option of negative base rates.
- Credit spreads tightened further reflecting increased economic activity and central bank support for struggling companies. The average sterling investment grade spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) ended the quarter a further 30bps tighter at 0.99%, which compares with an average spread of 1.14% at the end of 2019. This is a remarkable turnaround considering that the average spread was as wide as 2.25% at the peak of the market sell-off in March.
- Sterling was among the stronger major currencies over the quarter, strengthening another 5.4% against the US dollar following the recent decision by the Fed to alter its inflation targeting methodology. It also strengthened marginally against the euro and against the yen. This strength tempered the returns for sterling investors in global equities.
- Oil prices recovered strongly in the quarter as global economy continued to grow and Saudi Arabia announced production cuts. The price of Brent crude oil rose by +26.5% to over $52 a barrel. Copper continued to strengthen as economic activity strengthened in China, rising +15.8% over the quarter. Gold fell -0.2% to $1,933/oz., although this masked its volatility across the quarter as some investors sought a safe haven on renewed fears about Covid-19 and political risks.

Performance and activity

- The **RL Global Equity Diversified Fund** performed broadly in line with the benchmark. Stock selection was notably strong in semiconductors, where the holdings in **Taiwan Semiconductor Manufacturing** (TSMC) and **Micron** performed strongly. Whereas Micron was driven by the industry-wide recovery in DRAM prices (with spot prices rising +28% from their August lows), the strong performance of TSMC was specific to the decline of Intel. TSMC has achieved such an IP advantage in core and graphical processors that Intel has announced a strategic review and is considering outsourcing the manufacture of its processors to TSMC. This transformative shift would be a major boost for TSMC. As an example of its leadership, TSMC is producing the M1 chip that is integral to new Apple MacBooks. Combined with not owning Intel, this was a strong contributor to performance. Otherwise, **Trade Desk**, which is a digital advertising marketplace, rose +46% over the quarter following strong results and improving competitive landscape – the stock was a relatively recent purchase for us. French aircraft engine manufacturer **Safran** performed well across the quarter. Following the lifting of some European travel restrictions in October, the broader hope of successful vaccine rollouts was very positive for travel-related companies. The company's valuation remains attractive and it is well placed to benefit from a recovery in the airline industry. Otherwise, not owning Salesforce, Nvidia and SAP was beneficial for performance as these index constituents notably underperformed. These outperformers were offset to some extent by weakness in Consumer Staples holdings, like **Church & Dwight** and **McCormick**, and other stocks perceived to have defensive cashflows, such as **Verizon Communications**, the mobile network operator, and car insurer **Progressive Corporation**.

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- Volatile market conditions and the rotation away from highly-rated growth companies to 'Covid-recovery' stocks provided opportunities to add to some holdings at attractive prices. In terms of strategy, we increased the balance towards the more leveraged stocks in the fund, such as financials, chemicals and energy stocks. We also initiated positions in **Nvidia** (at the end of the quarter, following underperformance), where the wealth creation potential is strong and not fully discounted, funded by reducing exposure to **Tesla**; and **Pinterest**, which we funded by reducing **Alphabet**. Otherwise, we conducted a review of the medical equipment and technology sector, reducing **Thermo Fisher Scientific**, **Medtronic** and **Danaher** to initiate positions in **Intuitive Surgical**, **Idexx Labs**, **Mettler-Toledo** and **Carl Zeiss Meditec**, and add to **Stryker**. We also decided to sell down **Omnicom**, feeling there are better opportunities elsewhere, and continued selling **PCCW** on governance concerns following a corporate action.

Outlook

- While new, more transmittable strains of Covid-19 represent a near-term challenge with the need for tighter lockdowns, a number of other risks have lifted, including whether vaccines could be developed, US political risks and the UK-EU trade talks. While the first half of the year could be particularly volatile, governments and central banks remain committed to supportive monetary and fiscal policies, and we believe that equities will outperform bonds over the year with a strong economic recovery in the second half.
- We are conscious, however, that following the remarkable recovery of global equity markets from their lows in late March, valuations are less compelling. They are challenged in many areas and using our global discount rate methodology are approaching the extremes seen in the Tech Bubble. Nonetheless, relative to bonds, while clearly more expensive than at points in 2020, equity valuations are still not extreme and are actually lower than in 2018. We also believe earnings momentum will remain favourable. We believe sectors will be a key point of volatility risk, with the rotation into more cyclical/Covid-recovery stocks in the autumn showing the potential for positive and negative effects on performance. We are addressing this risk by minimising factor exposure to sectors and focusing on stock-specific risk.
- There will be challenging periods in the year ahead. At a macro level, a reversal in the bond markets similar to 1994 would impact equity returns as would a change in perception around central bank support. In this respect, the sustained rallies in oil, copper and other commodities could create a headwind to the expectations of lower rates for longer as higher input prices could feed through to inflation if they're not absorbed by manufacturers. This may challenge the current low rate environment orthodoxy, which has been a contributor to the outperformance of growth stocks. There are also signs of increasing costs elsewhere with container rates from China to the Los Angeles having more than doubled since the start of 2020. Other than these risks, there will no doubt be stock-specific hits from earnings releases or trading statements for companies that fail to meet the high expectations of analysts and investors. Some technology stocks that pulled forward demand in lockdown could be vulnerable once we move to more normal conditions.
- The benefits of our disciplined investment approach – a focus on stronger business models combined with robust portfolio risk controls – enable superior stock wealth creation and valuation to drive long-term performance. As vaccination programmes roll out and economic conditions normalise, we see opportunities for the underlying stability of many of the businesses to be better reflected in valuations. We believe that active equity managers, in particular, will perform well in the recovery from the pandemic. The crisis will result in strong companies (high returns, strong balance sheets and good 'moats') getting stronger as they are better able to take advantage of opportunities, whether through new areas of demand or having better balance sheets to navigate through lower levels of cash generation in most industries.

Further insights from the Global Equity team

- To find out more about our investment approach to investing in global equities and our current thinking, please visit rlam.co.uk.
- Talks from the online *RLAM Investment Series* that was held in September/October 2020 can be viewed on BrightTALK.com; including Will Kenney's *The growth vs. value debate: is it real or relevant anymore?* and James Clarke's and Carlota Garcia-Manas's *Responsible global equities*. Each presentation lasts for 30 minutes, including Q&A.
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2021 document.

ROYAL LONDON
ASSET MANAGEMENT

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