ROYAL LONDON GLOBAL EQUITY SELECT

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Top 10 holdings

	Fund (%)
Microsoft	4.8
Anglo American	4.8
Steel Dynamics	4.7
Reliance Steel & Aluminum Co.	4.7
Safran	4.6
Amazon	4.5
Visa	4.5
Samsung	4.0
HCA Healthcare	3.6
Bandai Namco	3.6
Total	**43.9**

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

Fund data

	Fund
No. of stocks	34
Fund size	£269.0m
Launch date	10.10.2017
Active share	87.2%
Tracking error	4.2%

Performance

	Fund* (%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**9.50**	**7.78**	**1.72**
Year-to-date	17.32	12.32	5.00
1 year p.a	17.32	12.32	5.00
3 year p.a	13.22	10.16	3.06
Since inception p.a. 10.10.2017	13.21	10.08	3.12

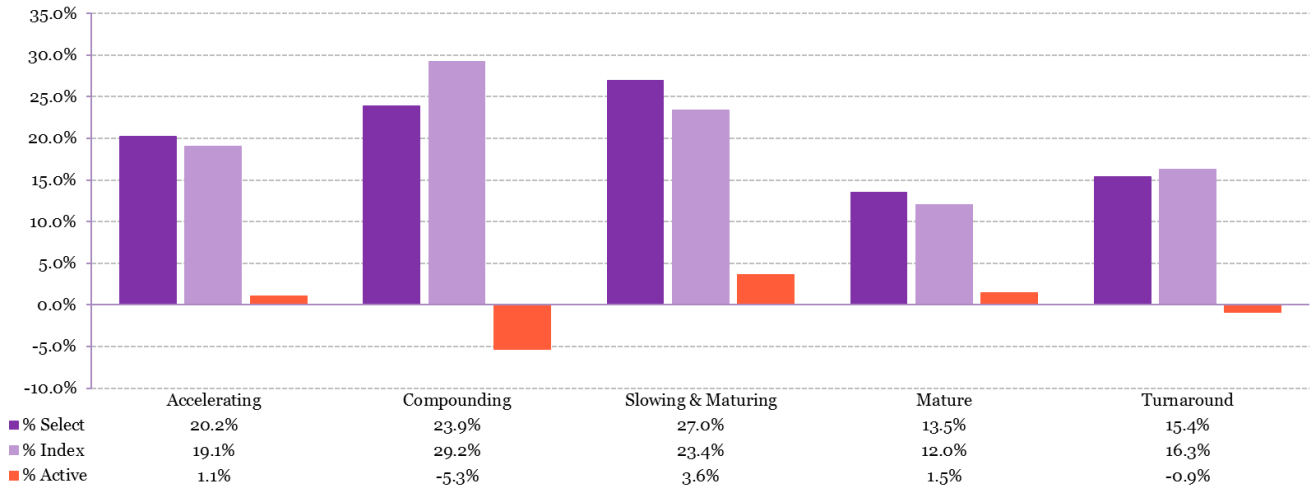
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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.*

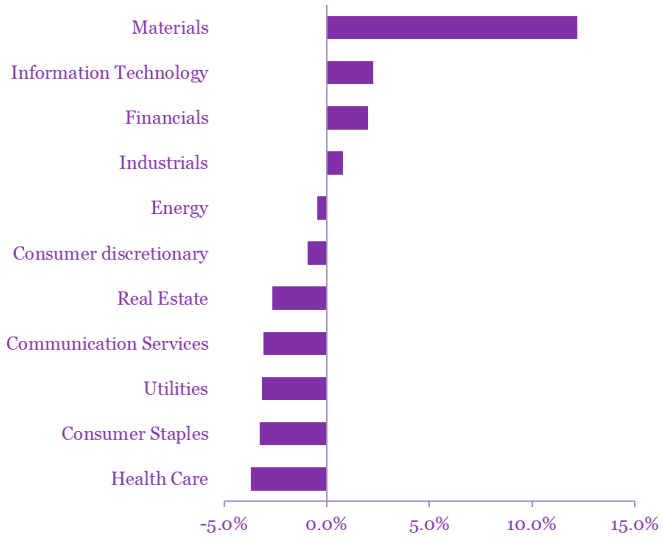
Holdings and Weights



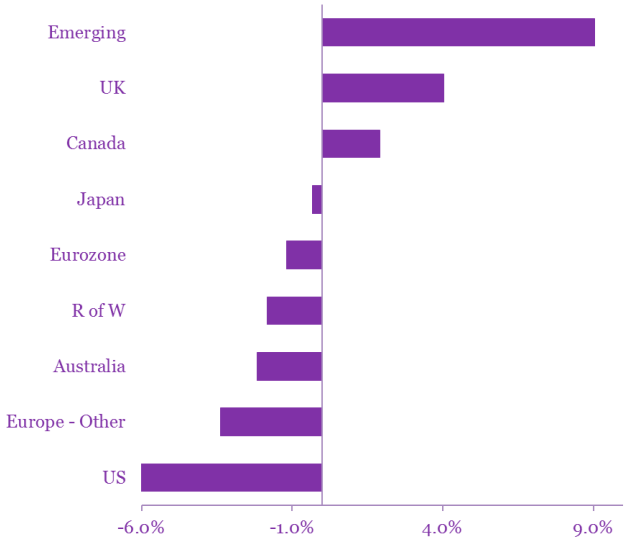
Source: RLAM as at 31 December 2020.

ROYAL LONDON GLOBAL EQUITY SELECT

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 Select Fund** strongly outperformed its benchmark over the quarter and 12-month period. Semiconductors stocks (Samsung, Micron and Taiwan Semiconductor (TSMC)), Safran and Anglo American contributed strongly to returns over the quarter. **Samsung**, which is in the 'Turnaround' category of the corporate Life Cycle, and **Micron** ('Slowing & Maturing') are closely aligned as DRAM chips are a key component of their sales. Both companies benefitted from an upturn in the DRAM market – while not a perfect indication of the contract part of the market, spot prices for standard chips have increased +28% from their recent lows in August. Crucially, the manufacturers also stayed profitable across the cycle, which has not been the case in previous DRAM price cycles. As well as this structural boost, there is a long-term demand story as 5G phones require more RAM and the ongoing trend to digitisation, which has been boosted by increased remote working in the pandemic, is increasing the demand for data centre servers. The strong performance of **TSMC** ('Compounding') was related 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. French aircraft engine manufacturer **Safran** ('Slowing & Maturing') 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. **Anglo-American** ('Mature') also benefitted from the general positive shift in sentiment. While metals have been more resilient than oil through the crisis, the possibility of a 'return to normal' next year, still boosted prices. As an example, copper rose +15.8% in the quarter to reach its highest level since early 2013.

- Detractors from performance included Church & Dwight, Verizon Communications and Progressive Corporation. Having been an outstanding performer last quarter, US household products company **Church & Dwight** ('Slowing & Maturing') paused as the market shifted with the optimism around successful rollouts of vaccination programmes. The company's defensive qualities had served it well through the recent challenging period with demand for its staple products holding up or even increasing despite the impact of the Covid-19 pandemic as well as the positive impact of a lower rate on its cashflows. It naturally underperformed as both factors reversed. The same applied to **Progressive Corporation** ('Accelerating'). The US auto insurance specialist had performed particularly well earlier in the year as its revenue is particularly defensive – insurance is a legal requirement and paid in advance, so is far less vulnerable to consumer discretion in a downturn. Given the early lockdown greatly reduced miles driven and accident claims, this led to a period of supernormal profit. As activity returned to more normal levels later in the year, this effect unwound. However, even with the quarter's weaker performance, Church & Dwight and Progressive each returned roughly twice the level of the broad market over the full year. While we have taken some profits, both stocks remain key components of our diversified portfolio approach. **Verizon Communications** ('Mature') was similarly affected by the rotation into 'Covid-recovery' stocks as the defensive cashflows of mobile telecoms were less prized by investors. In addition, its revenues were impacted by lower international roaming activity (for which the charges are onerous for US consumers) and the launch of the new Apple iPhone 12, which delayed handset upgrades. Nonetheless, we remain positive on the rollout of 5G in the US, particularly as the company hopes to capitalise on this by offering 5G at home as a broadband connection.
- 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 the run up to the US elections, the valuation of **HCA** was attractive as its prospects as the largest-scale provider of hospitals across the US are compelling. Following a sector review, we added to South Korean bank **KB Financial** and separately added to **Safran** and **Bridgestone**. We felt the market reaction to **Reliance Steel**'s results provided an opportunity to add to this high-quality metal services company. Against these trades, we took some profits in a number of defensive stocks that have performed strongly through the crisis, including **TSMC**, **Church & Dwight**, **McCormick** and car insurers **Progressive Corporation** and **Admiral**. We also reduced Japanese stationary supplier **Kokuyu**, feeling there are better opportunities elsewhere.

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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