ROYAL LONDON UK EQUITY INCOME FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Astrazeneca	5.5
British American Tobacco	4.4
GlaxoSmithKline	4.0
Rio Tinto	4.0
Royal Dutch Shell	3.8
IG Group	3.4
Signature Aviation	3.4
Dunelm Group	2.9
3i Group	2.8
Close Brothers	2.8
Total	**37.0**

Fund data

	Fund
No. of stocks	49
Fund size	£1,796.2m
Launch date	11.04.1984

Source: RLAM, based on the A share class.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**13.70**	**12.62**	**1.08**
Year-to-date	-14.30	-9.82	-4.48
Rolling 12 months	-14.30	-9.82	-4.48
3 years p.a.	-0.97	-0.91	-0.06
5 years p.a.	4.24	5.14	-0.89
10 years p.a.	8.77	5.57	3.20
Since inception p.a. 30.06.2000	6.97	4.47	2.50

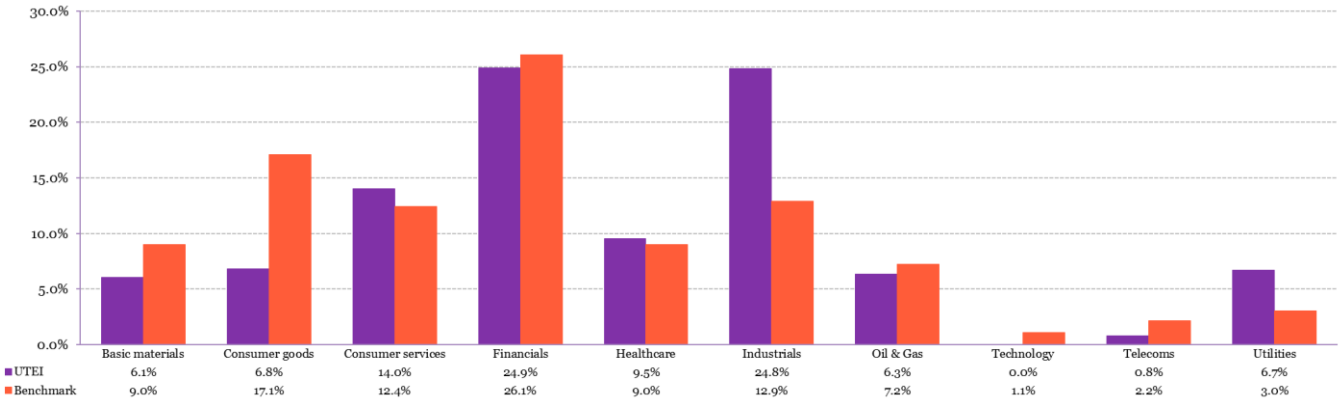
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated.

Source: RLAM, as at 31 December 2020, based on the A Income share class.

[1]Benchmark: FTSE® All Share Index.

Sector breakdown



Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held.

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Fund performance

- During the fourth quarter, the fund was ahead of the FTSE All Share index, but behind competitor funds. Performance benefited from a number of stocks including **Signature Aviation**, **McCarthy & Stone**, **WH Smith**, **ITV** and **Paragon**. Both Signature Aviation and McCarthy & Stone received bid approaches from private equity during the quarter at significant premiums to their prevailing share prices. All these stocks have seen their share prices negatively impacted by the pandemic and should benefit from economic recovery post-Covid.
- Detractors from performance included **Dunelm**, **Hargreaves Lansdown**, **IG Group**, **Segro** and **Pennon Group**. In general, these stocks performed well in the earlier part of 2020, being seen by the market as quality growth stocks, and were vulnerable to profit taking as the market rotated towards perceived recovery stocks during the quarter.
- 2020 has been a disappointing year for performance, negatively impacted by Covid-19. Nevertheless, we still believe that our investment philosophy and approach is the right one longer term, and it has served us well over many years. We continue to back our convictions and have not allowed our investment style to drift. Ultimately, we believe the stockmarket will reflect the intrinsic worth of companies, or else be corrected through takeover activity.

Fund activity

- During October, the shape of the portfolio did not change materially, with activity largely focussed on broadly-based trades to cover client activity. We are maintaining liquidity so that we have the flexibility to participate in any fund raisings that result from the current challenging economic conditions.
- During November, we participated in a share placing by **Ricardo**, with the company strengthening its balance sheet to give itself more financial flexibility. The placing was done at a 10% discount to the prevailing share price and it felt like an attractive time to add to the holding given the valuation multiples are undemanding, especially when the economy starts to recover. We also took some profits in **McCarthy & Stone** at slightly above the agreed bid price.
- During December, 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 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. Shares have been very dull over the last few months, but industry volumes are holding up well in key markets, the high dividend looks secure and the FDA does not look to be targeting any material industry change over the immediate future, such as a menthol ban.

Market background and outlook

- During the fourth quarter, the pandemic has continued to take a significant toll on the economy and personal lives. Sadly, with cases currently rising sharply across many European countries, in part due to a more virulent strain of the virus, we are facing a tough first quarter of 2021 with further lockdowns and tightening restrictions. Throughout the pandemic, the strategy of governments across Europe appears to be to suppress the virus through a range of restrictions until a vaccine arrives.
- The good news is that effective vaccines have now arrived and been approved by the UK regulator and other countries around the world. These are set to be rolled out in the UK during the first half of 2021 at speed. The Pfizer vaccine has already been used widely in hospital settings and the AstraZeneca vaccine can be rolled out quickly and more widely due to its simple logistical requirements.
- In addition, we have seen resolution of Brexit after more than four years of negotiations. For much of this period the Brexit negotiations have been centre stage, but during 2020 their potential impact on the UK and European economies has been dwarfed by the global pandemic. The deal appears to be a reasonable one for both the UK and EU, and provides a platform for future cooperation and partnership between two sovereign entities. It also gives much wanted clarity and certainty for businesses about future trading arrangements.
- The pandemic has touched everyone's lives in a profound manner. Unfortunately there has already been a huge economic cost to dealing with Covid-19, although this has not yet been fully felt by the population due to the cushioning effect of government measures such as furloughing. Rising unemployment looks likely in 2021. The immediate outlook for the UK economy is far from clear, although given tier four lockdowns across much of the country, it feels right to assume that we face a very challenging start to 2021. However, things are likely to look significantly more positive later in 2021, provided vaccines can be successfully rolled out.
- We still do not know exactly what the 'new normal' will eventually look like, or indeed how robust consumer confidence will be. The extent to which individuals will be able to decide their own risk appetite for the activities they choose to do going

forward is unclear, although it looks increasingly likely that the government will continue to micromanage many areas of everyday life post vaccines. We suspect that economic recovery will take several years to happen, with 2021 being a transitional year for improving economic activity, but the truth is nobody really knows yet. Ultimately, we suspect that we will just have to learn to live with the virus longer term.

- The response to Covid-19 has meant that government debt levels are much higher than have hitherto been the case, except in the immediate aftermath of world wars. Given the scale of government indebtedness, interest rates look set to remain at rock-bottom levels for the foreseeable future and yield curves will be heavily managed by governments. When the dust settles, taxes may need to rise to help pay for the support given by governments.
- The geopolitical background remains as fluid as ever. Issues such as simmering trade tensions between the US and China have not gone away and we do not think that a new president will make much difference short term, judging by the rhetoric so far.
- 2020 has been characterised by the widespread cuts in UK dividends. Many companies stopped giving forward guidance due to the uncertain outlook, and others, with more challenged balance sheets, have raised additional capital to bolster their finances. We think that virtually no industry will ultimately be immune from the economic and political impact of coronavirus, which is likely to cast a shadow over the global economy for a significant period of time. More encouragingly, we have seen a range of companies reinstate their dividends during the last few months, including a number held by the fund. Companies are now much more on the front foot and planning for the future. Successful companies will adapt to the 'new normal'.
- We expect more companies, that have historically prioritised dividend payments, will return to paying regular dividends during 2021, albeit the quantum may be rebased in some cases. Equity in business has a cost of capital and that is expressed through dividend payments. History teaches us that companies which thrive longer term have capital discipline in their DNA. Equity investment combines a number of attractive features in normal times, such as good liquidity, an inflation hedge and income, and therefore will remain an important asset class for investors, albeit one that can be incredibly volatile. In a world that continues to be hungry for income, we believe that once we have put coronavirus behind us, the UK stockmarket will still be an attractive and sustainable source of income, and that well-executed equity income strategies can again flourish.
- We expect opportunistic takeover activity to be a theme of 2021. There is plenty of longer-term value in many Covid-impacted companies that is not reflected in their current share prices. Private equity and infrastructure funds currently have access to some incredibly cheap capital, which they can profitably deploy. The recent **Signature Aviation** bid approach is a good example of this.
- Our approach of investing in companies with sustainable dividends has inevitably been seriously challenged in the short term by the exceptional circumstances we currently face, but we still believe that the fund is well positioned longer term through its focus on companies with strong market positions and sound finances. We will continue to target those companies which we consider to have good medium- and longer-term dividend paying capacity, without chasing dividends in the short term, as this would risk too narrow a portfolio centred on a small number of companies and industries. We will retain a breadth and depth of industry exposure, as well as a balance between domestic and international earners. We are very much sticking to our investment process and using it to guide us through the crisis.

ROYAL LONDON
ASSET MANAGEMENT

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