ROYAL LONDON GMAP DEFENSIVE FUND

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON GMAP DEFENSIVE FUND **3**

ROYAL LONDON GMAP DEFENSIVE FUND

Fund data

	Fund
Fund size	£83.6m
Launch date	14.03.2016

Source: RLAM. Based on the M Inc share class.

Performance

	Fund (%) (M Acc)	Fund (%) (M Inc)	Benchmark (%)	Relative (%) (as compared to M Inc)
Q4 2020	**3.74**	**3.75**	**2.85**	**0.91**
Year-to-date	0.86	0.77	2.97	-2.20
Rolling 12 months	0.86	0.77	2.97	-2.20
3 years p.a	2.08	2.03	2.90	-0.87
Since Inception p.a. 14.03.2016	3.60	3.57	4.35	-0.78

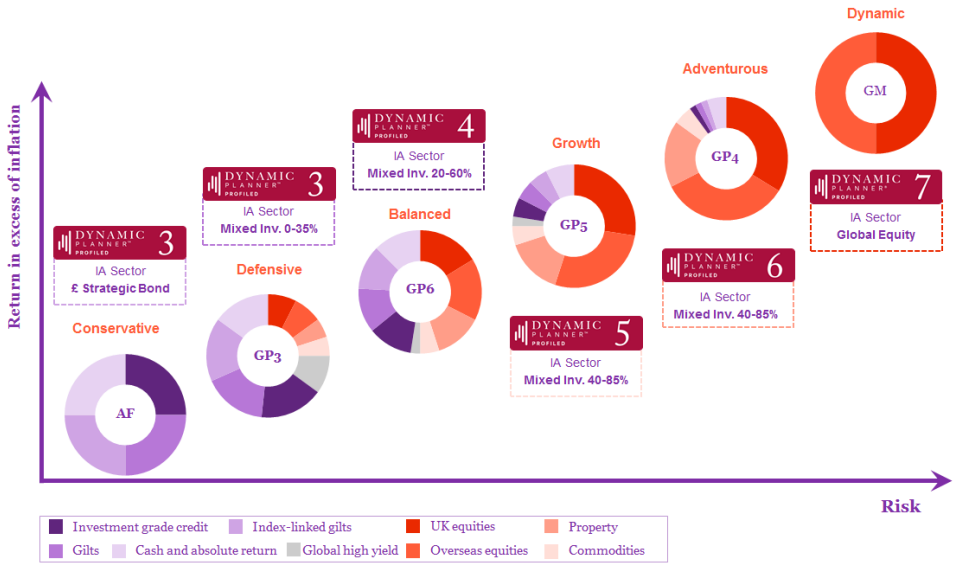
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Source: RLAM, based on the M share classes. Performance for the fund is calculated on a mid basis with income re-invested. The fund returns in the table above are gross of standard management fees. All performance figures stated gross of fees and tax unless otherwise stated.

[1]GMAP Defensive Composite Benchmark. The benchmark has been designed with the aim of maximising long run return in excess of inflation for a given level of risk.

As of 6 April 2017, the UK Government announced that funds paying interest distributions (funds more than 60% in interest bearing assets, such as fixed income securities/bonds and cash) will be required to pay those distributions gross of tax.

RL GMAP range

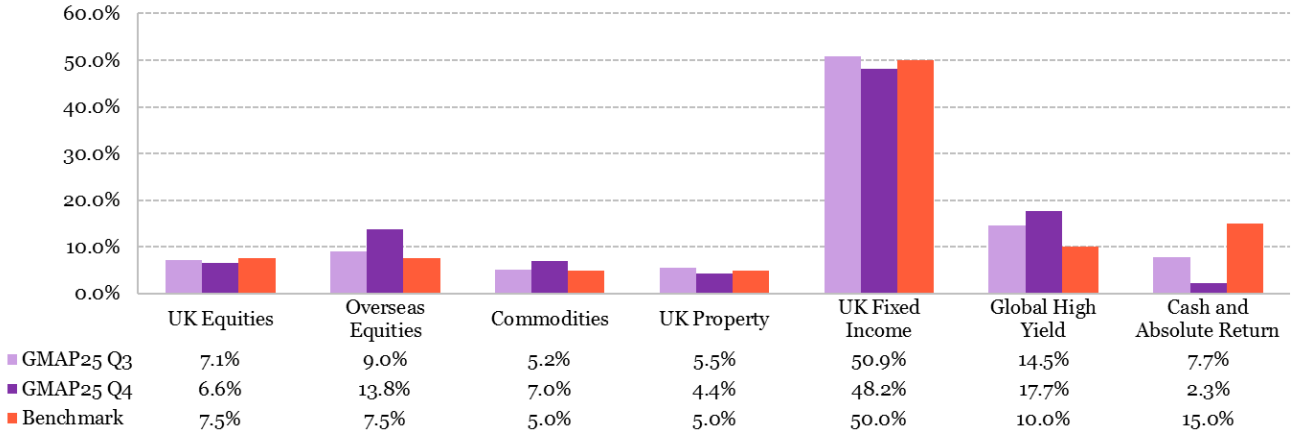


Risk rating is established by Distribution Technology (DT) and is out of 10. For illustrative purposes – reflects Strategic Asset Allocation weightings, may vary in accordance with tactical asset allocation.

Our GMAPs fund range is designed to span the risk return spectrum, with each fund aiming to maximise the long-term real return for its given level of risk through a broadly diversified portfolio of investments.

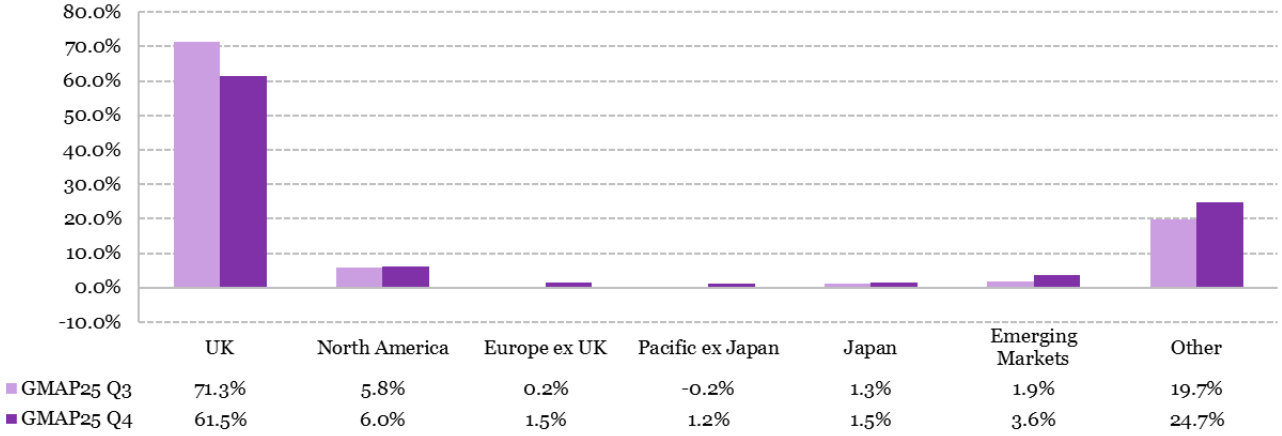
ROYAL LONDON GMAP DEFENSIVE FUND

Asset split



Source: RLAM. We take a holistic approach to fixed income management and fund weights relative to their respective benchmarks may not reflect tactical exposures. Figures calculated on a 'look through' basis, reflecting underlying assets, not fund component weights.

Geographical breakdown



Source: RLAM. 'Other' region includes global fixed income exposures, which are sterling hedged and commodity exposures. Figures calculated on a 'look through' basis, reflecting underlying assets, not fund component weights.

Ten largest holdings

	Asset type	Weighting (%)
RL Global High Yield Bond Fund	Global High Yield Bonds	16.2
RL Short Duration Gilts Fund	UK Fixed Income	12.2
RL Investment Grade Short Dated Bond Fund	UK Fixed Income	11.5
UK Treasury 0.125% IL 2026	UK Fixed Income	7.9
Commodities ETF	Commodities	7.0
RL Ethical Bond Fund	UK Fixed Income	6.7
RL UK All Share Tracker Fund	UK Equities	5.7
RL Short-Term Money Market Fund	Cash	5.5
RL Sterling Credit Fund	UK Fixed Income	4.9
RL UK Government Bond Fund	UK Fixed Income	4.8
Total		**82.5**

Source: RLAM. Information as at 31 December 2020 and correct at that date, unless otherwise stated. Total weight reflects rounding.

ROYAL LONDON GMAP DEFENSIVE FUND

Executive summary

- Covid-19 cases generally increased over the fourth quarter and a more transmissible variant spread 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 prospect of a Biden presidency with increased fiscal stimulus expected. Congress finally agreed a $900bn (4% GDP) fiscal deal. The UK also agreed a trade deal with the European Union, boosting sentiment.
- Leading global stock markets delivered a strong quarter with all major markets rising. Emerging markets, Asia Pacific (ex Japan) and the UK were the stronger markets, whereas Japan, Europe (ex UK) and the US were more pedestrian. Dispersion in returns came more from sector rotation. Companies that had been struggling because of Covid-19 reacted very positively to the positive vaccine news, while several sectors rose on the prospect of a more traditional US president and the prospect of more stimulus. Governments and central banks continued to offer support to companies and furloughed employees as well as underpinning financial markets through quantitative easing (QE). With renewed lockdowns in many countries and activity remaining below normal levels, government bond yields fell in most major developed markets, apart from the US, Canada, Sweden and Japan. Gilts were particularly volatile as the UK-EU trade negotiations went down to the wire. Credit spreads tightened further and ended the year lower than at the end of 2019, boosting the returns from investment grade and global high yield corporate bonds. Oil prices recovered strongly as the global economy continued to grow and Saudi Arabia announced production cuts. Copper prices rose to their highest level since early 2013 as economic activity continued to strengthen in China and the wider region.

GMAP fund	Q4 2020 performance (M class, Acc – net of fee)	GMAP custom benchmark	IA sector	IA sector average performance
Conservative	1.67%	1.01%	£ Strategic Bond	3.81%
Defensive	3.58%	2.85%	Mixed Investments: 0-35% shares	4.21%
Balanced	5.05%	4.32%	Mixed Investments: 20-65% shares	6.71%
Growth	7.06%	6.72%	Mixed Investments: 40-85% shares	7.99%
Adventurous	8.01%	7.89%	Mixed Investments: 40-85% shares	7.99%
Dynamic	10.39%	10.61%	IA Global	9.47%

- We participated in the ongoing rally in risk assets, remaining overweight in global high yield and commodities through the quarter. We had moved to a more neutral position in equities in the third quarter, feeling that the risks were more finely balanced following the strong recovery in global stocks from the March lows and the risks of renewed restrictions and political disruption (US elections, UK-EU trade deal and EU recovery fund). This paid off as equities retrenched in October. We then moved back overweight in early November as the positive vaccines developments shifted sentiment back to 'risk on'. We started the quarter with a regional tilt to emerging markets (as Covid-19 has been managed well in China and neighbouring countries, and economic activity has recovered strongly) and the US, with a tactical allocation to Japan. We dialled down the US exposure mid-quarter as the technology and consumer discretionary sectors started to appear expensive. Against this we were modestly underweight in government bonds and underweight in commercial property and cash. These positions were largely positive for performance over the quarter with all the funds outperforming their respective benchmarks, other than GMAP Dynamic, which performed more-or-less in line net of fees (see table – above).
- Stock markets continued to climb higher towards year end on the back of very loose policy that is likely to remain in force given benign inflation expectations. Sentiment has remained positive since the vaccine announcements in early November. Markets could be vulnerable to a short term correction, but we remain positive on longer-term recovery.
- At the broad asset class level, we are very overweight global high yield and overweight equities, and would view a sell-off as an opportunity to add further given the good prospects for post-Covid recovery in 2021 based on expected successful vaccine rollouts. US breakeven inflation is back to around 2%, but nominal bond yields have stayed low, supporting the multiples of growth stocks like US technology. Emerging markets could continue to outperform on dollar weakness. The Democrats

achieving a strong position in the Senate could be seen as negative for stocks and US inflation as it raises the possibility of more radical policies and higher spending and taxes – the initial reaction of US treasuries certainly indicates this. However, the situation is likely to be more nuanced as more radical policies may struggle to find support across the broad Democrat coalition.

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 (ex 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%, despite the strong final quarter.
- 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 are operating similar QE 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. The yield spread between index linked gilts and US TIPS tightened by another 17bps to 181bps at the end of the quarter as the Fed's revised approach to US monetary policy – under which inflation will be allowed to run higher – continued to drive up inflation expectations, also causing the dollar to weaken further. The US currency suffered its second weakest year since the global financial crisis.
- Credit spreads tightened further reflecting positive developments on vaccines and short-term 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 remarkable considering that the average spread was as wide as 2.25% at the peak of the market sell-off in March. The Markit iBoxx Sterling Non-Gilt All Maturities Index delivered total returns of +3.12% for the quarter.
- It was a very positive quarter for global high yield corporate bonds, with many key negative risks getting diminished. In particular, the US energy sector benefitted from the election results, which suggested that more extreme policies are unlikely to pass through Congress. The market has factored these improvements by reducing default rate expectations; though we think that high yield credit spreads continue to overcompensate for the risks. The ICE BofAML (BB-B) Global Non-Financial High Yield Index returned 5.68% to sterling investors over the quarter.
- 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.

ROYAL LONDON GMAP DEFENSIVE FUND

Asset allocation overview

What we thought	What we did	What happened	Effect on portfolio
In the third quarter, the two-way risks had increased following the strong recovery of global equities since March and with Covid-19 cases rising again in Europe and rising political risks. The strong vaccines data shifted the balance, increasing the likelihood of a strong economic recovery in 2021. However, in the US, our favoured technology and consumer discretionary sectors looked fully valued, having performed very strongly. We also believed that Japan would continue to perform well with the new prime minister committed to reform.	We had moved to neutral in global equities in the third quarter, feeling that the risks were more finely balanced following the strong recovery and with increased risks. We maintained this allocation in October. With the vaccines data news, we moved back overweight and increased our weightings through the remainder of the period. With the US looking fully valued, our regional tilt was to emerging markets We maintained our tactical overweight in Japan.	Global equities returned -3.3% to sterling investors in October. Within this, emerging markets and the US outperformed. Global equities then delivered strong performance in November and December, returning +7.9% to sterling investors for the quarter as a whole. Emerging markets were the strongest region (+13.1%), while the US was the weakest leading market. Japan delivered relatively moderate returns, compared to other global markets.	Our neutral position in equities in October, then moving up to overweight in November and December was positive for performance. Our regional and sectoral allocation also made a positive contribution. While the returns from Japan were more moderate, this market still outperformed the US over the quarter, having also been resilient in the October weakness.
We started to reduce the underweight in the UK in the third quarter. It had been a long-term underperformer hampered by heavy resource and financials sector weightings, and was slower to exit lockdown than many other countries. However, there were several scenarios in which the UK could outperform in a global recovery, particularly once there was clarity around the trading terms or otherwise with the EU. Against this, Europe (ex UK) was struggling as Covid-19 cases picked up.	We maintained our underweight position in Europe (ex UK), but reduced the long-standing underweight in the UK to neutral and then to a small overweight by year end.	The UK performed notably well over the quarter (+10.6%), with the outperformance coming in the second part of the quarter with the rotation into more cyclical sectors and subsequent agreement of a trade deal with the EU. While Europe (ex UK) performed reasonably in absolute terms, it was one of the more pedestrian global markets over the quarter.	Moving from underweight to neutral in UK equities was positive for performance, as was the underweight allocation to Europe (ex UK).
We maintained our view that corporate credit will outperform government bonds as the global economy recovers.	We maintained the moderate underweight position in gilts and were moderately overweight in investment grade credit for much of the quarter before moving to neutral.	Gilts returned +0.63%, with stronger performance at the long end. Index-linked gilts returned +1.21%. Sterling credit outperformed, returning +3.12%.	Despite the challenges in the real economy, staying underweight in government bonds and overweight in investment grade credit was positive for performance.
We felt that high yield bonds offered potential for further outperformance given elevated spreads and the huge financial support from governments and central banks.	We remained overweight global high yield bonds, particularly short duration high yield, as this asset class should be less volatile than equities, yet give upside exposure to any recovery. Having fallen sharply in the crisis as investors feared defaults, high yield had further recovery potential.	Global high yield bonds continued to perform strongly over the quarter and the high yield spread tightened further. Global high yield funds returned +7.0%, with short duration delivering +1.7%.	The overweight allocation to global high yield was positive for performance, with short duration high yield performing well on a risk-adjusted basis.
As the recovery in the real economy continued, particularly in industrial production in China, we remained constructive on commodities.	Having increased our allocation from neutral in the third quarter, we maintained this overweight through the fourth quarter.	Commodities performed strongly over the period.	The overweight exposure to commodities was positive for performance.
With the economic shock, we believed UK commercial property would underperform, at least until there is a sustained economic recovery.	While recognising its diversifying benefits, we maintained an underweight position in property through the quarter, and increased this over the period.	Commercial property performed poorly over the quarter as lockdowns resumed and the retail and hospitality sectors continued to struggle.	Our underweight position had a positive impact on performance.

Please note: This table details our main asset allocation decisions for the quarter across the GMAPs funds. Clearly only some of the allocations are relevant to the Conservative fund (fixed income-only) and Dynamic Fund (equity-only).

ROYAL LONDON GMAP DEFENSIVE FUND

- Our proprietary Investment Clock model had registered growth improving strongly as lockdowns eased in the summer and moved back towards its 'Overheat' zone, albeit with low inflation and interest rates; this should be constructive for equities, industrial commodities and corporate bonds, including global high yield. However, renewed lockdowns are impacting growth and the output gap should ameliorate inflation pressures, despite unhelpful base effects over the first half.
- We had moved to a more neutral position in global equities in the third quarter. We felt that the risks were more finely balanced following the strong recovery from the March lows and the risks of renewed restrictions and political disruption (US elections, UK-EU trade deal and EU recovery fund). This paid off as equities retrenched in October. We then moved back overweight in early November when the positive vaccines developments shifted sentiment back to 'risk on'. We started the quarter with a regional tilt to emerging markets (as Covid-19 has been managed well in China and neighbouring countries, and economic activity has recovered strongly) and the US. We also maintained our tactical allocation to Japan as the economic data continued to look more favourable and with a new prime minister committed to further reforms. We dialled down the US mid-quarter as the technology and consumer discretionary sectors started to appear expensive. These allocations were beneficial for performance as global equities were weak in October, then performed strong after the release of the positive vaccines data in early November. In addition, emerging markets was the outstanding regional performer over the quarter, returning +13.1% as Chinese stocks reached 12-year highs. The US was the weakest global market, but had been more resilient than global equities as a whole in October's weakness, so shifting from overweight to neutral at this point paid off. While Japan made a limited contribution, it still outperformed over the quarter having also been resilient in October.
- In the third quarter, we had moved underweight in Europe (ex-UK) as Covid-19 cases picked up and local lockdowns and travel restrictions were imposed. Against this we had started to reduce the underweight in the UK, which had been a long-term underperformer hampered by heavy resource and financials sector weightings, and which was slower to exit lockdown than many other countries. However, with several scenarios in which the UK could outperform in a global recovery, particularly once there was clarity around the trading terms or otherwise with the EU, we felt it was time to close the underweight and we ended the quarter slightly overweight. This also contributed positively to performance. While Europe (ex UK) performed reasonably in absolute terms, it was one of the more pedestrian global markets over the quarter. In contrast, the UK performed strongly (+10.6%), with the outperformance coming in the second part of the quarter with the rotation into more cyclical sectors and subsequent agreement of a trade deal with the EU.
- We remained overweight in high yield bonds, particularly short duration high yield, as we expected the asset class to be resilient and felt that high yield bonds offered potential for further outperformance given the huge financial support from governments and central banks. Otherwise in fixed income, we continued to feel that investment grade credit would outperform government bonds as the global economy recovers. These allocations contributed positively to performance: global high yield was the best performing asset class in fixed income with investment grade credit outperforming gilts.
- As the recovery in the real economy continued to come through, particularly in industrial production in China, we retained our constructive view on commodities. This was positive for performance as commodity prices rose strongly in the quarter.
- We remained underweight in UK commercial property; this was positive for performance given the asset class's economic sensitivity, but the diversification benefits of this asset class relative to equities are beneficial.

Outlook

- Stock markets continued to climb higher towards year end on the back of very loose policy that is likely to remain in force given a benign inflation picture. Sentiment has remained positive since the vaccine announcements in early November. Markets could be vulnerable to a short term correction, but we remain constructive on the longer-term recovery.
- At the broad asset class level, we are very overweight global high yield and overweight equities, and would view a short term sell-off as an opportunity to add further given the good prospects for post-Covid recovery in 2021 as vaccine programs are rolled out. New variants of coronavirus could trigger deeper lockdowns before vaccines are effectively deployed. US breakeven inflation is back to around 2%, but nominal bond yields have stayed low, supporting multiples of growth stocks like US technology. Emerging markets could continue to outperform on dollar weakness. Democrats achieving a strong position in the Senate could be seen as negative for stocks and US inflation as it raises the possibility of more radical policies and higher spending and taxes – the initial reaction of treasuries certainly indicates this. However, the situation is likely to be more nuanced as more radical policies may struggle to find support across the broad Democrat coalition.
- Please see our Investment Clock blog for the latest information on our active strategies. Also, talks from the online *RLAM Investment Series* that was held in September/October 2020 can be viewed on BrightTALK.com, including *A multi asset view of the Covid crisis* by Trevor Greetham. Each presentation lasts for 30 minutes, including Q&A.

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ASSET MANAGEMENT