ROYAL LONDON UK EQUITY INCOME FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)
Astrazeneca	7.1
GlaxoSmithKline	4.9
British American Tobacco	4.7
Rio Tinto	3.8
Dunelm Group	3.4
IG Group	3.5
Royal Dutch Shell	3.2
IMI Plc	2.8
Pennon Group	2.7
Relx Plc	2.7
Total	**39.0**

Fund data

	Fund
No. of stocks	50
Fund size	£1,723.2m
Launch date	11.04.1984

Source: RLAM, based on the A share class.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2020	**-3.70**	**-2.92**	**-0.77**
Year-to-date	-24.63	-19.92	-4.70
Rolling 12 months	-19.27	-16.59	-2.68
3 years p.a.	-4.00	-3.21	-0.79
5 years p.a.	2.93	3.47	-0.53
10 years p.a.	8.27	5.06	3.20
Since inception p.a. 30.06.2000	6.38	3.92	2.47

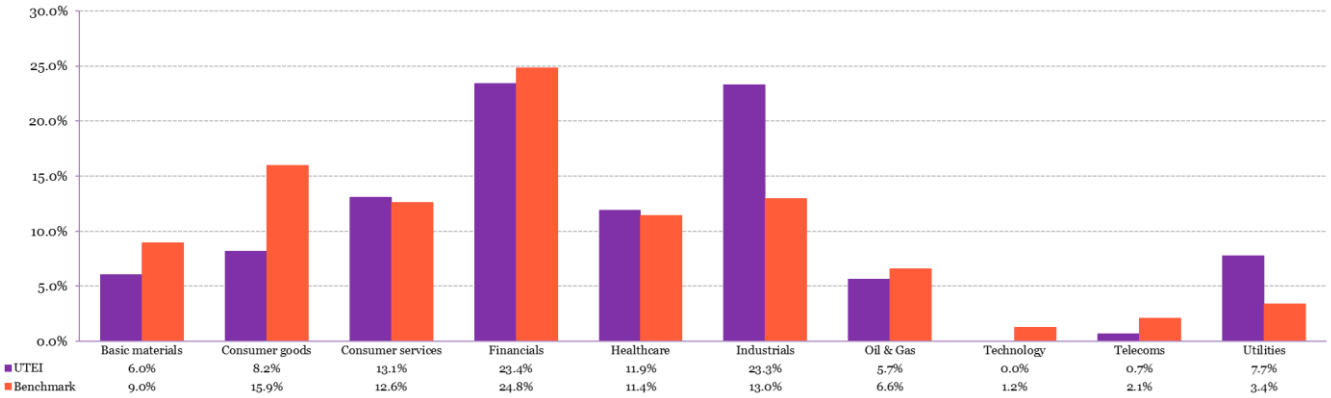
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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

Source: RLAM, as at 30 June 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 third quarter, the fund's performance was behind the FTSE All Share index, but in line with competitor funds. Performance benefitted from a number of stocks including **3i Group**, **Dunelm**, **IMI** and **Segro**. Dunelm has continued to trade strongly in recent months against a background of resilient demand for homewares and the company is growing its market share. IMI shares reacted positively to a solid trading update and the decision to reinstate the 2019 final dividend as well as pay an interim dividend.
- Detractors from performance included **Informa**, **Stobart Group** and **Imperial Brands**. Tobacco stocks have continued to lag other consumer staple stocks, despite resilient demand, and this negatively impacted performance. We remain comfortable holding both tobacco stocks. Both Informa and Stobart Group have the balance sheet strength to see them through an extended period of challenging trading conditions, having both raised additional equity during 2020.
- The fund continues to retain its balance between domestic and international earners and has maintained its economic sensitivity within the portfolio. It also retains a depth and spread of industry exposure, and will not chase short-term income, with stock selection focussed on companies with good medium- and longer-term dividend-paying potential.

Fund activity

- In July, we sold the fund's residual holding of **HSBC**. The bank will not be paying any dividend for the foreseeable future and the growth of its risk-weighted assets will be heavily influenced by government initiatives, as big banks need to be seen as good corporate citizens. In addition, Hong Kong increasingly looks likely to be a focus of geopolitical tensions between the US and China. We also added to the fund's positions in **Daily Mail** and **British American Tobacco** (BATS), taking advantage of share price weakness. BATS shares have lost virtually all their year-to-date relative gains, despite the 7.8% dividend yield looking secure and the company having a strong balance sheet. Tobacco industry trends have remained similar to pre-Covid.
- During August, we sold the fund's holding in **Cineworld**. The Covid-driven shutdown of the business worldwide has seriously weakened its balance sheet position and any potential equity raise is complicated by the family shareholder structure. Social distancing, face masks and studios delaying new film releases are all unhelpful. The shares are now stub equity and could recover, but dividend payments currently look a distant prospect. Elsewhere, we added to the fund's position in **BATS** and **WH Smith**, taking advantage of share price weakness. WH Smith is managing its cash burn well by cutting costs and will be a survivor. It may well also benefit longer term from a number of competitors falling by the wayside.
- During September, we participated in three fund raisings where the fund is already a holder: **Saga**, **Essentra** and **Diploma**. Diploma issued shares to part pay for a US acquisition of a specialist low voltage cable distributor at a sensible price and there is a good strategic fit. The shares responded positively when the deal was announced. Saga announced a refinancing that will see its founder take a significant holding in the recapitalised business and become chairman. We would expect to see a broad range of further fund raising across the UK market over the next few months.

Market background and outlook

- We continue to live in unprecedented times. The easing of lockdown restrictions during the third quarter will have been welcomed by many people. The 'eat out to help out' campaign was successful in re-establishing the habit of people going out with friends and family and the government had started to encourage everyone to return to working in the office, where practicable. Sadly all this changed toward the end of the quarter, following a rising trend of positive Covid tests, both in the UK and other European countries. This has led to the imposition of fresh restrictions, including a 10pm curfew for pubs and restaurants, as well as the government now encouraging everyone to work from home where possible again. The current indications are that this policy is likely to last the whole winter, and further restrictions may be imposed if Covid trends worsen further. The economic recovery, which had been slowing during the summer, may be jeopardised by these new lockdown measures and, while a new job retention scheme is being put in place, rising unemployment looks likely.
- Across Europe now, hospitalisations and deaths are still well down from their peak levels and governments will want to avoid full lockdowns again, given the economic and social costs these would entail. Unfortunately there has already been a huge economic cost to dealing with Covid-19, which has not yet been fully felt by the population due to the cushioning effect of government measures such as furloughing. The immediate outlook for the UK economy is far from clear, although the tentative economic recovery we had been seeing may have been stalled by recent events.
- We still do not know exactly what the 'new normal' will eventually look like or indeed how robust consumer confidence will be. It is unclear the extent to which individuals will be able to decide their own risk appetite for what activities they choose to do going forward, although it is looking increasingly likely that the government will attempt to manage many areas of everyday life. We suspect 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. We are very much in unchartered territory. Economic recovery could be much quicker, we just don't know. Ultimately, we suspect that at least one vaccine will be approved and administered to a broad cross section of the population, treatment plans will improve, and 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. Indeed negative interest rates, which would have been inconceivable a few years ago, cannot now be entirely ruled out. When the dust settles taxes may need to rise to help pay for the support governments have given. Issues such as simmering trade tensions between the US and China, as well as the UK's future trading arrangement with Europe, have not gone away. By the end of the fourth quarter, we will know the name of the next US president and the outcome of Brexit will have been finally decided.
- One of the consequences of the response to Covid-19, and the associated decline in economic activity, has been widespread cuts in UK dividends across swathes of companies. Many companies have stopped giving forward guidance due to the uncertain outlook and others, with more challenged balance sheets, have raised additional capital to bolster their finances. Our view is 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 recently started to see a range of companies reinstating their dividends, including a number held by this fund. We believe 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 of the companies that have historically prioritised dividend payments will return to paying regular dividends, 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 think that once the coronavirus is behind us, the UK stockmarket will still be an attractive and sustainable source of income, and that well-executed equity income strategies will again flourish.
- Our approach to investing in companies with sustainable dividends has undoubtedly 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 companies that have good medium- and longer-term dividend-paying capacity. We will do this without chasing dividend in the short term to avoid risking too narrow a portfolio, instead retaining a breadth and depth of industry exposure. We are very much sticking to our investment process and using it to guide us through the crisis.

ROYAL LONDON
ASSET MANAGEMENT