ROYAL LONDON UK OPPORTUNITIES FUND

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

CONTENTS

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Asset split

	Fund (%)
Ashstead Group	6.1
Rio Tinto	4.8
JD Sports	4.7
DCC	4.2
Prudential Plc	4.2
Melrose Industries	4.1
Intermediate Capital Group	4.0
B&M	3.8
Berkeley Group	3.7
Fevertree Drinks Plc	3.6
Total	**43.2**

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

Fund data

	Fund
No. of stocks	35
Fund size	£694.4m
Launch date	31.07.2007

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2020	**-1.86**	**-2.92**	**1.06**
Year-to-date	-20.87	-19.92	-0.95
Rolling 12 months	-12.52	-16.59	4.07
3 years p.a.	-3.17	-3.21	0.05
5 years p.a.	1.65	3.47	-1.82
Since inception p.a. 31.12.2010	4.16	4.43	-0.28

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.

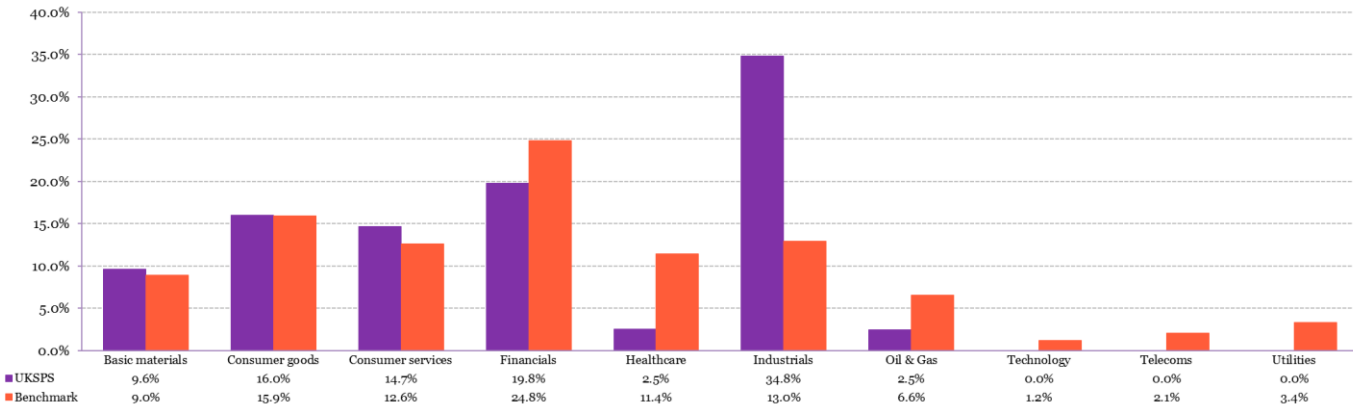
All performance figures stated gross of fees and tax unless otherwise stated.

Source: RLAM, as at 30 June 2020, based on the M Accumulation share class.

[1]Benchmark: FTSE® All Share Index.

As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Sector breakdown



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

ROYAL LONDON UK OPPORTUNITIES FUND

Background

- Plus ça change seems an apt description with which to start this quarterly review. Why do I write this? Predominantly because the types of companies in favour, and to that extent, those most certainly out of favour, remain the same. Technology stocks are at the vanguard of the UK stockmarket and these companies have been ably assisted by those which reside in the basic materials sector. On the other hand, banks and the oil sector remain deeply out of favour with investors. Unsurprisingly, following **Royal Dutch Shell**'s decision to slash its dividend, **BP** took the opportunity to follow suit. This led to an unpopular sector becoming completely friendless. Banks also remain deeply unpopular due to a host of reasons, including a potential zero interest rate environment, together with uncertainty surrounding future dividend payments.
- Following the very strong second quarter, it is perhaps unsurprising that the market paused for breath over these last three months. There was a noticeable divergence between the performance of the FTSE 100 and that of the Mid 250 and Small Cap. Given the comments above, it is perhaps unsurprising that the large cap index returned -4% versus a positive return of 1.8% for the mid cap index and 1.2% for the small cap index. The fund outperformed its benchmark during the three months under review. Between July and September, it returned -1.9% versus -2.9% for the FTSE All-Share (Total Return).
- The market is currently at an interesting crossroads. Without doubt, the mood music has changed from extreme pessimism in March, when it looked certain that the world economy would be heading into a deep recession, to now where many participants believe we are in the early stages of recovery. The direction of the UK market in the short term is very hard to call and much will depend on the outcome of the Brexit negotiations. If common sense prevails, the market could rally hard from here. If a vaccine is found for Covid-19 then, using racing parlance, we could be 'off to the races.' Of course, the other scenario is equally plausible, and if we add a material increase in unemployment following the end of the furlough scheme, with many businesses in dire straits, then a further correction could be awaiting.

Performance review

The fund runs an 'all-cap' structure which allows us to find the most exciting investments across the market cap spectrum.

Positive contributors

- Over the course of the quarter, the strongest performer was **JD Sports** (+28%), which continues to trade well during current restrictions. Happily, huge progress has been made in online sales, which saw a triple-digit jump.
- **B&M European Value Retail** has continued to trade ahead of expectations as new shoppers have found it during lockdown. Management is hopeful that its value proposition will continue to chime with consumers and upgrades to earnings estimates helped to drive the price 20% higher.
- **Synthomer** (+15%), the specialty chemical company, produced a strong set of results which showed little disruption to its business. The business is one of the world's largest producers of disposable nitrile gloves, which are currently in huge demand.
- A recent purchase for the fund, **Fevertree** (+13%), continues to perform well, both at home and abroad. The opportunity for the company in the United States is considerable and the market appears to be appreciating this.
- Other stocks worthy of mention include **Spirax-Sarco** (+12%), the world leader in high-quality products for the control and efficient use of steam, and **Rio Tinto** (+7%), the global mining group.

Negative contributors

- The poorest performer during the quarter was **SSP Group**, the travel concession business. We rate the management highly but the business is in the wrong place at the wrong time, with revenues still materially down. The shares dropped 29% as the lack of visibility continues to take its toll on investor confidence.
- Oil companies, as mentioned above, continue to remain friendless as reduced dividend payments, a lack of demand for its products and ESG worries cloud investor appetite. **Royal Dutch Shell**, our only holding in the sector, finished the period off 23%.
- **TI Fluid Systems** (-17%), a leading global manufacturer of fluid storage, carrying and delivery systems to the automotive industry remained out of favour due to concerns around the speed of recovery in car demand.

ROYAL LONDON UK OPPORTUNITIES FUND

Portfolio activity

- At the end of the quarter the fund had 35 investments spread across a variety of market capitalisations. The active share, the percentage of holdings that deviate from the benchmark index, is currently 82%.
- The split of the investments was as follows:

	Weighting (%)
FTSE 100	68
FTSE 250	21
Small Cap/AIM	8
Cash	3

New holdings

- There were no new investments during the quarter.

Stocks sold

- The only stock which exited the portfolio was **BP**. The fund was already underweight the sector and this was increased following the sale. Royal Dutch Shell had previously cut its dividend and we thought it highly likely that BP would follow suit. This indeed did happen and the shares, unsurprisingly, reacted poorly.
- Otherwise, there were only a few reductions in the portfolio. We took the opportunity to reduce our weighting towards **Standard Life Aberdeen** following a robust period of share price performance. We are mindful the incoming CEO will have his own ideas about the business and he may look to cut the uncovered dividend.
- **DS Smith** was trimmed within our industrial holdings. Its management is doing a good job in a difficult environment, but with the balance sheet still a little stretched in the short term, we took some money off the table.
- Following a very strong run in the share price, we took some profits in **B&M European Value Retail**. The company is still a large holding within the fund and we remain enthusiastic about its future prospects.

Additions

- We added to a number of holdings where we felt the market was being overly pessimistic. We firstly used some of the proceeds from the sale of BP to add to our weighting in **Royal Dutch Shell**. As mentioned previously, the company had already slashed its dividend and we felt the market had reached peak negativity. Only time will tell if we were correct.
- We added to our position sizes in the housebuilders **Bellway** and **MJ Gleeson**. Both stocks had been left behind during a sector rally and this afforded us an opportunity to add at attractive prices.
- Following a very positive meeting with the management of **One Savings Bank**, we added to our holding as we believe the company is well placed to increase its market share in buy-to-let mortgages. The company has a strong balance sheet and earns a very attractive return on equity. There has yet to be a pronounced increase in impairments and therefore we are confident it can navigate this challenging period well.
- **Melrose** has been volatile in terms of share price performance and we have taken advantage of weak days in the market to increase our position. Its end markets are challenging but management has done a fantastic job in ensuring debt has not increased. Its Nortek division is likely to be sold in 2021 which should transform its balance sheet. Management has shown in the past that its 'Buy, Build and Sell' strategy can be highly shareholder accretive.
- **Synthomer** was added to following our post-results call with management. The company seems to be on the front foot and the nitrile market is very strong, being forecast to remain so for the foreseeable future. The company trades on an undemanding rating and therefore we believe there is a strong possibility it could be rerated.

ROYAL LONDON UK OPPORTUNITIES FUND

Outlook

- The last seven months have been challenging, not just for fund managers, but also for investors. The world has become a very different place in a remarkably short period of time, and the stock market, as it always does, has reacted quickly. We entered the year full of optimism on the back of a resounding Conservative Party election win, but the world changed in March and we have had to adjust accordingly.
- Having spent much time speaking with the management teams of the companies in which we are invested, there is definitely a sense things are slowly getting better. It is certainly tough out there, with some companies more affected by this pandemic than others, but there is a sense that the stocks we are invested in are on top of the situation. We believe there is an incredible amount of latent value both within the companies we are invested in and within the UK stockmarket more generally.
- The UK market has performed poorly this year in relation to many overseas markets, and much of that can be explained by a reluctance of overseas investors to allocate funds to this region. There are many reasons for this, such as the government's handling of the Covid-19 outbreak, the likelihood of a further lockdown and low business confidence, but the key factor is the uncertainty of Brexit talks. We are confident/hopeful (delete as appropriate) that common sense will prevail and a deal can be agreed. If this transpires, we would fully expect the market to make up some of the lost ground caused by Covid-19.
- We are confident the portfolio is well placed for such an outcome, and indeed for a post Covid-19 world, whenever that may be.

ROYAL LONDON
ASSET MANAGEMENT

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