Royal London Global Equity Strategies

Quarterly Report 31 December 2021

Executive summary

- Over the fourth quarter our pooled funds delivered net returns of +8.12% for the **RL Global Equity Select Fund** and +8.31% for the **RL Global Equity Diversified Fund**, compared to +7.28% for the benchmark (MSCI World Net Total Return in sterling). For the 12-month period, the funds have returned +29.72% and +26.71%, respectively, against +22.94% for the benchmark (fund returns net of fees, for M Acc share classes).
- The new Omicron variant of Covid-19 injected uncertainty into markets at the end of November – a stark reminder that coronavirus risks are far from behind us – leading to volatility in global equity markets.
- 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 limiting factor and sector exposure whilst focusing on stock-specific risk in the portfolios.
- 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 pursue the correct strategy for their position in the Corporate Life Cvcle, combined with an attractive valuation pay-off opportunity.

Market overview

- The quarter was somewhat mixed for global equities, with increased volatility in November leading to more pedestrian returns (the FTSE All-Share actually returned -2.2% in November, while the MSCI ACWI still delivered a positive return of 1.1% to sterling investors): however, the strong positive returns in October and December more than compensated. As a result, for the fourth quarter the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned +4.2%, +7.3% and +6.2% to sterling investors, respectively. For the year as a whole, these indices returned +18.3%, 23.4% and 20.0%, respectively.
- The themes that influenced the market throughout 2021 continued in the fourth quarter: periods of volatility – arising from new strains of Covid-19 and renewed travel restrictions and lockdown measures, as well as concern about inflation and the implications for quantitative easing (QE) and interest rates – may have taken the headlines, yet corporate earnings continued to surprise on the upside and push equity markets to new highs.
- Whereas the third quarter started with the spread of the Delta variant of Covid-19, the fourth quarter began with some confidence about vaccine programmes and the rollout of booster jabs. There was initial concern about the rapid spread of the Omicron variant as the holiday season loomed; however, while there are ongoing fears about the ability of healthcare systems to cope with the huge numbers of new cases and the impact of staff shortages on key services, investors took comfort from early data from South Africa that suggested that, while highly contagious, this variant is less deadly, and vaccines remain effective in mitigating its effects.
- Currency movements were muted in the fourth quarter. Sterling was one of the stronger global currencies, strengthening against the US dollar and euro as the Bank of England raised the UK base rate. The yen was a notable outlier, weakening 3.3% against the US dollar.
- Commodities delivered mixed returns after rising strongly earlier in the year. Brent crude oil fell back to below $80 a barrel after weakness in November. However, it still enjoyed a remarkable year after being particularly weak in the initial aftermath of Covid-19 – for 2021 as a whole, the price of Brent crude increased by over 50%. Copper futures resumed their upward trend (+7.7%) after retrenching in the third quarter: prices rose nearly 27% for the full year. The gold spot price rose +2.2% to just below $1,800/oz.
- Global government bonds were mixed in the fourth quarter, a period notable for its volatility. The quarter also saw very definite hawkish tilt from a number of central banks under pressure from persistently high global inflation data. Regional government bond returns differed in the period: the UK provided positive returns to investors with the 10-year gilt yield falling by five basis points (bps); in Germany and the US, 10-year bund and treasury yields both crept higher – by 2bps – providing slightly negative returns.

- In the US, messaging from the Federal Reserve (Fed) saw the removal of the term "transitory" from its inflation commentary. Fed Chair Powell gave very clear messaging regarding the likely future path of monetary policy, including a likely increase in the pace of the tapering (an increase in pace of quantitative easing (QE)), which in turn brought forward expectations of the first rate hike in the US. The Fed's December policy announcements delivered on its messaging, causing US yields to rise during the December, having previously sold off in response to fears over Omicron.
- In Europe, the European Central Bank (ECB) met in December and announced what was perceived as a hawkish set of measures. It announced that the end of the Pandemic Emergency Purchase Programme (PEPP) in March will be accompanied by a doubling of its Asset Purchase Programme (APP) to €40 billion a month for the second quarter, reducing to €30bn and €20bn in the third and fourth quarters. Despite assurances of flexibility in the re-investment of maturing PEPP proceeds, the market viewed the policy as less supportive for peripheral European bonds – European yields rose into year-end as a result, and periphery market spreads widened.

Performance and activity

Global Equity Select Fund only:

- The **RL Global Equity Select Fund** outperformed its benchmark over the quarter, driven by positive stock selection.
- **UnitedHealthcare**, **Old Dominion Freight Line (ODFL)** and **Nvidia** were strong contributors to returns in the fourth quarter. **UnitedHealthcare** in the 'Slow & Maturing' category of the corporate Life Cycle gained during the period as the Optum healthcare arm of the business continued to grow at a fast trajectory. The company's third quarter results highlighted the continued evidence of the better integration of UnitedHealthcare (focused on health insurance) and Optum (focused on health services) to deliver superior outcomes at cheaper costs and an associated ability to share in that benefit. **ODFL** the less than truck load (LTL) company that is in the 'Accelerating' category of the corporate Life Cycle performed strongly amid the current shortage of truckers. The US has been grappling with a chronic lack of drivers for years, but the shortage reached crisis levels during the pandemic, which also sent demand for shipped goods soaring. In November, ODFL's revenue per day soared by 29.9% YoY, signalling ongoing strong demand. ODFL's premium service offering focusing on delivering on time and undamaged meant that the company announced in December a general rate increase of 4.9% for certain tariffs, effective January 3. Meanwhile, **Nvidia** 'Accelerating' contributed to returns amid strong third quarter results. The company had a very strong quarter with milestones positive almost across the board. It is difficult to imagine how things could be going any better for Nvidia; it is benefiting from a refresh cycle in gaming and crypto as well as huge demand growth for its chips used in data centres.
- **Bridgestone**, **Safran** and **Sanwa** detracted from returns over the period. **Bridgestone** in the 'Turnaround' category of the corporate Life Cycle detracted amid higher input energy costs / raw material costs which created a headwind to improving margins. French aircraft engine manufacturer **Safran**, which is in the 'Slowing & Maturing' category of the corporate Life Cycle, detracted as Omicron brought further travel restrictions, increasing uncertainty and reducing demand for air travel. However, the company's valuation remains attractive, and it is well placed to benefit from a recovery in the airline industry. **Sanwa,** a 'Mature' holding, meanwhile took a hit amid parts shortages in North America, labour shortages and production constraints, meaning it was unable to fulfil certain customer orders. However, given many of these issues are affecting the industry overall and are widely cyclical in nature, the valuation pay-off remains very attractive.

Global Equity Diversified Fund only:

- During the fourth quarter, the **RL Global Equity Diversified Fund** outperformed its benchmark.
- **UnitedHealthcare**, **Old Dominion Freight Line (ODFL)** and **Nvidia** were strong contributors to returns in the fourth quarter. **UnitedHealthcare** in the 'Slow & Maturing' category of the corporate Life Cycle gained during the period as the Optum healthcare arm of the business continues to grow at a fast trajectory. The company's third quarter results highlighted the continued evidence of better integration of United Healthcare and Optum to deliver superior outcomes at cheaper costs and associated ability to share in that benefit. **ODFL** the less than truck load (LTL) company that is in the 'Accelerating' category of the corporate Life Cycle, performed strongly amid the current shortage of truckers. The US has been grappling with a chronic lack of drivers for years, but the shortage reached crisis levels during the pandemic, which also sent demand for shipped goods soaring. In November, ODFL's revenue per day soared by 29.9% YoY, signalling ongoing strong demand. ODFL's premium service offering focusing on delivering on time and undamaged meant that the company announced in December a general rate increase of 4.9% for certain tariffs, effective January 3. Meanwhile, **Nvidia** 'Accelerating' contributed to returns amid strong third quarter results. The company had a very strong quarter with milestones positive almost across the board. It is difficult to imagine how things could be going any better for Nvidia; it is benefiting from a refresh cycle in gaming and crypto as well as huge demand growth for its chips used in data centres.

- **Bridgestone**, **Safran** and **PayPal** detracted from returns over the period. **Bridgestone** in the 'Turnaround' category of the corporate Life Cycle detracted amid higher input energy costs / raw material costs which created a headwind to improving margins. French aircraft engine manufacturer **Safran**, which is in the 'Slowing & Maturing' category of the corporate Life Cycle, detracted as Omicron brought further travel restrictions, increasing uncertainty and reducing demand for air travel. However, the company's valuation remains attractive, and it is well placed to benefit from a recovery in the airline industry. **PayPal,** in the 'Accelerating' category, declined as it missed analysts estimates and warned that the impact of the change in their relationship with eBay would continue to pressure result in the short term. We continue to like the long-term prospects for the business.

Outlook

- Omicron looks set to dent growth and after a bounce, slower and more 'normal' quarter-on-quarter rates of growth look likely over the rest 2022. Fiscal policy is already less supportive, monetary policy is on a tightening path and households are seeing a hit to real income growth given still high rates of inflation. Healthy aggregate household and firm balance sheets will help though, and significant vaccination coverage in developed economies should help keep economies on a smoother (and less inflationary) track as the year goes on. Inflation is expected to fall in 2022, but strong short-term inflationary pressure looks set to persist well into 2022 as supply chain problems and labour market shortages linger. Given the general uncertainty, we feel that our approach of investing in a broad range of companies from different sectors and stages of their lifecycle has never been more appropriate and will allow performance to continue to be driven more by the success of our hunting for undervalued long-term cashflows than by the prevailing winds of the macroeconomy, or factors such as growth or value styles being in vogue.
- The benefits of our disciplined investment approach – a focus on superior wealth creating 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. 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

- A record number of current and prospective clients and consultants joined us online for the 2021 RLAM Investment Series (our annual client conference) between 1 and 5 November 2021. Fund managers and other in-house specialists addressed the macroeconomic environment and prospects for different asset classes, and the issues that they consider in managing their funds. There were also sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. All the sessions are available to watch on demand – please visit the RLAM Digital Insight Hub.
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2022 document, and regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk

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