ROYAL LONDON GLOBAL SUSTAINABLE EQUITY FUND

Quarterly Report 30 September 2021

For professional clients only, not suitable for retail investors

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Top ten holdings

	Fund (%)
Microsoft	4.7
Taiwan Semiconductor Manufacturing Company	3.8
Thermo Fisher Scientific	3.7
Texas	3.3
Alphabet	3.3
Adobe	3.1
Amazon	3.0
ASML Holding	3.0
AIA Group Limited	2.8
Nordson Corporation	2.8
Total	**33.4**

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

Fund data

	Fund
No. of stocks	44
Fund size	£199.2m
Launch date	25.02.2020

Performance

	Fund (M Acc) (%)	Benchmark[1] (%)	Relative (%)
Q3 2021	**4.96**	**1.37**	**3.59**
Year-to-date	15.38	12.65	2.73
Rolling 12 months	23.70	22.19	1.51
Since inception 25.02.2020	28.15	17.65	10.51

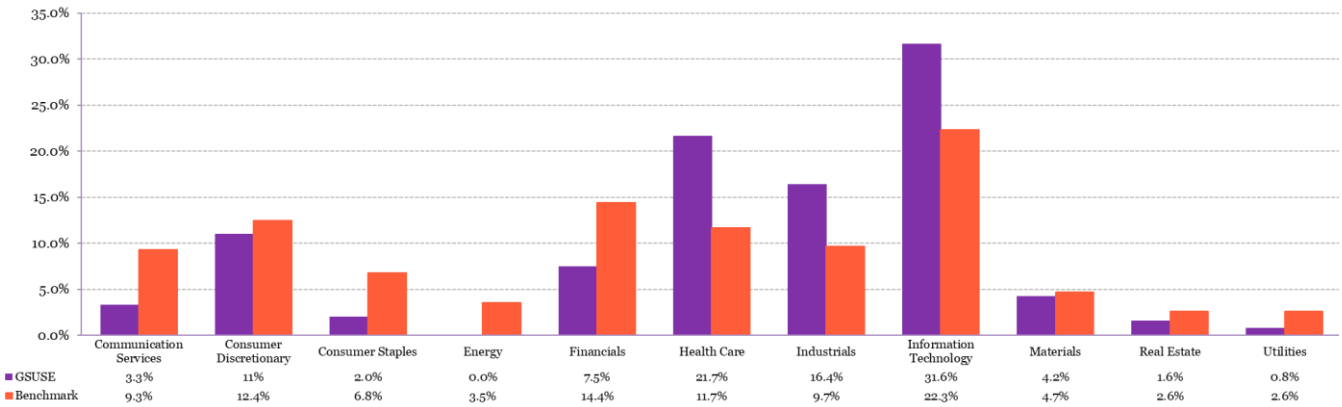
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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

Source: RLAM, gross of fees.

[1]Benchmark: MSCI All Countries World Net Total Return Index GBP.

Sector breakdown



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

ROYAL LONDON GLOBAL SUSTAINABLE EQUITY FUND

Executive summary

- Our equity-only strategies performed strongly this quarter, delivering top quartile performance across the board. This was helped by both macroeconomic developments as lower bond yields were positive for high-growth, long-duration equities (which includes many of the technology and healthcare stocks that our funds own). More important, however, was the impact of second-quarter results, which refocused investors' attention on the fundamentals of individual companies. Some of our holdings that had been left behind during the market rotation at the time of the 'Covid-19 reopening trade' performed well as analysts and investors took on their strong operating performance. Conversely, reality caught up with some non-sustainable sectors that had performed well in the first part of the year, such as mining. As a result of this strong quarterly performance, the funds have also delivered strong relative returns for the year to date.
- We noted three important elements in the quarter that support our sustainable investment thinking. First, during Boris Johnson's recent visit to the US, the Biden Administration announced significantly higher climate change funding than had been expected – this was disclosed prior to the UN Climate Change Conference (COP26) that starts in Glasgow at the end of October. This is very different from the position taken by the previous administration. Secondly, healthcare is an important theme for our sustainable funds: as hospitals have increasingly reopened for elective procedures, we have seen that 'healthcare efficiency' is a clear focus to reduce backlogs and hit targets. We believe that this will benefit a number of holdings in our funds in due course. Lastly, the shortages that have arisen because of post-Covid supply chain disruption raise still further our conviction that the shift from the physical world to the online/digital world will continue apace.

Market overview

- For much of the quarter, the prevailing sentiment in financial markets was 'more of the same' with the ongoing recovery in economic activity causing some supply chain frictions, interspersed with bouts of concern about inflation on the one hand or an autumn Covid spike on the other. The huge recovery in risk assets since March 2020, however, meant that markets were increasingly vulnerable to negative news. Several such 'shocks' came more-or-less together in the last weeks of the quarter.
- First, the likely collapse of giant property conglomerate Evergrande shook investors and there were fears that this could be China's 'Lehman moment', with a single corporate bankruptcy leading to systemic failure. Subsequently, bottlenecks in supply chains caused by Covid disruption (and, in the UK, possibly exacerbated by Brexit) led to more-visible shortages and price spikes, which ultimately led central bankers to revise their forward guidance on the tapering of quantitative easing measures and interest rate rises.
- The quarter began with the Delta Covid variant increasingly prevalent across the US, eurozone, the UK and Asia. Over the period, the global picture became more varied, with cases rising in the US and UK, but with waves in Europe, Japan and China seemingly more contained. With vaccine programmes continuing, governments were reluctant to maintain or tighten social distancing restrictions, instead preferring to introduce booster jabs and vaccinate children.
- Global economic data was mixed, with inflation still causing concern and economic growth appearing to slow in the third quarter. In late September, the US Federal Reserve (Fed) made substantial changes to its economic forecasts, revising its growth outlook and increasing inflation expectations. Chair Jerome Powell suggested it could "easily move ahead" with plans to taper its $120bn monthly asset purchases programme as early as November. The market expects US inflation to peak at 4.2% this year before falling back to 2.2% in 2022. The Federal Open Market Committee also revised its interest rate path, signalling three potential interest rate rises of 25bps during 2022.
- In the same week, the Bank of England (BoE) said inflation could reach 4% over the winter months, largely due to rising energy and goods prices. However, it expects it will then fall back towards its 2% target in the medium term. The European Central Bank voted to keep interest rates unchanged at its September meeting, but opted to slow the pace of net asset purchases through the pandemic emergency purchase programme.
- The MSCI World Index posted positive returns of 2.62% in the third quarter. Although performance was strong in July and August, global stock markets contracted in September, as more hawkish central bank commentary indicated that policy tapering could come earlier than had been expected. Japan was the strongest regional market following the resignation of Prime Minister Suga, returning 7.43% to investors in sterling terms. The US was next strongest (2.94%), followed by the UK (2.11%), and Europe (0.95%). Emerging market equities lagged dramatically over the period, returning -5.71% to investors in sterling terms; slowing growth, problems in the real estate sector and government interventions in China weighed on valuations in the region.
- For the period, the MSCI World Growth Index returned 3.38% versus 1.85% for the MSCI World Value Index. Financials led sector returns (4.79%) followed by energy (4.21%) and information technology (4.03%). Materials was the worst performing sector (-2.39%), while consumer discretionary, consumer staples and industrials sectors also lagged the broader market. During the recent volatility, we started to see a rotation within equities similar to the first quarter of this year with traditionally cyclical and defensive sectors holding up better than their high growth counterparts.

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- The US dollar was one of the strongest currencies globally in the third quarter, as more risk sensitive currencies weakened in relative terms – the US dollar spot price rose by 1.94% over the period. The euro weakened by 2.39% versus the dollar, while the sterling spot price fell by 2.53%.
- Commodities extended their rally, led by energy, towards the end of the quarter with heightened demand as the global economy opens up. Brent crude oil rose by 4.5% to more than $78 a barrel in the quarter. In metals, copper futures fell by 4.5% to $419 (after a strong rally earlier in the year), while the gold spot price fell by 0.8% to $1,755/oz.

Performance and activity

- Our sustainable strategies are orientated to those companies that have a positive impact on society and create value for investors through access to long-term growth markets and innovation. Areas such as healthcare and technology remain at the core of the equity portfolios, complemented by engineering, utilities, selected financial services, and companies that lead their industries in ESG performance. While the Sustainable funds have different mandates, risk profiles, asset mixes and geographical exposures, equity exposure is driven by the same underlying team, philosophy and process. Many of our key stocks will be held across multiple portfolios.
- The quarter was quite mixed from a financial markets' perspective. In July and August, micro factors were to the fore as fundamentals drove the performance of sustainable and non-sustainable sectors alike. This was particularly positive for our funds as good second quarter results reminded analysts and investors of the strength of many of our holdings that had fallen out of favour during the 'reopening trade' rotation from November last year into the spring. These results were the first in which meaningful year-on-year comparisons could be made. We also benefitted on a relative basis as many non-sustainable sectors retrenched.
- September saw a shift to macroeconomic drivers: the Evergrande 'collapse', further concerns about inflation as post-Covid (and possibly post-Brexit) supply chain disruption created shortages and pushed up prices, whether for energy, semiconductors, lorry drivers or berths at US West Coast ports; the return of the US debt ceiling extension fears (which is seemingly becoming an annual pre-Halloween horror show); and a shift in forward guidance from central banks as the tapering of asset purchases and interest rate increases shifted closer as 'transitory inflation' proved more sticky than expected. Collectively, these issues made markets far more volatile as investors struggled to absorb the sudden gear change. The Evergrande issue and ongoing intervention in the economy by the Chinese government were beneficial for performance, however: due to low corporate governance standards, we are underweight China in the fund.
- Stock performance was generally positive. US life sciences company **Thermo Fisher Scientific**, which enables healthcare innovation by supporting drug development in the pharmaceuticals and biotech sectors, continued to benefit from Covid-19 testing, diagnostics and vaccines. The company also held a well-received analysts' day in September that resulted in the upgrade of long-term forecasts. **Rentokil**, the UK global leader in hygiene and pest control, benefitted from ongoing trends around safer and more hygienic spaces, and also bounced back after suffering during the reopening trade rotation. The company also held an analysts' day in late September with a 'deep dive' into its hygiene business, which was received favourably by investors. **Novo Nordisk**, the Danish pharmaceutical company that specialises in diabetes-related treatments, performed strongly over the period after gaining US approval in the second quarter for its new obesity drug, Wegovy (a GLP-1 analogue). The company also announced that initial sales were particularly strong, reflecting the product's efficacy and an increased focus on treating obesity in the wake of Covid-19. Of the 650 million people globally living with obesity, only 2% are currently treated with prescription medicine. Against these strong performers, **Adidas** was notably weak. The German sportswear and 'athleisure' clothing company was hit by specific concerns about disruption to its supply chain as it has extensive manufacturing in Vietnam, which only has a 6% vaccination rate at present; and concerns about the negative outlook for China, which is a key end-market for the company.
- Notable trades this quarter included a new position in **TopBuild**, adding to existing holdings in **Schneider Electric**, **TSMC**, **London Stock Exchange** and **AIA**, while we trimmed positions in **Philips** and **Novo Nordisk**.

Outlook

- The drama in financial markets in the last two weeks of the third quarter and at the start of October suggest that we could be in for a period of volatility in the coming months. Inventory and capacity shortages and other supply chain issues will no doubt continue to generate headlines, particularly if they might Christmas. Higher inflation will no doubt remain a key concern for many investors, given this could force central banks to raise interest rates much earlier than previously thought.
- Higher energy costs will feed through to inflation in 2022 and we expect ongoing supply disruptions to impact prices in some sectors. However, despite the likely short-term spike, we are not yet convinced about the arguments for inflation returning in the long term. Our view is that it is more likely that the pandemic will ultimately prove a long-lasting deflationary force as technology reduces our dependence on finite physical resources. Also, there are plenty of drags on

growth that will mitigate inflationary pressures. In the UK, businesses face higher taxes, including National Insurance, and increased wage costs. Similarly, consumers face higher energy bills, an end to the £20 Universal Credit uplift and the prospect of higher mortgage rates. At a global level, the deflating of its property market may impact the Chinese economy and have wider knock-on effects. And all of this before we even consider the risk of a renewed wave of Covid-19 in the northern hemisphere winter – while vaccination programmes have been astonishingly effective, a bad flu season and spike in Covid cases could lead to renewed lockdown measures.

- While we expect central banks to taper their asset purchase programmes and raise interest rates sooner than anticipated a few months ago, we believe that we will remain are in a low interest rate environment for much longer than current market sentiment suggests. There may be some short-term pain, but inflation will ease by the second half of next year and this will benefit strategies such as ours. By its very nature, sustainable investing is a long duration strategy – as it picks out companies and trends that will take many years to fully develop. This can be seen in our turnover figures, which in the last 12 months is about 10% for the equities we own, suggesting an average holding period of 10 years. And what we have seen historically in our performance is that, while market trends ebb and flow in our favour, fundamentals dominate over the long term, and these will remain the key drivers of our portfolios.
- The pandemic and its aftermath have accelerated the sustainability agenda across governments, businesses and consumers. This will be positive for the types of company that we seek to invest in. While a slowdown in growth and easing of inflationary pressures would be positive for bonds in the shorter term, we believe that equities will outperform bonds over the year ahead. September and October are seasonally weak months for markets. It seems more likely than not that the current concerns will pass and in time markets will make new highs, maybe before the end of the year. Uncertainty is the friend, not foe, of investors: long-term returns are improved by buying at times of uncertainty, with the pandemic last year being the latest example of this.

Find out more

- Join us online for the *2021 RLAM Investment Series* (our annual client conference) between 1st and 5th November. A range of our fund managers and other in-house specialists will address the macroeconomic environment and prospects for different asset classes, and the issues they are considering in managing their funds. There will also be sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. For more details and to register, please visit rlam.co.uk.
- You can find more information on our sustainable funds and our views on sustainable investing and other ESG-related issues at rlam.co.uk.

ROYAL LONDON
ASSET MANAGEMENT

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