



COVID-19 INVESTMENT UPDATE: SUSTAINABLE UPDATE – 10 JUNE 2020

What is happening?

Equity markets have continued their stunning recovery, with the US S&P 500 closing up on the year on 9 June. Just to recap, this index started the year at 3231, rose to 3386 on 19 Feb, fell to 2237 on 23 March and then fully recovered to 3232 on 9 June. We are often asked what is different about this market cycle. Our answer: speed. In previous bear markets and recessions these moves would have taken months, maybe years to play out. In today's markets, weeks are like months and months are like years.

As often happens with big market moves, the arguments for and against them become more emotive as time goes on. Those on the wrong side of them find new reasons each day to be negative, whilst those on the right side of them try to link cause and effect in ways that are often debateable. In March we felt we were in the midst of a good old fashioned market panic and, believing that panic is a temporary not permanent state of mind, we found a number of attractive investment opportunities. Once this panic subsided (we would say at around 2900 on the S&P 500 in mid-May) we felt that the risk reward was much more balanced. Markets are submissive to no one however, and rode straight on past us! We think there are three reasons for the continued march higher:

- Infinite money vs finite assets – the amount of money being created by central banks, trillions and trillions of it, is – in all practical senses – infinite. And their promise (threat?) to continue doing this until economies recover is stark. Where does all this money go? Consumers and corporates aren't borrowing new money; they are too focused on servicing existing debt. It therefore ends up in financial assets such as bonds and equities. There are of course only a finite number of securities listed on equity and debt markets, now being bid up by infinite money. It is simple economics to know infinite money versus finite assets will result in rising prices.
- There is no alternative (TINA) – this is an idea Ed Yardeni, one of our research providers, has created when commenting on equity markets. The reality is corporate pension funds and individual savers, as a generalisation, cannot meet their future liabilities owning government bonds with low/negative interest rates. The yields on cash are pitiful too. Their only alternative is equities. This speaks to an idea we think is under discussed, that the value of an equity is both a function of the future profits of the company it is attached to, and the required return of the investor to own it. Historically equity investors have wanted 6-8% pa returns to compensate them for the risk of owning them. If cash returns zero, government bonds 0-1% and credit 2-3% (these are not forecasts but sensible numbers relative to today's reality) then investors will be willing to take lower equity returns. If 6-8% pa goes to 4-6% pa then equity prices will, and have, readjust upwards.
- The global economy is re-opening – investors have also been spurred on by the early signs of economic reopening being faster and less impaired by a second wave of virus infections than expected. Each month the US publishes employment data. Last Friday, the last time they did this, expectations were that the US economy had shed a further 7.5m jobs in May; it actually created 2.5m jobs! For those wishing to believe in a V shaped economic recovery, this was encouraging.

Place these three points in front of a bear, and they will say this is a liquidity fuelled rally and the economic recovery is too nascent to prove anything. Place them in front of a bull, and they will say the Fed is doing what it has done since Alan Greenspan in the 1980s, and supported the business and investment cycle until the economy recovers, which has now started to happen.

We have to confess to not finding either of these choices attractive. Fortunately our investment process can work well without having to take sides, so we are intrigued to watch and see how this plays out. We would however say that a bit more caution seems sensible given overall market levels, and that when we look at the output of our investment process it is telling us more defensive, less cyclical investments have the best risk/reward. This is very different from March, when our process was telling us nearly all risk was priced too cheaply.

What will happen next?

We have a strong view that we need to deal with the reality in front of us at the moment, rather than devising grand theories about how all of the above influences markets on a multi-year view. Many of the theories that came out of the financial crisis (QE would be inflationary, sub-trend growth) proved incorrect or at best debateable. What we can see though is the world in front of us becoming more digital, less carbon intensive, more health focused and generally more attractive for socially and environmentally useful companies, which will remain the bedrock of our sustainable funds.

One thing we would like to share though, which we find fascinating, is how the path of a number of economies and markets are following is similar to that of Japan, with a time lag. For the majority of my investment career (21 years and counting) I was told that Japan was an outlier. Low, then negative, bond yields? Yes in Japan, it won't happen here! Central banks buying government bonds, credit and equities? Yes in Japan, it won't happen here! Low growth and low inflation, despite huge stimulus packages? Yes in Japan, it won't happen here! Levels of debt to GDP which make levels in the US and UK look conservative? Yes in Japan, but it won't happen here!

The truth is that Japan has not been an outlier in my career, it has been a lead indicator. Where they have gone first, we have followed. Is this still the case now? Possibly. And if it is the case there are two important lessons to learn. The first lesson is that despite all their printing of money and large government deficits, nothing bad actually has happened. Inflation and economic growth have remained subdued and equity markets continued to rise. The second lesson is that in a world of permanently low interest rates, which Japan has seen for much longer than we have, the value ascribed to equities, and growth equities in particular, is an order of magnitude above what is perceived to be expensive in markets such as the US and UK. Japan embraced TINA some time ago!

So if Japan is a lead indicator still, maybe everything will be okay after all?

What are we doing?

Activity levels have been relatively low in the last two weeks, reflecting contentment with the existing portfolio structures and fewer opportunities post the market rally. We have supported two of our companies, Dechra and Segro, in fund raisings they have done. Interestingly neither of them needs the money to sustain their current businesses; these are not distressed companies, but both see the economic disruption as a catalyst for greater opportunities as other distressed companies may need to sell assets fast. As such they think they can accelerate their strategic development in a positive way, so have raised money to support this.

Asset allocation in the mixed asset funds remains pro equity. After such a run in equity markets it is worth reminding investors that we have relatively fixed asset allocation in our mixed asset funds, give or take a few percent related to market movements, and that it is pro equity. Our view, not unlike that expressed above, is that cash and credit provide a low hurdle rate of return beyond which equities are attractive, especially when considering we typically invest over a 3-5 year time horizon.

How are we performing?

In the rally of the last two weeks the highest risk investments have tended to perform best. For investors believing in a V-shaped recovery, and a faster resolution to Covid-19 than previously expected, purchasing those investments most impacted in recent market fall makes sense. These tend to be the indebted, cyclical and less liquid names which we have something of an aversion to. As such the funds have seen some underperformance. The operational performance of the companies we own remains very good and we'd expect them, once this more aggressive period of risk taking ends, to be excellent investments. Year to date performance remains top decile.

Anything else?

Although lockdown has presented many challenges, it has at least offered, for most, a less frantic pace of life. One of the big benefits of this I've found has been more time to read. When we look for common characteristics of successful investors, one thing that stands out to us is how well read they are. Investing is in essence a quest for knowledge, and more specifically diverse knowledge. The best investment books, as in most additive to investment decision making, are not investment books at all. They can be about science, psychology, art, business, philosophy and many other topics. My own experience of investing has been something similar to looking at the stars and trying to find the shapes. Each piece of knowledge can be thought of as a star, and the more of these you have the more likely we can find shapes, which in my world are investment ideas. Breadth of thinking is a huge competitive advantage in fund management, but it is something that only comes with a determination to read and to learn about areas broader than those traditionally considered relevant for investment professionals. If there is perhaps one thing I'd like to keep as (hopefully) the world returns back to normal, it is more time to read.

Please note that this is a fast moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing, and performance numbers are estimates and not audited.

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature

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For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Price page on www.rlam.co.uk.

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