Royal London UK Opportunities Fund

Quarterly Report 30 June 2022

Asset split

	Fund (%)
Royal Dutch Shell	7.0
Glencore Plc	5.3
Ashtead Group	4.8
Melrose Industries	4.7
AstraZeneca	4.5
Rio Tinto	4.2
Intermediate Capital Group	4.0
OSB Group Plc	3.7
Prudential	3.7
BP Plc	3.6
Total	**45.4**

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

Fund data

	Fund
No. of stocks	34
Fund size	£741.5m
Launch date	31.07.2007

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q2 2022	**-15.05**	**-5.04**	**-10.02**
Year-to-date	-22.16	-4.57	-17.59
Rolling 12 months	-16.69	1.64	-18.33
3 years p.a.	-0.22	2.41	-2.63
5 years p.a.	0.68	3.32	-2.65
10 years p.a.	5.88	6.88	-1.00
Since inception p.a. 31.12.2010	4.61	5.94	-1.33

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.

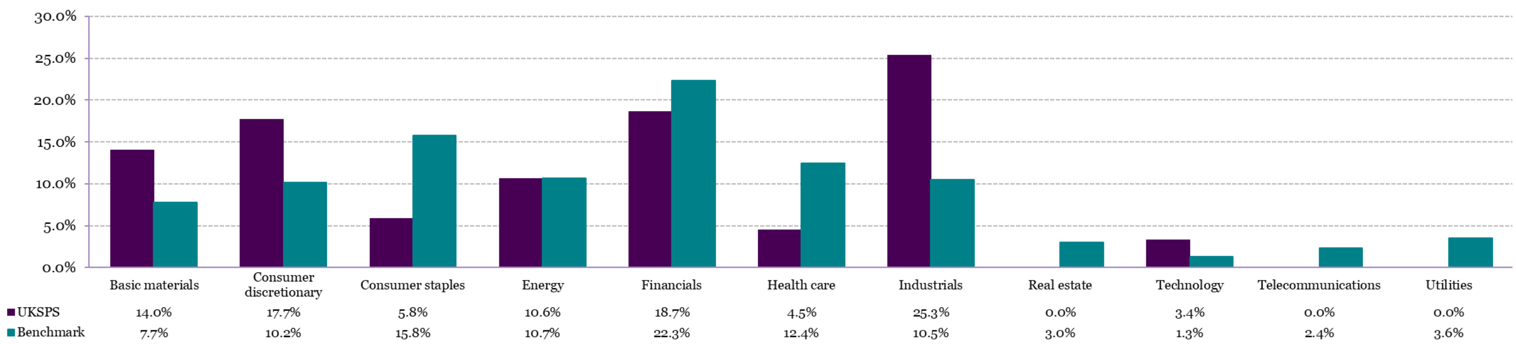
All performance figures stated gross of fees and tax unless otherwise stated. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.

Source: RLAM, as at 30 June 2022, 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.

Market review

- As we finish the second quarter of 2022 the anxiety which gripped many areas of the market in the first three months of the year only intensified. The list of concerns is not new but to recap: a rate of inflation not seen in decades, an impending cost of living crisis, increasing base rates and the conflict in Ukraine.
- The key theme in markets remains high inflation and how monetary authorities can realistically dampen this threat. The Bank of England is only concerned with containing the level of inflation and therefore there exists the possibility the Monetary Policy Committee use the blunt weapon of increasing base rates which could send the economy into a deep recession. Although this is not our central case scenario, it seems almost inevitable the UK economy will enter a recession. The great unknown is how long this will last for and what are the implications for corporate profits.
- The cost-of-living squeeze that households are facing is having an extremely negative impact on many parts of the UK stock market such as general retailers and housebuilders. At the heart of this issue is the much higher cost of energy, driven by the severe disruption to the energy markets from Russia's invasion of Ukraine. That said, the pressures are by no means confined to energy. Others inflationary factors are also at play, such as supply chain disruption from COVID lockdowns in China, tight labour markets and sharp rises in many agricultural products feeding through into food prices.
- To try to counter the severe pressure on household budgets the UK government announced a series of support measures to tackle fuel affordability. These measures will be part funded by a windfall levy on oil and gas firm profits. In addition, there was also a suggestion that this could be extended to include electricity generation companies.
- In a repeat of the first quarter, the FTSE 250 fared significantly worse than the FTSE 100 given its higher domestic exposure.
- The Royal London U.K. Opportunities Fund underperformed its benchmark during the three months under review. Between April and June, the Fund returned -15.1% versus -5.0% for the FTSE All-Share (Total Return), placing it in the fourth quartile.
- To be brutally honest, 2022 has thus far been an annus horribilis for unit holders in the fund and reasons for this will be discussed in more detail later in the review. Times of underperformance, as we have recently witnessed, are chastening for all concerned and rest assured we are doing all we can to improve performance. That said, we believe we are in good quality stocks although accept many of them are deeply out of favour at present.

Performance review

- The UK Opportunities Fund runs an 'all cap' structure which allows us to try and identify the most exciting investments stocks across the market cap spectrum.

Positive contributors

- Over the course of the last quarter, the strongest performer was **Melrose Industries** (+21%). The company has been deeply out of favour for the last two years as worries over their end markets of automotive and aerospace drove the bulls of the stock away. The company announced the sale of one of its businesses Ergotron for $650m together with the commencement of a £500m share buy-back. In addition, management hosted a capital markets day where they set out new, higher operating margin targets for their aerospace division which has been taken extremely well.
- **Imperial Brands** (+15%) reported in-line results which pleasantly surprised the market. It seems anomalous that an in-line set of numbers could drive the shares higher, but the market has been so used to disappointments every time the company reported. The company is under new leadership and sensible steps to refocus the business is reaping early rewards.
- Another defensive stock which proved its mettle was **AstraZeneca** (+6%). Although there was no specific catalyst to move the price higher, investors were looking for perceived safe havens and the company benefited accordingly.
- The only other company which finished the period under review in positive territory was **Shell** (+2%). Shell, along with BP, have obviously been large beneficiaries of the current oil price which has afforded these businesses the opportunity to generate meaningful levels of free cash flow. This is turn, with a disciplined view on capital expenditure, has allowed large share buy backs to take place. This phenomenon shows no signs of abating. We are no experts on the likely direction of oil prices but given geopolitical events, we see no correction for the time being.

Negative contributors

- The negative contributors to performance swamped the few successes the fund enjoyed over the last 3 months. Chief amongst the problems witnessed was **Integrafin** (-46%), the online financial platform. Having reported respectable results alongside a disappointing outlook statement which highlighted heightened costs going forward, the share price plunged. We have since had a full and frank discussion with the new Chair and we await developments. That said, the current rating looks attractive on a medium-term view, and we see no reason at this juncture to "throw out the baby with the bath water". Of course, we are watching the situation closely as one would expect.
- **Future** (-34%), a new holding for the fund, lost a third of its value over the course of the last quarter. This seems a perplexing move for a company which has an enviable track record of successfully acquiring and integrating businesses across the online media space. Quality growth stocks have, as we are all aware, been derated thus far in 2022, and unfortunately Future has been caught up in this.
- Another company we see tremendous value in is **Marshalls** (-33%), a long-term holding in the UK Opportunities Fund. During the quarter, they announced the purchase of Marley, the UK's leading roofing specialist. Marley had previously looked to list on the LSE but given nervousness of market participants, their Private Equity owners decided not to proceed. Marshalls took the opportunity following this withdrawal to acquire the business.
- Another business which was caught up in the market's anxiety over consumer spending was **Watches of Switzerland Group** (-33%). Since coming to the market, the company has not put a foot wrong and results just released continued this momentum. Management is as confident as ever that they will continue to win market share, both in the UK as well as the US where there remain huge opportunities. We are all too conscious there is a cost-of-living crisis for millions of people, but we would argue the WOSG client is less impacted.
- **B&M European Value** (-29%) was another such company caught up over concerns that retail spending will be squeezed this year. In addition to macro concerns, the market, and ourselves, were disappointed at the announcement that the Chief Executive is stepping down. The CEO founded the business and has been the driving force behind its success. That said, on a current modest rating, we are hopeful most of the concerns are already in the price.
- Lastly, **Ashtead Group** (-29%) is another company which has been de-rated over concerns the US will soon move into a recessionary environment. The company recently released robust numbers together with a positive outlook statement. We still don't believe the market fully understands this business and remain convinced that if there is a material slowdown, Ashtead will emerge in an even stronger position. We remain enthusiastic holders.

Portfolio activity

- The Fund has 35 investments which are spread across a variety of market capitalisations. As at 30 June, the breakdown of the portfolio was as follows: 64% in the FTSE 100, 30% in the FTSE 250 and 2.5% in Small Cap/AIM. The Fund has 3.5% in cash and the active share is currently 72%.
- The split of the investments was as follows:

	Weighting (%)
FTSE 100	64
FTSE 250	30
Small Cap/AIM	2.5
Cash	3.5

New holdings

- The Fund added one new investment during the quarter, **BP**.
- We added the oil company BP during the three months under review. The oil price, at current levels, as previously mentioned, is allowing BP to generate meaningful levels of free cash flow which is being returned to shareholders. We believe the discipline within the industry now is leading to capital expenditure being well controlled and therefore shareholders are benefitting from higher returns. The company, along with many others, is benefiting from the strength of the dollar also. With no signs of a weakening oil price, we decided to start a 3% position in the company which we have subsequently increased.

Stocks sold

- The fund exited its positions in **DS Smith** and **TI Fluid Systems**.
- DS Smith has been a long-standing holding in the fund and although we like the business very much, we are concerned about earnings risk over the next couple of years. At present, the business is well hedged against ballooning energy costs but as these hedges roll off, the risks of a profit downgrade increase materially. If the European economy weakens substantially, DS Smith would likely be caught in this. The decision was therefore taken to sell our stake and reinvest elsewhere.
- Following a post result meeting with the management of TI Fluid Systems, we decided to jettison our position. We were wholly unconvinced the business was being aggressive enough in trying to recoup from their customers increased costs they are facing. If our thesis plays out, a profit downgrade would be likely.

Additions

- The fund took advantage of weakness in many share prices in existing holdings to top up position sizes. We added to our holding in **Marshalls** through a share placing following the announcement of the Marley acquisition. In addition, position sizes were increased in **Watches of Switzerland Group** and **Future** following meaningful drops in the value of both companies. **JD Sports** shares, which have been weak since January, fell sharply following the announcement that the Executive Chairman had left. We added at what we feel is a very attractive level and one which underestimates the growth potential of the business.

Sales

- The fund trimmed its positions in both **B&M European Value** and **Tesco** over the course of the quarter.

Outlook

- The uncertainty which is rippling through markets currently sees no signs of abating as serious issues such as inflation, base rate hikes and the cost-of-living crisis dominate thinking. As we alluded to earlier, the speed and extent to which central bankers increase base rates is having an unpleasant effect on quality growth stocks which have been severely de-rated. Our hope is the Monetary Policy Committee members can successfully walk the tightrope of reducing inflation whilst not plunging the economy into a prolonged recession.
- The second quarter continued to see several UK stocks being subject to a bid from either PE firms or competitors. We see this trend continuing through the rest of the year as financing costs remain very low on an historic basis allied to a low starting rating for many stocks.
- The FTSE 250 index has substantially underperformed the FTSE 100 as a lack of commodity plays together with a larger percentage of domestic earners has taken its toll. The fund is structurally overweight this out-of-favour area of the market as we are trying to invest in tomorrow's larger companies today. That said, we are of the view that our holdings, many of which are currently shunned by investors, offer substantial upside.
- To conclude, we are confident in our portfolio stocks and are optimistic that once economic activity gets back to something akin to normal over the medium term, we are well placed for recovery.

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