Royal London US Growth Trust

Quarterly Report 30 June 2022

Top 10 holdings

	Trust (%)
Apple Inc	8.3
Microsoft	7.3
Alphabet	5.1
Amazon	3.8
United Health Group	2.6
Nvidia Corporation	2.3
Eli Lilly and Company	2.2
Visa	1.9
Johnson & Johnson	1.9
Exxon Mobil Corporation	1.8
Total	**37.1**

Source: RLAM, based on the A Inc share class.

Trust data

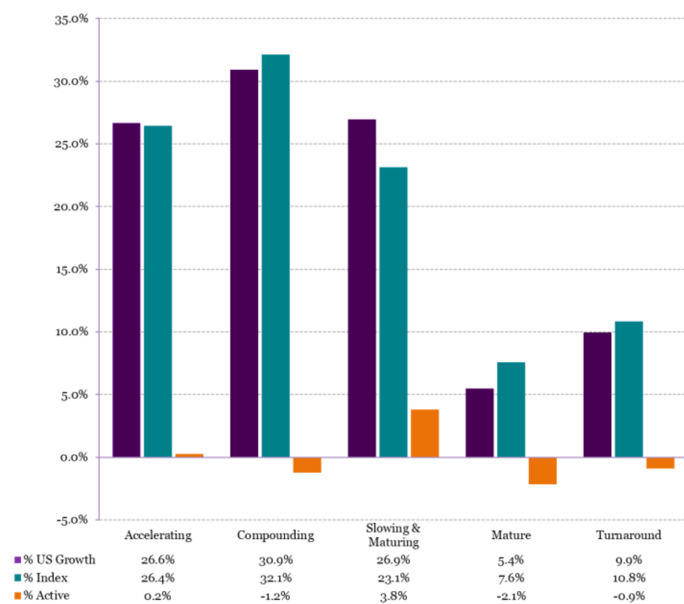
	Trust
No. of stocks	104
Fund size	£249.1m
Launch date	19.02.2001
Active share	59.8%
Tracking error	2.2%

Performance

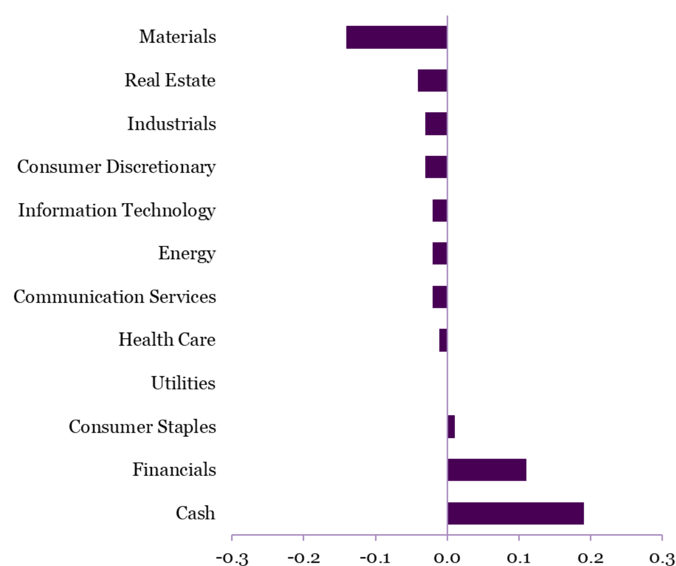
	Trust (%)	Benchmark[1] (%)	Relative (%)
Q2 2022	**-11.40**	**-9.88**	**-1.52**
Year-to-date	-13.10	-12.21	-0.89
1 year p.a.	0.93	-1.23	2.16
3 year p.a.	12.77	11.64	1.12
5 year p.a.	11.39	12.34	-0.95
10 year p.a.	15.99	15.66	0.33
Since inception p.a. 19.02.2001	7.74	8.41	-0.66

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.
Source: RLAM, based on the A Inc share class.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.
[1]Benchmark: MSCI US £ Net Total Return Index

Holdings and weights



Sector weights



Source: RLAM as of 30 June 2022. Shows weight relative to index.

Executive summary

- The fund recorded a net return (A Class, Income) of -11.69% for the second quarter, compared with -9.88% for the MSCI US Net Total Return Index (in sterling).
- 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 commentary

- Equities struggled as interest rate expectations rose and investors factored in the possibility of a Fed-induced recession in the next six to 12 months. As a result, the first half of 2022 was the worst start to a year for US equities since 1970. For the second quarter the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned -5.0%, -16.1% and -15.5% to sterling investors, respectively. Regional returns were again widely dispersed. According to MSCI regional data, Asia-Pacific (ex-Japan) was the best-performing region, returning -0.9%. Otherwise, the UK and emerging markets returned -3.0% and -4.4%, respectively, while the returns for Japan, Europe (ex-UK) and the US lagged at -7.7%, -8.1% and -10.2%, respectively.

- Within equity markets, the significant inflation-related rotation out of 'growth' and into 'value' that started in the first quarter continued. The MSCI World Value Index returned -4.4% versus -14.9% for the MSCI World Growth Index, outperformance of 10.5%. Energy again led the MSCI World sector returns (+2.6%), with consumer staples, healthcare and utilities the only other sectors with positive returns (+1.2%, +0.3% and +0.1%, respectively). Consumer discretionary (-17.7%), technology (-15.5%) and materials (-13.25%) were the weakest sectors.
- We are at what appears to be an important fork in the road for the global economy and financial markets. It all comes back to the ever-looming question: Is inflation transient or here to stay? Much like the bowls of porridge from the story of Goldilocks, is the economy 'too hot' with inflation unabated by central bank action and becoming structurally embedded, or is it – as Jamie Dimon recently predicted – about to get very cold and hit the buffers with interest rate rises, inflationary pressure and consumers running out of the Covid savings surplus leading to a big slow down or economic 'hurricane'? Some (including central banks) are predicting that things will be 'just right' with rising interest rates, quantitative tightening and rising bond yields helping to bring inflation and the economy into a soft landing. It's one of three scenarios; too hot and inflation entrenched, about to get very cold with a recession, or just right. As you can imagine, each of these environments might lead to very different financial market outcomes increasing the importance of asset allocation and equity portfolio construction (style risk).
- What can investors do in the meantime? We focus on three things. First, balance portfolios that cover the different scenarios (unless you have a strong view on which one will emerge); second, look to pick up individual stocks in the volatility where their long-term fundamentals are mispriced in a moment of extreme sentiment; and third, be fleet of foot reacting to the incoming data and evidence. The next six months will see a lot more data and evidence emerge as to which outcome is correct – a hot economy and entrenched inflation, an ice bath of a recession slowing the economy and inflationary pressures, or the soft landing down the middle with central banks bringing inflation down without ushering in a recession.
- Currency swings were notable in the quarter, following the volatility of the first quarter. The sharp rise in US interest rate expectations meant that the US dollar was the strongest global currency: it appreciated significantly against the Swiss franc, euro and sterling, and rose over 11% against the yen. These movements will impact global trade and overseas earnings over coming months, and dollar strength will also be a risk for any emerging markets countries and companies that have borrowed in dollars. The price of brent crude oil rose by another 6.4% to nearly $112 a barrel, but copper futures fell 21.9% on fears of recession and renewed Covid restrictions in China during the quarter.
- The macroeconomy is currently volatile and very difficult to predict. Inflation is currently rife in all parts of society, enhanced by Russia's war with Ukraine, and is causing consumers to lower their discretionary spend on goods. The impact it will have on corporate capex is still hard to assess, given that balance sheets are strong and many required investments are structural in areas like technology or climate transition. Meanwhile, long term underinvestment in commodities provides potential for continued elevated prices caused by lack of supply, rather than particular strength in demand.

Fund performance and activity

- The world continues to be impacted by the Covid-19 pandemic, but macroeconomic concerns have shifted sharply to other areas. The war in Ukraine has contributed to a surge in the price of Oil and Gas as well as other commodities. Supply chain and inflation concerns remain significant and perception of inflation being more than transitory has seen government and central bank policy become less accommodating. The Fed Funds rate has been raised 3 times since March to a level of 1.5%, having been at zero at the start of the year. Markets are pricing in further rate hikes through 2022 and US 10-year bond yields have hit 3% from 1.5% at the end of 2021. These factors have led to increased volatility and reduced risk appetite, seeing the US market lose 17% (10% in sterling terms) in the second quarter having lost north of 5% in Q1 2022.
- Changes in sentiment and rates expectations have a knock-on effect on discount rates and have brought about some contraction in the longstanding outperformance of Growth over Value, with Value outperforming Growth in the US in Q2 and YTD. It should be noted that over the previous five years Growth had outperformed Value by 25% p.a. in the US. From a sector perspective energy/utilities and defensives consumer staples and health care have led the way in Q2 at the expense of consumer discretionary, communication services and information technology. Large caps like Eli Lilly, Exxon Mobil and UnitedHealth Group made the largest contribution to benchmark returns at the expense of technology players Apple, Amazon and NVIDIA.
- Rising discount rates and the changing economic landscape have been a headwind to the US Growth Trust strategy, with the fund having a longer-term focus on Shareholder Wealth Creation. Stock selection in consumer discretionary (+60bps), financials (+27bps) and materials (+11bps) contributed positive returns with Eli Lilly, Ollie's Bargain Outlet, Northrop Grumman and United Health Group outperforming.

- These gains were offset by stock selection at the sector level in information technology (-48bps), health care (-23bps) and communication services (-9bps). At the stock level NVIDIA Corp, Amazon, HCA Healthcare and Alphabet were the largest contributors to underperformance. Not holding Merck – up 21% in Q2 – was also a negative for the fund.

Key views within the fund

- The trust aims to deliver above average medium- to long-term capital growth by investing in a diversified portfolio of US equities and will typically hold up to 100 stocks. The equities in which the fund invests may be from any sector, industry or market capitalisation. The fund aims to maximise the stock specific views from the US equities held in the Royal London Global Equity Diversified Fund, while minimising exposure to macroeconomic and sector influences using an optimisation strategy.
- We are fundamental, bottom-up investors and therefore don't invest according to top-down macroeconomics. The broad economic environment will have an effect, but we believe that good companies perform well across the economic cycle. What matters more is how the company is using its capital.
- Our Corporate Life Cycle model categorises companies according to their stage of development. We believe that corporate returns on productive capital and growth tend to progress along a cycle with five defined stages: Accelerating, Compounding, Slowing & Maturing, Mature and Turnaround. We seek portfolio diversification across the Corporate Life Cycle.
- Quantitative analysis helps us to identify potential opportunities by scoring stocks across a range detailed financial factors. We then apply our scoring system to rank characteristics to identify which companies to research further for possible inclusion in the portfolio.
- Stock selection really matters: looking at MSCI World Stock Returns between 2014 and 2019, the worst performing 80.2% of stocks performed behind the benchmark, with a third losing value, whereas the best performing 19.8% of stocks represented 99% of the excess return.

Outlook

- Inflation is continuing to rise, reflecting higher raw material costs, energy price increases and tight labour markets. However, central bank interest rate increases are already showing signs of slowing down activity and we believe that inflation will peak in major economies during the second half of 2022. Weaker GDP growth and recession in some areas will impact the corporate sector.
- Equity markets are unlikely to recover until we have a better view of the duration and severity of the downturn. In the meantime, we expect our companies' fundamental attributes should enable them to be more resilient than peers and gain share through a downturn; but we will have to be patient and await proof. We believe that our approach of building a diversified, liquid portfolio, invested in profitable and cash generative companies with strong balance sheets, is the best way to mitigate some of the risks faced as investors in this asset class.

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