Royal London Equity Funds

Fund Manager Commentary – May 2022

FOR PROFESSIONAL INVESTORS ONLY, NOT SUITABLE FOR RETAIL INVESTORS.

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RLAM Equity Performance

	1 month (%)	Rolling 12 Months (%)
RL UK Equity Income M Inc	**-0.19**	**8.99**
IA UK Equity Income Sector	1.02	6.23
FTSE All Share Index	0.69	8.27
RL UK Dividend Growth Fund M Acc	**0.18**	**2.67**
IA UK All Companies Sector	0.32	0.27
FTSE All Share Index	0.69	8.27
RL UK Mid Cap Growth Fund M Acc	**0.24**	**-12.13**
IA UK All Companies Sector	0.32	0.27
FTSE 250 ex-IT Index	-0.72	-8.83
RL UK Opportunities Fund M Acc	**0.19**	**-8.78**
IA UK All Companies Sector	0.32	0.27
FTSE All Share Index	0.69	8.27
RL UK Smaller Companies Fund M Acc	**-3.39**	**-16.20**
IA UK Smaller Companies Sector	-2.39	-13.94
FTSE Small Cap ex-IT Index	-1.92	-6.37
RL Global Equity Income Fund M Inc	**0.15**	**13.86**
IA Global Equity Income	-0.15	8.91
MSCI All Countries World Index	-0.26	5.14
RL Global Equity Select Fund M acc	**-0.88**	**17.38**
IA Global	-1.34	1.29
MSCI World Net Index	-0.31	7.36

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 AND FE, CORRECT AS OF 31 MAY 2022. RETURNS QUOTED ARE NET OF FEES.

UK market focus – May themes

Oil rules

- Oil prices rose around10% in May, driven by the EU's potential import ban on Russian oil, resulting in a similar gain for energy stocks with only telecoms, basic materials and financials posting positive returns for the month. All other sectors were down, reflecting the 30bps move in bond yields to the highest level since 2014 driven by inflation running close to 9%, as well as an increasingly weak UK consumer who is facing an energy shock that will dent disposable income. Consumer confidence has plummeted to recession lows, putting pressure on domestically exposed stocks, particularly consumer discretionary, resulting in the underperformance of the FTSE Small Cap. With its large exposure to commodities (20%), healthcare (11%) and consumer staples (15%), the FTSE All-Share offers a wide population of stocks to hedge against stagflation, explaining the index's continuing strong performance both within the UK and global context as well as the outperformance of the IA UK Equity Income sector.

Company news

- *Tame windfall taxes:* In response to the UK cost of living crisis and high profit levels, the government announced a 25% windfall tax on the oil and gas sector which will run until prices return to 'normal levels' or by December 2025 at the latest. Importantly, companies will receive £91.25 in tax relief for every £100 of investment into the UK, with Shell and BP already committing to $30bn and $23bn respectively (Bernstein Research). Given the magnitude of these investments, Bernstein Research estimates that most of the windfall tax will be cancelled out, not impacting cash flows or dividends. Surprisingly, UK utilities could be included in the plans with a possible £10bn windfall tax of excess profit made by power generators or a levy on power price upside which caused negative share price reactions. However, many of the utilities are planning to invest heavily in UK renewables and networks and the government is consulting with the sector to drive forward the energy transition while ensuring that the price paid for electricity is more reflective of the costs of production.
- *Record share buybacks:* According to AJ Bell's first Q1 2022 Buyback Bulletin, FTSE 100 companies have declared £32.7bn in share buybacks equal to 1.6% of the index's market cap, adding to a consensus forecast dividend for of £81.2bn (3.9% forecast yield) for this year. Financials are currently the largest generator of buybacks (£10.5bn) followed by oil (£7.4bn) and consumer staples (£6.9bn). Shell is running the most expansive buyback programme (not affected by windfall taxes) and the top ten are responsible for 75% of the cash return schemes announced so far this year. £38.7bn already exceeds the annual totals of every year since 2000 except two – 2006 (£33.6 billion) and the £34.9 billion all-time high of 2018. Many companies continue to announce buybacks.

Royal London UK Equity Income

Portfolio Commentary

- The fund returned -0.19% in the month, behind both the benchmark and peer group median. The fund placed 74th percentile in the month but remains ahead of median year to date.
- Domestically the key theme remains high inflation and the cost-of-living squeeze that UK households are facing. 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. However, 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 and there was also suggestion that this could be extended to include electricity generation companies.
- The two biggest hits to performance in the month were the holdings in **IG group** and **Segro**. In the case of IG investors are perhaps worried that the recent market sell-off and volatility may reduce the number and trading activity of their retail investment customers. This may be the case, but historically trading activity has tended to increase when markets are volatile. Segro was hit on concerns that as and when consumer spending slows, the online giant Amazon would seek less warehousing growth, reducing what has been high demand for the logistics warehouses that Segro owns.
- During the month the fund established a new holding, in the pharmaceuticals company **Hikma**. Hikma is a company that we have followed for some time, and we chose to start the position after the shares were weak due to announcing that one of its generic products would be delayed. While the delay means a downgrade to this year's results, the contribution from the product will still occur, just later than originally hoped. We see the current price as an attractive entry point. The purchase was funded by trimming the holdings in **United Utilities**, **Severn Trent**, **National Grid** and **RELX**.

Investment Outlook

- Consumers are facing a significant cost of living squeeze, as inflation is currently at its highest level for decades. Likewise, companies are battling to defend margins, as their own input costs increase significantly. In this tricky background we feel that our approach of investing in a broad range of companies from different sectors and stages of their lifecycle is very 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.

CITYWIRE A

Richard Marwood

Senior Fund Manager

Royal London UK Dividend Growth Fund

Portfolio Commentary

- The fund returned +0.18% in the month, behind both the benchmark and peer group median, with the fund placed 54th percentile in the month.
- Domestically the key theme remains high inflation and the cost-of-living squeeze that UK households are facing. 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. However, 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 and there was also suggestion that this could be extended to include electricity generation companies.
- Two notable hits to performance in the month were the holdings in **IG group** and **Hikma**. In the case of IG, investors are perhaps worried that the recent market sell-off and volatility may reduce the number and trading activity of their retail investment customers. This may be the case, but historically trading activity has tended to increase when markets are volatile. Hikma shares were weak due to announcing that one of its generic products would be delayed. While the delay means a downgrade to this year's results, the contribution from the product will still occur, just later than originally hoped.
- The most significant trading in the month was to increase the holding in the retailer **B&M**, whose shares were weak after announcing results that showed declining sales. Investors are nervous about almost all consumer stocks currently, due to the clear squeeze on household finances, but B&M should be better placed relatively, due to its competitive value offering. In our view the valuation of the shares is now attractive, compared to the company's cash generation.

Investment Outlook

- Consumers are facing a significant cost of living squeeze, as inflation is currently at its highest level for decades. Likewise, companies are battling to defend margins, as their own input costs increase significantly. In this tricky background we feel that our approach of investing in a broad range of companies from different sectors and stages of their lifecycle is very 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.

CITYWIRE A

Richard Marwood

Senior Fund Manager

CITYWIRE A

Niko de Walden

Fund Manager

Royal London UK Mid Cap Growth Fund

Portfolio Commentary

- The fund returned +0.2% during May, which compares to -0.7% from the benchmark (FTSE 250 ex IT) index, and +0.1% from the IA All Companies peer group.
- Equity markets made little progress during the month, as investors continued to fret about the impact of cost inflation on both consumer spending and corporate profit margins. The monthly data release showed that UK CPI accelerated to hit 9% during April, and the UK 10-year gilt yield ended the month at 2.1%, the highest it has been since 2015. That equity markets didn't decline more during May, shows the extent to which current share prices are already anticipating a severe cost of living crisis for consumers. It will soon be more obvious which companies are able to navigate the challenges of rising costs and (potentially) slowing sales to sustain earnings growth into 2023 and beyond, and which will not. The equity market is treating all suspects as offenders in the meantime, so while we believe our companies' fundamental attributes should enable them to deliver better results than peers, we will have to be patient and await the results. We are not altering our investment process, and 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.
- Two notable contributors to performance, online card retailer **Moonpig** and online auction platform **ATG**, are examples where companies have delivered solid operational results despite headwinds, and seen share prices bounce in response. Both companies have been victims of the wider equity market rotation away from "growth" stocks in favour of "value" stocks (traditionally commodity producers and financials, seen as beneficiaries of inflation and rising interest rates), while Moonpig has also been caught up in the fevered selling of anything consumer related. Nevertheless both delivered solid results with analysts upgrading forecast earnings, in Moonpig's case due to a materially earning enhancing deal to acquire experience gifting platform Smartbox, and in ATG's case because customer auction volumes have been growing faster than expected. While higher discount rates are likely to keep a lid on valuations short term, these remain high quality, cash generative businesses with sustained growth opportunities ahead of them.
- The fund initiated a new position in **Spectris**, the specialist engineering group. After nearly four years of strategic change under the current management team, Spectris today is a focussed, high quality, industrial engineering group. The three remaining "platform" operating businesses are capable of mid-to-high single digit revenue growth and high teens margins, due to their IP and focus on attractive end markets such as Life Sciences and Semiconductors. The group has a significant net cash balance sheet, and current trading has been robust with burgeoning order books. The valuation came under significant pressure following management's aborted bid for Oxford Instruments earlier this year, and remains below peers and below the group's historic valuation – despite being an improved business (higher margins and returns on capital) today. This was funded through reducing existing positions in **SSP Group** and **Rathbones**.

ALPHA MANAGER 2022
Henry Lowson

Henry Lowson

Head of UK Alpha Equities

Royal London UK Opportunities Fund

Portfolio Commentary

- The UK Opportunities Fund returned 0.19% over the month, behind both the benchmark and peer group median, with the fund placed 54th percentile.
- Domestically the key theme remains high inflation and the cost-of-living squeeze that UK households are facing. At the heart of this issue is the much higher cost of energy, driven by the severe disruption to the energy markets caused by Russia's invasion of Ukraine. That said, the pressures are by no means confined to energy. Other 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 partly funded by a windfall levy on oil and gas companies and there is also the suggestion that this could be extended to include electricity generation companies.
- This months' strongest performer was **Melrose Industries**, up 15% from what appeared an oversold position. Worries over tightening supply chains and the implications these would have on the automotive and aerospace arenas have weighed heavily on the share price in recent months. **BP** and **Shell** continued their relentless march and added 12% and 10% respectively. **Imperial Brands** surprised the market by announcing in-line results and were rewarded with a 9% move in its share price and **Synthomer** bounced 7% following a period of underperformance.
- On the downside, **B&M European Value** announced strong results but unfortunately this was accompanied by a cautionary outlook. The market is unforgiving, and the shares fell heavily to finish the month off 21%. **Integrafin** was another company to disappoint, this time on the outlook for higher costs which saw the price decline 16%. **Spirax-Sarco** continued to be caught in the crosshairs of a quality growth de-rating with a move downwards of 13% and **Marshalls**, following its recently announced acquisition of Marley, also lost 13%.
- The fund had a relatively quiet month in terms of trading with one stock, **TI Fluid Systems**, exiting the portfolio following a hugely disappointing trading update which left more questions than answers. We recycled some of the proceeds into topping up positions where we felt recent share price drops had been unwarranted such as **JD Sports** and **Watches of Switzerland Group** or where we feel the prospects deserve a higher weighting in the cases of **Shell** and **Imperial Brands.**

Investment Outlook

- Consumers are facing a significant cost of living squeeze, as inflation is currently at its highest level for decades. Likewise, companies are battling to defend margins, as their own input costs increase significantly. We believe our approach of investing in a broad range of companies who are in control of their own fates, irrespective of market conditions is the right one. As well as looking for durable businesses, a willingness to look through short-term extremes of sentiment and buy stocks when they are out of favour, or take profits when sentiment becomes exuberant should drive longer-term performance. We remain excited about the outlook for our portfolio companies and believe that over the medium to long-term, they can outperform the wider market.

Craig Yeaman

Senior Fund Manager

Royal London UK Smaller Companies Fund

Portfolio Commentary

- The fund returned -3.4% during May, which compares to -1.9% from the benchmark (FTSE Small Cap ex-IT index) and -2.6% from the IA UK Smaller Companies peer group.
- Equity markets made little progress during the month, as investors continued to fret about the impact of cost inflation on both consumer spending and corporate profit margins. The monthly data release showed that UK CPI accelerated to hit 9% during April, and the UK 10-year gilt yield ended the month at 2.1%, the highest it has been since 2015. That equity markets didn't decline more during May, shows the extent to which current share prices are already anticipating a severe cost of living crisis for consumers. It will soon be more obvious which companies are able to navigate the challenges of rising costs and (potentially) slowing sales to sustain earnings growth into 2023 and beyond, and which will not. The equity market is treating all suspects as offenders in the meantime, so while we believe our companies' fundamental attributes should enable them to deliver better results than peers, will have to be patient and await the results. We are not altering our investment process, and 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.
- Two notable contributors to performance, online auction provider **ATG** and investment platform **AJ Bell**, are examples where companies have delivered solid operational results despite headwinds, and seen share prices bounce in response. Both companies have been victims of the wider equity market rotation away from "growth" stocks in favour of "value" stocks (traditionally commodity producers and financials, seen as beneficiaries of inflation and rising interest rates). Nevertheless both delivered solid results with analysts upgrading forecast earnings, in in ATG's case because customer auction volumes have been growing faster than expected and in AJ Bell's case because rising interest rates will support margins. While higher discount rates are likely to keep a lid on valuations short term, these remain high quality, cash generative businesses with sustained growth opportunities ahead of them.
- The fund initiated a new position in **Videndum**, the manufacturer of accessories for the photography and cinematography markets. The group trades through leading brands such as JOBY, Manfrotto, Teradeck and SmallHD – each of which are the market leader in their nice, with IP and brand loyalty providing pricing power. Demand for original content creation, whether commissioned by the likes of Netflix, Apple TV and Disney+ or created by individuals for their YouTube and TikTok channels, drives growing end markets which have been turbocharged following the pandemic. Investment in highly automated, scalable, production facilities leaves the business well placed to navigate current challenges of supply chain delays and cost inflation, while the valuation discounts a significant slowdown in earnings growth, which we believe to be unlikely. This was funded through a reduction in various existing holdings including **InSpecs**, which had hit our 3% individual position size limit.

ALPHA MANAGER 2022
Henry Lowson

Henry Lowson

Head of UK Alpha Equities

Henry Burrell

Fund Manager

ROYAL LONDON ASSET MANAGEMENT

Royal London Global Equity Income Fund

Portfolio Commentary

- The Royal London Global Equity Income fund returned 1.13% in May (vs -0.26% MSCI ACWI). Year to date, the fund has returned 0.48% (vs -6.32% MSCI ACWI).
- Despite markets being relatively flat in the month, there was broad divergence in performance of different parts of the market, with the energy sector up 12%, whilst tech and consumer discretionary were down 3%. We are slightly overweight the energy sector through our positions in **Suncor** and **Shell** and note the amount of fast money which is now descending on the sector as investors reduce underweight positions. Nevertheless, the valuations of our holdings still assume significantly lower oil prices in the medium term, making for attractive risk rewards, so we are content to maintain our current positioning. **Cisco** was a notable underperformer during May, with their Q3 results demonstrating continued supply chain issues due to China's lockdown. With the order backlog very strong, we see these issues as ones which should resolve themselves over the next 12 months, without detrimental impact on long term wealth creation.
- During the month, the fund started a position in diversified mining company, **Glencore**. Glencore have a highly desirable collection of transition metal assets, and a clear plan to decarbonise over the long term, at a valuation which offers a highly attractive risk reward. We also reduced the funds position in healthcare company, **Eli Lilly**. They have been a star performer through success in developing obesity and Alzheimer's drugs to commercial stage, but with the yield now very low and expectations high, it seems sensible to take some profits, despite the strong momentum.

Investment Outlook

- The macroeconomy is currently volatile and very difficult to predict. Inflation is currently rife in all parts of society and is causing consumers to lower their discretionary spend on goods, but the impact it will have on corporate capex is still hard to assess, given that balance sheets are strong and many investments are structural technology or climate transition investments. Meanwhile, long term underinvestment in commodities provides potential for continued elevated prices caused by lack of supply, rather than particular strength in demand. Given these uncertainties, we are confident that a balanced approach to portfolio construction, where it is our stock picking that drives the majority of performance can hopefully continue to provide compounding outperformance, whilst delivering attractive income for stakeholders.

CITYWIRE A

Niko de Walden

Fund Manager

ROYAL LONDON
ASSET MANAGEMENT

Royal London Global Equity Select Fund

Portfolio Commentary

- Global equity market returns stabilised in May with a flat return in US dollar terms, however they remained volatile intramonth with a sell-off that recovered by month end. The main headwind to markets remains central bank tightening especially by the Federal Reserve in the US, denting global risk sentiment, and resulting in equity volatility. As such, the soft versus hard landing debate has come to the fore. A soft-landing meaning that inflation is kept at target level without triggering a recession.
- In contrast to recent years, we have seen that the correlation between stock market and bond returns has been positive in recent months. The move lower in stock markets has come alongside the spike higher in yields. As policy continues to tighten over the year, we continue to see rates mean revert to their long-term levels.
- New Covid case numbers fell a touch globally at the end of May as China's virus cases fell again.
- The Australian dollar rebounded 1.75% against the US dollar over the month. Thus, the value of US stocks was negatively impacted by this, when translated back for Australian domiciled clients.
- **Suncor Energy**, **Progressive Corp** and **Anglo American** contributed to gains in May. Calgary-based oil producer Suncor Energy in the Turnaround stage of the corporate Life Cycle continues to gain from soaring crude prices and refined product prices. Progressive Corp ('Slowing & Maturing') is successfully managing to increase rates though this is partially offset by higher costs. Meanwhile, Anglo American ('Slowing & Maturing') witnessed a bounce back after the post results sell off in April. Prices are also surging in the diamond market that their De Beers division is a major participant in. This is in part due to sanctions on their Russian competitor Alrosa, the world's largest producer.
- **Old Dominion**, **Admiral Group** and **Safran** detracted from returns over the period. Old Dominion ('Accelerating') declined as some brokers issued downgrades. We continue to be impressed by the strong operating performance of the business and believe that the wealth creation attributes, underpinned by the strong culture, are currently undervalued by the market. Admiral Group ('Slowing & Maturing') having benefited from lower car usage in lockdown, it continues to rise in the UK, albeit remaining below pre-pandemic levels. This suggests motor insurers are still enjoying some frequency benefits in claims trends, which is helping to offset accelerating repair inflation partially. Motor new business pricing is starting to react to inflation, but with a lag, held back in part by the regulators pricing review in Q1. Safran ('Turnaround') is seeing revenues recover as passenger miles flown are recovering, however more slowly than expected. Covid lockdowns in China are a headwind, impacting the stock in the short term.

CITYWIRE AAA

Peter Rutter

Head of Equities

CITYWIRE A

James Clarke

Senior Fund Manager

CITYWIRE AAA

Will Kenney

Senior Fund Manager

IMPORTANT INFORMATION