Royal London Global Equity Diversified Fund

Quarterly Report 30 September 2022

Top 10 holdings

	Fund (%)
Apple Inc	5.3
Microsoft	4.1
Amazon	2.8
Alphabet	2.7
United Health Group	1.7
JP Morgan Chase and Company	1.4
Exxon Mobil Corporation	1.3
Lilly (eli) and Co	1.3
Berkshire Hathaway	1.3
Visa	1.3
Total	**23.2**

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

Fund data

	Fund
No. of stocks	205
Fund size	£3,089.1m
Launch date	05.03.2018
Active share	65%
Tracking error	1.8%

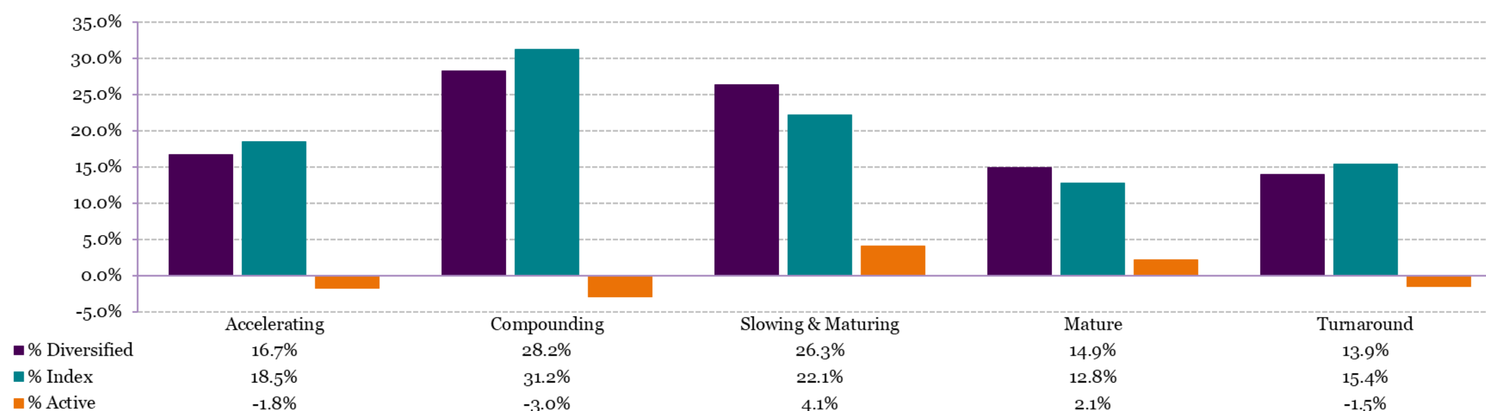
Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2022	**2.82**	**2.06**	**0.76**
Year-to-date	-8.60	-9.51	0.92
1 year p.a.	-0.90	-2.93	2.03
3 year p.a.	9.76	8.06	1.70
Since inception p.a. 05.03.2018	11.11	9.53	1.58

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 M Acc share class. All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding. 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.
[1]Benchmark: MSCI World NDR Index.

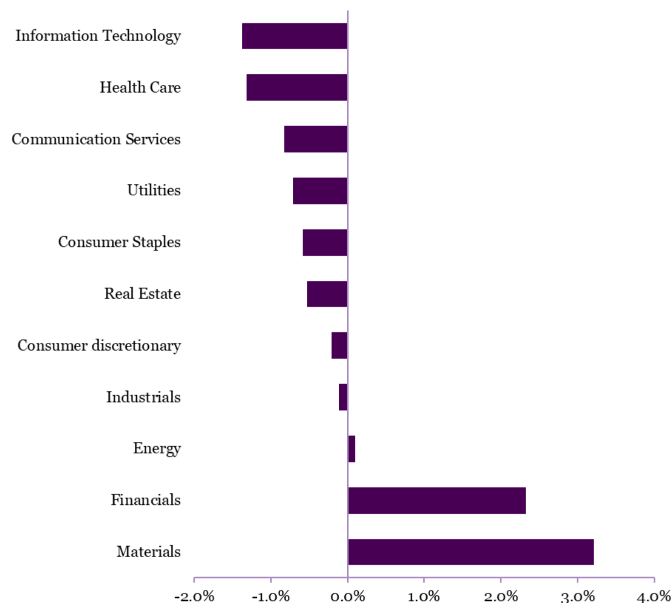
Holdings and Weights



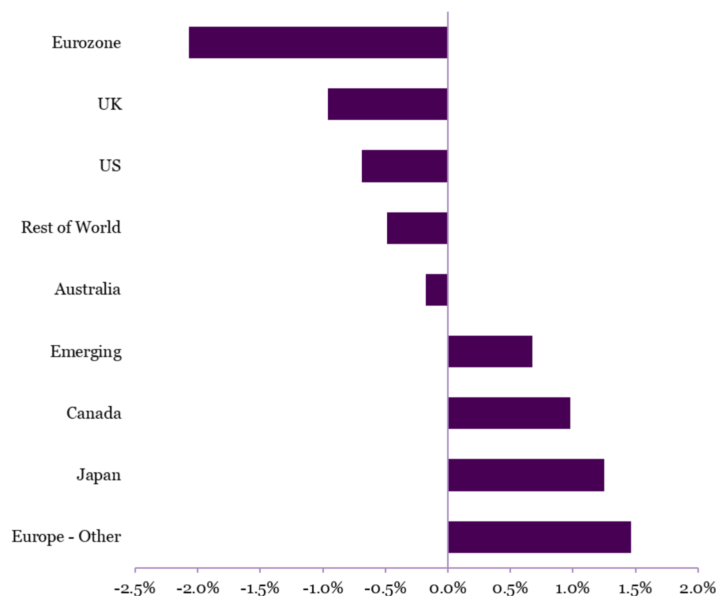
Source: RLAM as at 30 September 2022.

ROYAL LONDON
ASSET MANAGEMENT

Sector weights



Regional weights



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

Executive summary

- Over the third quarter our pooled funds delivered net returns of 3.64% for the **RL Global Equity Select Fund** and 2.82% for the **RL Global Equity Diversified Fund**, compared to 2.06% for the benchmark (MSCI World Net Total Return in sterling). For the 12-month period, the funds have returned 6.74% and -1.30%, respectively, against -2.93% for the benchmark (fund returns net of fees, for M Acc share classes).
- The macroeconomic factors that disrupted financial markets in the first half of 2022 continued to dominate in the third quarter – higher-than-expected inflation and interest rate increases were the key macroeconomic influences, along with growing fears of recession in the UK, Europe and the US. Inflation first surfaced in the aftermath of the Covid-19 pandemic but was exacerbated by the Russian invasion of Ukraine in February and retaliatory sanctions which sharply increased the prices of oil & gas and other commodities. Although they have fallen back slightly, energy prices remain high and geopolitical events continue to affect sentiment as winter approaches. The apparent sabotage of the Nordstream gas pipelines from Russia to Germany suggests that energy will remain a key pawn in relations between NATO countries and Russia.
- Central banks have responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The US Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. Since March, the Fed has raised rates five times by an aggregate of 3% – its 0.75% increases in June, July and September were the biggest increases for nearly 30 years. Its commitment to do more has led markets to price in further hikes in 2022. The European Central Bank (ECB) has so far been slower to react, partly due to a more fragmented backdrop with a gap between Germany and 'peripheral' economies. However, ended its bond buying programme in July and increased rates by 0.75% (its first increase in 11 years and a bigger increase than the 0.50% expected by economists). A further increase of 0.75% followed in September with a clear commitment of further increases to follow. The Bank of England (BoE) increased rates by 1.00% over the quarter to 2.25%, taking its tally to six increases so far in 2022 and seven in this cycle.
- The key theme of high inflation will continue to be a focus and the cost-of-living squeeze that households are facing. 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. 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. We diversify the portfolio 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 are pursuing an appropriate strategy for their position in the Life Cycle.

Market overview

- The third quarter saw further weakness in equities as interest rates continued to rise and investors increasingly factored in central bank-induced recession in the next six to 12 months. In local currency terms (i.e., without the impact of the strong dollar), nearly all major stock markets fell globally, although currency movements offset this weakness and boosted the sterling returns from overseas equities. For the third quarter the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned -3.4%, +2.2% and +1.5% to sterling investors, respectively. Regional returns were particularly widely dispersed. According to MSCI regional data, the US and Japan delivered the only positive returns (to sterling investors) at +3.7% and +0.6%, respectively. Otherwise, Europe ex-UK returned -2.0%, while the UK and emerging markets returned -2.9% and -3.6%, respectively. The Far East ex-Japan region was a notable outlier, returning -9.8%.
- Within equity markets, the significant inflation-related rotation out of 'growth' and into 'value' that dominated the first half of 2022 switched back, albeit to a limited extent. The MSCI World Growth Index returned +3.4% versus +1.1% for the MSCI World Value Index, outperformance of 2.3%. Unusually, for the MSCI World (in sterling), energy was only the second strongest sector: consumer discretionary returned +9.1%, with energy and industrials returning +7.6% and +2.6%, respectively. The laggards were consumer services, real estate and utilities at -5.3%, -3.7% and +0.3%, respectively.
- Inflation has continued to surprise to the upside across developed markets. The consensus view implied by bond and equity markets is that the aggressive policies of central banks rising rates to slow the economy and reduce inflationary pressures will most likely cause a recession. For example, rising rates will drive mortgage rates higher which in turn cools the property market, and with it, consumer sentiment and spending appetite. Higher rates on corporate loans and overdrafts cause companies to pay more in interest payments and encourage them to reduce any debt piles ahead of investing in growth projects. Whatever the mechanism, rising rates will slow demand and given the magnitude of rate rises and impacts of inflation already on consumers and companies', economists are finding it hard to see how a recession will not occur.
- There are two problems to this set up currently. First, central banks and city economists may not have fully factored in the policies of governments who are working very hard to protect voters from the negative impacts of rising inflation. In the process, they are likely staving off recession and driving more long-term inflation. Second, despite it being some months since the start of rate rises and inflationary pressures, the companies we speak to are generally not yet seeing major slowdowns in customer activity. Granted, some have more recently highlighted a change in behaviour of consumers such as a North American retailer we spoke to in late September, but this is more at the margin as many other management teams are indicating that demand remains strong and there is a lot of pent-up demand in their area of the economy. An example here might be a global industrial rental equipment company.
- Despite this non-immediate transition of central bank activity to slowing the economy, it is challenging to see how a recession is avoidable given the apparent determination of central banks to reduce inflation. The supply of goods and services is hard to increase in the near term – oil fields, fertiliser, Russian gas, skilled labour and so on – meaning demand will have to fall to reduce inflation and central banks are determined to make sure this happens. Falling demand without a recession is going to be hard to achieve.
- A final point though is our observation that despite all of this, many cyclical stocks in global equity markets appear to be pricing in a recession – so even if one were to occur, the relative downside in these stocks from this juncture might not be as bad a people fear. So, counter-intuitively as the recession unfolds it might be a good time to be buying cyclical stocks. Put another way there is a difference between what happens in the economy and what you might want to do with your investments as it always depends on the price of what you are buying and selling.
- Currency movements had a notable impact in the quarter, following the volatility in the first half of the year. The Fed's more aggressive approach to raising interest rates compared to other central banks has pushed the dollar higher. It was again the strongest major currency: it appreciated by over 6% against the yen and euro, and over 8% against sterling. On a translational basis, sterling's weakness benefits sterling investors in overseas assets as it boosted returns over the quarter. However, these movements will impact global trade 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 fell by 16.9%, but remains over $90 a barrel, and copper futures fell another 8.0% in dollar terms on fears of a slowdown in China and recession in the US, UK and Europe.
- 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.

Performance and activity

- During the third quarter, the fund outperformed its benchmark. **Steel Dynamics, HCA Healthcare, Reliance Steel and Amazon** were strong contributors to returns in the third quarter. Steel Dynamics, 'Slowing and Maturing', has gained on the back of elevated steel prices which are well above the pre-pandemic average. Margins in the business remain elevated, supported by the fabrication business. Excess cash is being used for a combination of buybacks and investment into a new aluminium rolling mill. HCA Healthcare, the hospital giant in the Compounding phase, has actively managed higher labour costs which have represented a headwind for the business. HCA is ultimately a solid long-term Compounder which benefits from unparalleled scale and high barriers to entry. We believe there should be attractive decent long-term growth opportunities with a focus on share buybacks between physical investments.
- Reliance Steel, in the Slowing & Maturing category, has seen another quarter of record results which were mostly positive against our milestones, with gross profit and cost control well ahead of targets. Cash generation meanwhile also continues to pick up. Reliance Steel has been ploughing cash into share buybacks over the last twelve months amounting to almost $600m. The board has just given fresh authorisation for $1bn of buybacks, and given the company's attractive valuation, we believe this represents a good use of shareholders' capital. That said, more reinvestment at attractive rates of return would have been even more positive. Meanwhile, online retail giant Amazon in the Slowing & Maturing category announced a strong set of Q2 results - Q2 net sales were +7% reported or +10% at constant currency, which is a solid growth rate given the lockdown comparison. The cloud AWS saw Q2 sales +33% yoy and included the comment in results: "*We believe we're still in the early stages of enterprise and public sector adoption of the cloud*." We continue to see the valuation pay-off as attractive.
- **Tesla Inc, Allegiant Travel, Suncor Energy** and **Baker Hughes** detracted from performance over the period. Tesla, in the Accelerating phase of the Life Cycle, saw its shares gain during the third quarter however we chose not to hold the stock on valuation grounds. As a result, this detracted from our overall performance. Meanwhile, Allegiant Travel, 'Turnaround', pulled back on higher costs, namely higher jet fuel costs that have been eroding business margins. Suncor Energy 'Turnaround' during the period raised guidance of capital spending as inflationary pressures continue to come through. Nevertheless, the company is doing a good job of reducing debt and buying back shares. Energy technology company Baker Hughes, 'Turnaround', pulled back over the period as the company announced a reorganisation in the Oilfield Services & Equipment (OFSE) and Industrial & Energy Technology (IET) areas. We believe this will advance its long-term strategic transformation. Other challenges have been Russian geopolitical headwinds and transitory project/maintenance delays in Turbomachinery & Process Solutions.

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.
- 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.

Find out more

- We are experiencing unprecedented times in markets. Inflation is at multi-decade highs, energy prices are rising and the latest Bank of England announcement created further uncertainty. Following on from the unsettling fixed income and currency markets of late September, RLAM hosted a webinar for RLAM's Head of Fixed Income Jonathan Platt, and Craig Inches, Head of Rates and Cash to discuss the situation and how central banks and policymakers might react. Investors can listen again via *Our Views* section of www.rlam.com, which also contains includes regular updates from Head of Fixed Income Jonathan Platt, Head of equities Peter Rutter, and Head of Sustainable Mike Fox.

Additional information

- As we highlighted in our Annual Report, RLAM has ambitious targets for the next few years, notably in international growth as well as investment in infrastructure and people. This investment is to make sure that we continue to provide clients with the service they need and positioning us to for future regulation changes and market development.
- As part of that ambition, we are pleased to announce that we are moving to a new investment platform and have selected the industry leading 'Aladdin' platform. This decision has followed months of analysis and pre-implementation planning with the vendor BlackRock. Aladdin will help us improve our service offerings to our clients, as well as delivering operational efficiencies.
- As you would expect, implementation is an extended task, and the project is expected to complete in 2024, but we believe it is important to be transparent about such projects with our clients. Throughout the implementation, the project and management of your client portfolios will be closely monitored by our Board and Risk functions to ensure that this transition is achieved smoothly, and we will keep you updated on our progress. This is an important part of our long-term strategic goal to ensure that we continue to meet your needs today and into the future.

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