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Royal London UK Smaller Companies Fund

Quarterly Investment Report

30 September 2023



Quarterly Report

The fund as at 30 September 2023

The purpose of this report is to provide an update on the Royal London UK Smaller Companies Fund. The report has been produced by Royal London Asset Management. The report starts with a summary dashboard showing key information about the fund. A glossary is located at the end of the report covering the description of some of the more technical terms used within the report. All data is as at the report date unless otherwise stated.

Contents

The fund	3
Performance and activity	4
Fund breakdown	6
Market commentary	7
Further information	8
Disclaimers	9
Performance net and gross	11
Glossary	12

The fund

Fund performance objective and benchmark

The fund's investment objective is to achieve capital growth over the medium term (3-5 years) by investing at least 80% in the shares of UK smaller companies listed on the London Stock Exchange. The fund's performance target is to outperform, after the deduction of charges, the FTSE Small Cap ex-IT (investment trusts) Total Return GBP Index (the "Index") over rolling 5-year periods (3). For further information on the fund's index, please refer to the Prospectus.

Benchmark: FTSE Small Cap ex-IT (investment trusts) Total Return GBP Index

Fund value

	Total £m
30 September 2023	271.53

Fund analytics

	Fund
Fund launch date	1 May 2012
Base currency	GBP
Number of holdings	66

Performance and activity

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	(2.16)	2.88	(5.05)
YTD	(6.07)	3.64	(9.71)
1 Year	0.99	12.72	(11.73)
3 Years (p.a.)	(0.62)	13.71	(14.32)
5 Years (p.a.)	(0.31)	3.42	(3.73)
10 Years (p.a.)	5.45	5.95	(0.50)
Since inception (p.a.)	7.77	9.20	(1.42)

Past performance is not a guide to future performance. Please refer to the Glossary for the basis of calculation and impact of fees. Performance and since inception date based on Royal London UK Smaller Companies (M Acc). Source: Royal London Asset Management; Net performance; Since inception date of the shareclass is 1 May 2012.

Performance commentary

Merger & acquisition activity was again elevated in the quarter, with fund holdings Instem, Blancco, and Ergomed all subject to takeover offers at substantial premiums to their undisturbed share prices. There were also approaches made for Renewi and Pendragon, amongst others, not held within the fund. As we have mentioned in other commentaries, it is our belief that if these companies don't get appropriately valued, there will likely be further approaches – all the more so while equity markets remain focused on short term economic fluctuations at the expense of valuing companies on their long-term fundamentals and earnings potential.

The fund returned -2.2% during the quarter, slightly behind the IA UK Smaller Companies peer group median return of -2.0% and placing 56th percentile. By comparison the benchmark (FTSE Smaller Companies ex IT index) returned +2.9%. The underperformance relative to the benchmark was primarily driven by stock selection, partly a result of the M&A deal spree referred to above. Renewi and Pendragon, which were not holdings in the fund, were subject to bids at material premiums. Hunting and Keir Group, also not held within the fund, were other material “detractors”. The fund generally avoids companies in the Contracting and Oil & Gas sectors due to their excessive cyclicality, our perception of ESG risks and, in the case of contracting, inherently low margins and returns on capital. Renewi and Pendragon didn't meet our fundamental attributes.

Ergomed, the pharmaceutical services group, and Blancco Technology, the data erasure software business, were significant positive contributors after both were subject to recommended cash offers by private equity investors. Johnson Services Group, the linen rental provider, was a top contributor following impressive first half results. Customers within the hotel, restaurant and catering market have seen substantial growth while JSG have also taken material market share from independent competitors. They also announced the acquisition of Celtic Linen, a market leader in the Irish Healthcare market, in earnings enhancing deal that provides substantial synergies with their existing Irish operations.

Performance and activity

Top 10 holdings

	Weighting (%)
Hollywood Bowl Group Plc	2.92
BOKU, Inc.	2.92
Hill & Smith PLC	2.72
Alfa Financial Software Holdings Plc	2.66
Porvair plc	2.61
Serica Energy PLC	2.60
GlobalData Plc	2.38
Alpha Financial Markets Consulting PLC	2.33
Cranswick plc	2.23
Advanced Medical Solutions Group plc	2.16
Total	25.53

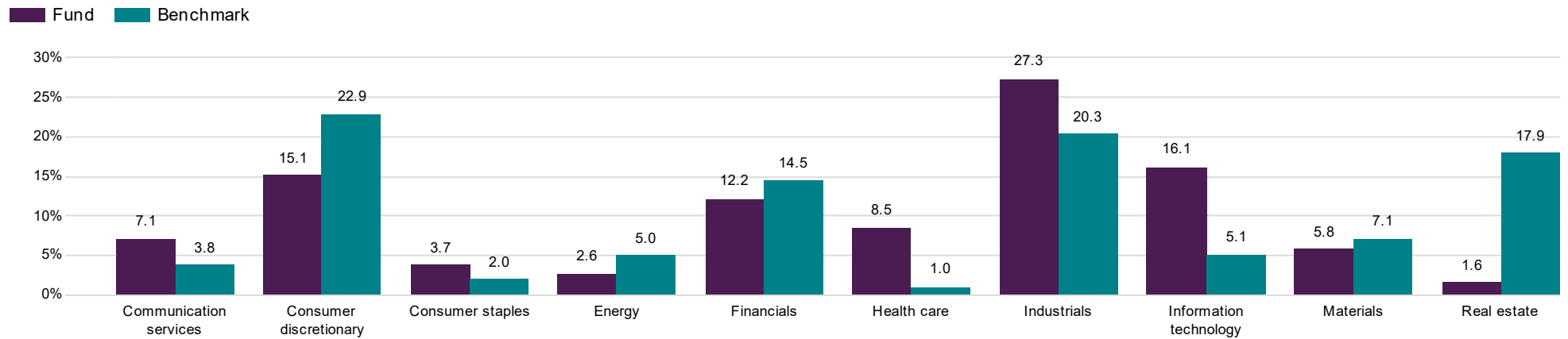
Fund activity

The fund initiated a new position in Bloomsbury Publishing, a leading publisher of consumer, academic and professional titles. The consumer division generates substantial operating cash flows which the management team have been steadily investing into the higher margin and higher growth Academic & Professional division. Organic growth should be supported by bolt on acquisitions, funded from the substantial net cash pile on its balance sheet. This new position was funded in part by the disposal of Aptitude Software. The CEO stepped down alongside a trading statement which raised questions about their ability to sustain double digit revenue following a sharp increase in customer churn, while cash flow had also deteriorated.

Instem was also disposed of, following a recommended cash offer by private equity, while a number of positions were added to including Advanced Medical Solutions, Volex, and Ricardo.

Fund breakdown

Sector weights



Market commentary

Market review

Despite the flurry of first half corporate results, inflation data and interest rates remained at the forefront of investor mindsets during the third quarter. Data released in July showed that the rate of UK core inflation had slowed to 6.9%, meaningfully lower than most commentators had expected, and softening slightly further in August. As a result, Bank of England policy makers decided to hold base rates steady in September, ending their cycle of 14 sequential rate hikes. The US Federal Reserve also held rates steady in September. Indications are that policy makers will leave rates around current levels for longer than normal (rate cuts are not expected for some time), nevertheless it should not be overlooked that the current monetary policy tightening cycle - which has dominated financial markets for the last two years - is effectively over. Base rates have most likely peaked. This excites us, as in the fullness of time this should reduce pressure on equity market valuations, and should allow more focus on company specific fundamentals, as opposed to macroeconomic data being the primary determinant of returns.

UK equity markets initially rallied in July, with UK small and mid-cap indices leading the way following lower than expected inflation data and supported by a generally upbeat earnings season. However rising 10-year bond yields (as investors anticipated “higher for longer” base rates), and weak PMI and house price data (which raised concerns of a slowing domestic economy), resulted in equity market declines through August and September. The mid-cap FTSE 250 index significantly underperformed its large-cap FTSE 100 counterpart in this environment.

We are not normally avid followers of the minutiae in macroeconomic data, however a slew of revisions to UK GDP data in September did grab our attention. New ONS numbers suggested that the UK economy bounced back from the COVID pandemic significantly faster than initially estimated, with GDP now believed to have grown 1.8% between December 2019 and June 2023 – faster than France or Germany – compared to a previous estimate for a contraction. Figures for GDP growth in the first quarter of 2023 were also revised higher. While it is tempting to dismiss these revisions as another example of the issues with macro data, and why we avoid constructing the portfolio to fit any single macroeconomic outcome, there is an important narrative here. Specifically, that the UK economy has consistently been more resilient than expected through the sequential shocks of the pandemic, supply chain disruption and the cost of living crisis. In our view this speaks to the fact that corporate and consumer balance sheets were significantly repaired through Covid, resulting in less sensitivity to rising interest rates. It also suggests that the economy might be able to better withstand higher interest rates for some time without seeing a destructive economic contraction.

In positive news, the UK’s agreement to rejoin the EU’s Horizon science program in September is another sign of incrementally improving relationships with our largest trading partner. This follows the “Windsor Framework” in February and speaks to increased political stability, key to unlocking both foreign and domestic corporate investment into the economy.

Outlook

There is considerable uncertainty about the outlook for the rest of 2023, with the risk that elevated interest rates could tip economies into a recession. However, corporate balance sheets remain very robust (meaning that the balance of power is in our hands as equity holders, rather than the debt holders), cost inflation is now receding (freight rates, raw materials and energy prices are materially lower than was the case a year ago) and much of the destocking and supply disruption following Covid appears to be moving into the rear-view mirror.

UK equity market valuations are currently at extreme levels. Indeed, the FTSE 250 is trading at the cheapest levels in 30 years relative to the FTSE 100 on a median 12-month forward dividend yield basis (Berenberg, September 2023). What has been interesting over the recent earnings season is how share prices have reacted to corporate newsflow. In several cases share prices have jumped significantly higher on in-line statements, suggesting investor sentiment has become overly negative. There is a reasonable argument to suggest that we are looking at a tempting combination of companies trading on trough valuations and trough earnings forecasts! It is of course difficult to predict the catalyst for improved UK stock market performance, but a normalisation in macroeconomic conditions and an end to UK equity outflows might just trigger it.

Our focus has always been on the long term and we continue to seek out companies with the valuable fundamental attributes that will allow them to ‘control the controllables’ in any economic environment. We continue to believe that it is these fundamental attributes that drive stock prices over the long term, and macroeconomic data or technical headwinds such as asset allocation flow can lead to short term mispricing. As such, we are excited by the opportunities currently on offer for UK investors.

Further Information

Please click on the links below for further information:



Find out more

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams. Notable publications in the third quarter include our annual Climate Report, as well as our annual Assessment of Value reports, available from the home page of www.rlam.com.

Disclaimers

Important information

For professional clients only, not suitable for retail clients.

This is a financial promotion and is not investment advice.

Telephone calls may be recorded. For further information please see the Privacy Policy at www.rlam.com.

Issued in October 2023 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

The Fund is a sub-fund of Royal London Equity Funds ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC000807.

The Authorised Corporate Director (ACD) is Royal London Unit Trust Managers Limited, authorised and regulated by the Financial Conduct Authority, with firm reference number 144037.

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

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Risks and Warnings

Investment Risk

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

EPM Techniques

The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Liquidity Risk

In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Counterparty Risk

The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Smaller Companies

The Fund invests in smaller companies, the prices for which can be less liquid and be more volatile than those of larger companies and therefore may have a greater impact on the value of the Fund.

Performance to 30 September 2023

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years	3 Years (p.a.)	5 Years (p.a.)
Fund (gross)	(1.97)	(0.38)	1.77	0.45	2.25	0.15	0.45
Fund (net)	(2.16)	(0.76)	0.99	(1.84)	(1.55)	(0.62)	(0.31)

Annualised (%)

Year on year performance (%)

	30/09/2022 - 30/09/2023	30/09/2021 - 30/09/2022	30/09/2020 - 30/09/2021	30/09/2019 - 30/09/2020	30/09/2018 - 30/09/2019
Fund (gross)	1.77	(35.30)	52.56	2.57	(0.75)
Fund (net)	0.99	(35.80)	51.40	1.78	(1.47)

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

Source: RLAM as at 30 September 2023. All figures are mid-price to mid-price in GBP for the Royal London UK Smaller Companies (M Acc).

Glossary

Fund value

Total value of the fund as of the last business day of the calendar month. The fund value is as at close of business and on a mid-price basis.

Number of holdings

Total number of unique holdings of the Fund excluding cash, currency and derivatives.

Performance

Performance is calculated using the daily end of day NAV per share produced by HSBC based on the mid price.

Sector weights

Breakdown of holdings by FTSE ICB (Industry Classification Benchmark) sector relative to the benchmark index.

Top 10 holdings

Top 10 assets held by market value, excluding derivatives and cash.