ROYAL LONDON ASSET MANAGEMENT

Investment Clock – Strategy Update

Issue #25, February 2022

Multi asset views from RLAM

Royal London Asset Management manages £163.8 billion in life insurance, pensions and third party funds*. The multi asset team manages the Governed Range pension portfolios as well as the Global Multi Asset Portfolios (GMAPs) and Multi Asset Strategies Fund (MAST) available on third party platforms.

*As at 31/12/2021

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Please visit **www.investmentclock.co.uk** for our blog and information about the multi asset range.

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In the deflationary shock of 2020, technology stocks and gilts helped old-style balanced funds to produce outsized returns.

In the more inflationary post-Covid recovery we are seeing a better performance from more diversified funds. with commodities and commercial property performing strongly.

Beating inflation in choppier waters

Our GMAP funds and Governed Range are designed to beat inflation over the long run for a given level of risk. This is becoming more challenging with financial asset valuations stretched and inflation surging. Broad diversification can create a greater resilience at these times, with traditional inflation-hedges like commodities and commercial property performing strongly. Tactical asset allocation will also be important, especially with geopolitics keeping volatility high. We are overweight commodities versus bonds with our equity exposure tilted towards value sectors and less expensive markets like the UK. For investors concerned about downside risk, our Multi Asset Strategies Fund (MAST) seeks to limit losses in turbulent markets.

Valuations are stretched after Covid ease

Our multi asset funds are designed to beat inflation over the long run for a given level of risk. This is becoming more challenging. The policy response to Covid pushed stocks and bonds to high valuations, limiting prospective returns. High inflation makes cash and other low yielding assets unattractive.

Lingering inflation means the Clock is in Stagflation

We are already 'late cycle' with the Great Lockdown interrupting, rather than ending, the previous expansion. Growth is slowing and inflation is at multi decade highs, leaving the Investment Clock in Stagflation. We are overweight commodities versus bonds and expect a wide trading range for stocks, as investors factor in the changing policy and geopolitical backdrop.

Focus on rotation not appreciation

Rising real yields are a particular challenge to expensive growth sectors and regions, but cheaper, less interest-rate sensitive parts of the market could make progress through 2022. We are positive on the financials and energy sectors but more cautious on highly valued technology and consumer discretionary stocks. We are overweight UK equities given the superior value the market offers.

Navigating choppy waters

Broad diversification and active tactical asset allocation will be important tools in seeking inflation-beating returns over the next few years. For investors concerned about downside risk, our Multi Asset Strategies Fund (MAST) also uses volatility management, aiming to limit losses in turbulent markets.

Figure 1: Sterling-based annual returns from major asset classes 2011-2022

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD
1	Gilts +15.6%	EM Stocks +12.8%	Global Stocks +21.2%	Property +19.5%	Property +13.9%	EM Stocks +35.4%	EM Stocks +21.1%	Property +7.5%	Global Stocks +22.6%	Global Stocks +14.3%	Commodities +28.3%	Commodities +9.8%
2	Property +8.1%	UK Stocks +12.3%	UK Stocks +20.8%	Gilts +13.9%	Global Stocks +4.4%	Commodities +33.3%	Global Stocks +14.0%	Cash +0.6%	UK Stocks +19.2%	EM Stocks +11.9%	Global Stocks +20.0%	Property +1.2%
3	Multi Asset +1.0%	Global Stocks +12.1%	Property +11.0%	Global Stocks +12.2%	Multi Asset +1.4%	Global Stocks +30.3%	UK Stocks +13.1%	Gilts +0.6%	EM Stocks +15.9%	Gilts +8.3%	Property +19.9%	EM Stocks +0.6%
4	Cash +0.6%	Multi Asset +7.8%	Multi Asset +7.2%	EM Stocks +7.9%	UK Stocks +1.0%	UK Stocks +16.8%	Property +11.2%	Multi Asset -2.0%	Multi Asset +10.3%	Multi Asset +2.9%	UK Stocks +18.3%	Cash +0.0%
5	UK Stocks -3.5%	Gilts +2.7%	Cash +0.5%	Multi Asset +6.7%	Gilts +0.6%	Multi Asset +12.6%	Multi Asset +6.7%	Global Stocks -3.1%	Gilts +6.9%	Cash +0.3%	Multi Asset +10.3%	UK Stocks -0.3%
6	Global Stocks -6.9%	Property +2.3%	Gilts -3.9%	UK Stocks +1.2%	Cash +0.5%	Gilts +10.1%	Gilts +1.8%	Commodities -5.7%	Commodities +3.5%	Property -1.0%	EM Stocks +1.0%	Multi Asset -1.1%
7	Commodities -12.7%	Cash +0.6%	EM Stocks -5.3%	Cash +0.5%	EM Stocks -10.3%	Property +2.6%	Cash +0.3%	EM Stocks -7.6%	Property +2.1%	Commodities -6.1%	Cash +0.0%	Gilts -3.8%
8	EM Stocks -18.4%	Commodities -5.4%	Commodities -11.2%	Commodities -11.8%	Commodities -20.3%	Cash +0.4%	Commodities -7.1%	UK Stocks -9.5%	Cash +0.7%	UK Stocks -9.8%	Gilts -5.2%	Global Stocks -4.1%

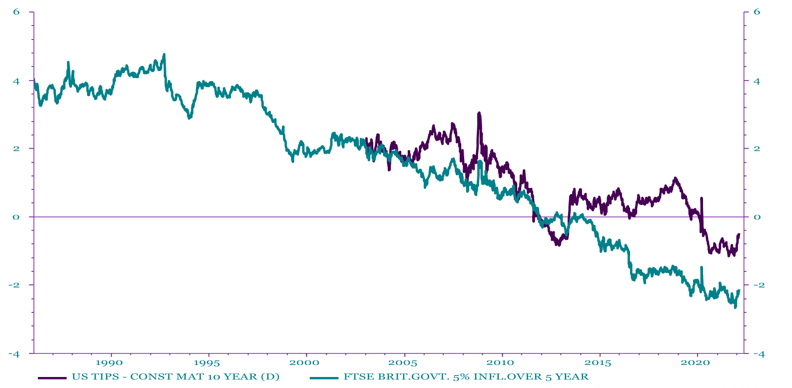
Source: RLAM, DataStream as at 1 February 2022. 'Multi Asset' returns are based on the benchmark weights of Royal London Global Multi Asset Portfolio (GMAP) Balanced Fund / Governed Portfolio 6. Indices used are FTSE All Share, FTSE World, MSCI Emerging Markets ESG Leaders, MSCI/AREF UK All Balanced Quarterly Property Fund, Bloomberg Commodity Index, BoAML BB-B Global Non-Financial High Yield Constrained Index, iBoxx Sterling Non-Gilt Index, FTSE Actuaries UK Index Linked Gilts, FTSE Actuaries UK Conventional Gilts Index, FTSE Actuaries UK Conventional Gilts up to 5 Years Index, SONIA. Total returns in sterling terms.

Markets are expensive, limiting future returns

The onset of the Covid-19 pandemic saw policy makers respond with unprecedented ease in an attempt to keep the economy from collapsing and to support incomes as social distancing measures were put in place. As central banks cut rates and enacted quantitative easing measures, bond yields slumped to all-time lows. Real yields on government bonds are negative in the UK and the US.

Negative real rates mean that investors are effectively losing money by holding government bonds to maturity once inflation has been accounted for.

Figure 2: Real government bond yields are negative



Source: Refinitiv Datasteam, RLAM. As at 15th February 2022.

Equity markets have rallied a very long way from their March 2020 lows, with loose policy and a strong global reopening helping stocks to post returns of over 80%.

Global equities are now expensive on a cyclically-adjusted valuation basis. This effect is most pronounced in the tech-heavy US market, where multiples are at their highest level since the dot com bubble. The UK market was left behind during the post Covid rally and is still seeing valuations in the middle of their 30-year range.

Figure 3: Cyclically adjusted PE ratios are high, especially the US

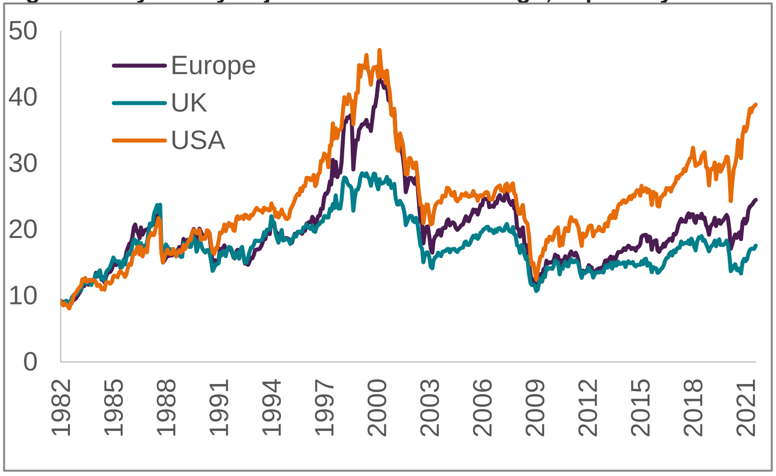
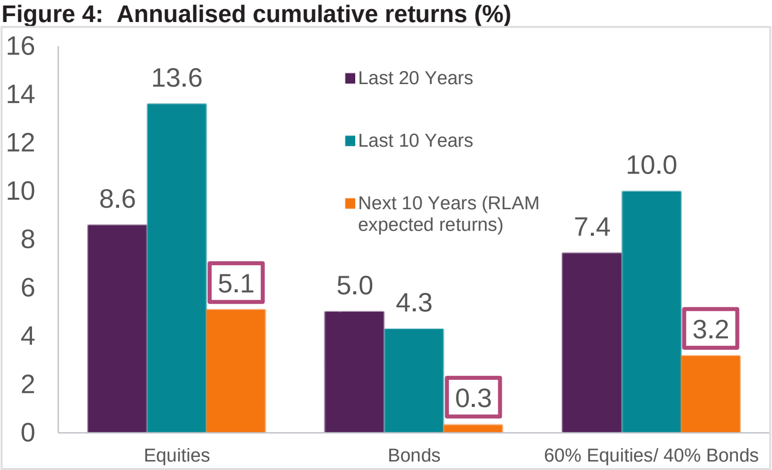


Chart refers to price earnings (PE). Source: Datastream, Barclays, RLAM at 14 October 2021.

High financial market valuations reduce prospective returns. RLAM's capital market assumptions are for equity returns of around 5% a year over the next decade with government bonds struggling to post positive returns as yields rise.

This suggests a traditional 60/40 balanced fund might only generate nominal returns in the region of 3% – better than we're expecting from cash, but only offering a small margin over the level of inflation we are anticipating.

Figure 4: Annualised cumulative returns (%)



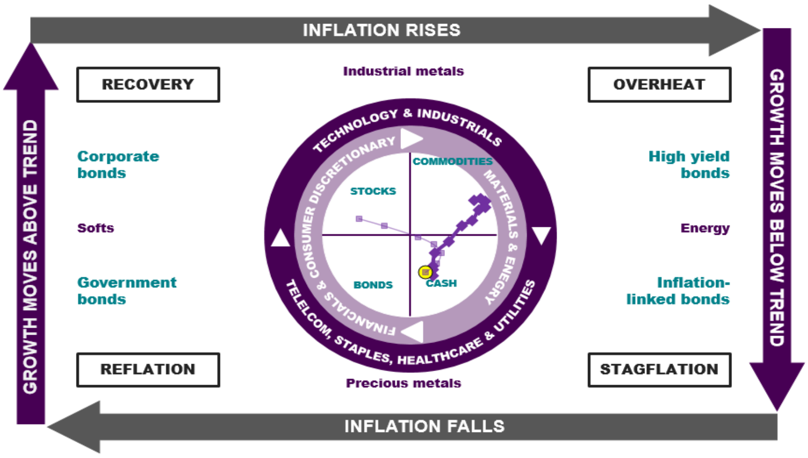
Source: RLAM. As at 1 November 2021.

The Investment Clock is in Stagflation

The Investment Clock model that guides our asset allocation spent 11 months in Overheat, with growth strong and inflation rising, as global re-opening took place. However, central banks kept policy loose in case further Covid variants led to renewed bouts of severe economic weakness.

The Clock moved into Stagflation at the end of 2021 as re-opening came to fruition and growth rates cooled. Inflation has proved less transitory than central banks hoped, with lingering supply chain problems and energy price shocks prolonging the agony. Conflict in Ukraine has the potential to push commodity prices higher still, complicating the picture further for policy makers.

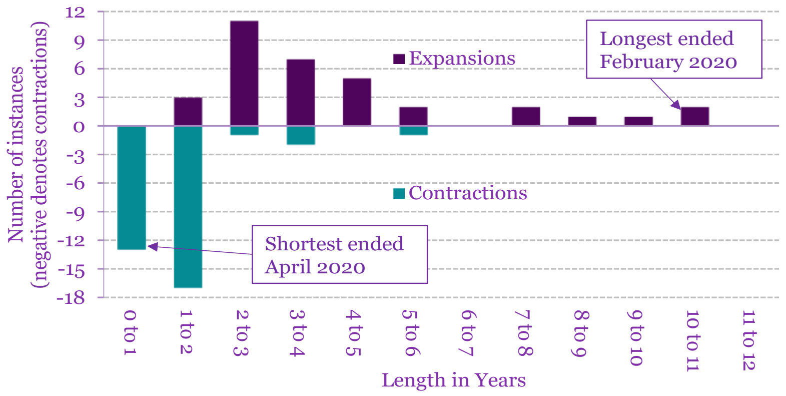
Figure 5: The Investment Clock is in Stagflation



Source: RLAM. For illustrative purposes only. Trails show monthly readings based on global growth and inflation indicators. As at February 2022.

We are already ‘late cycle’ because the Great Lockdown interrupted, rather than ended, the previous long expansion. Post-war upswings in the US economy have been long as a disinflationary trend allowed central banks to cut rates whenever growth slowed. With activity back to 2019 levels and loads of stimulus still in the system, the current recovery is inflationary, risking a return to the shorter boom-bust cycles of the past.

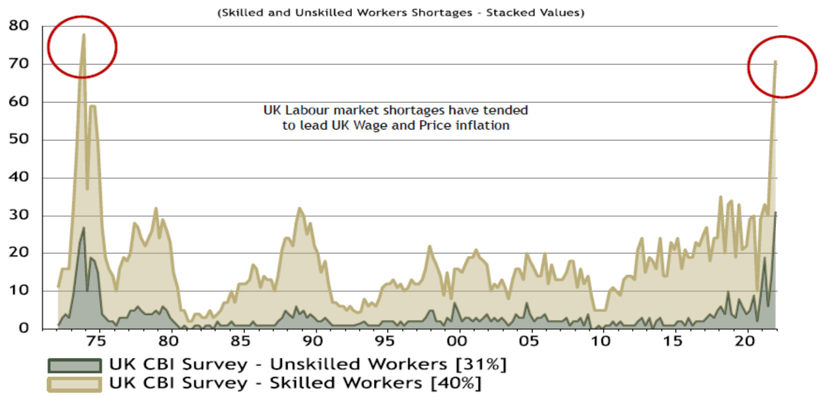
Figure 6: US business cycle lengths since 1857



Source: NBER; data from 1857 to 2022; the current expansion began in April 2020.

The risk of a policy mistake is high. In a sense, central bankers are flying blind as the supply side of the economy is extremely hard to judge. Policy makers would love supply and labour shortages to go away, as life returns to normal, and this is everyone’s base case over 2022, but they may not. The danger is central banks end up triggering a recession to create the spare capacity needed to bring inflation back to its normal range.

Figure 7: Skilled and unskilled workers shortages

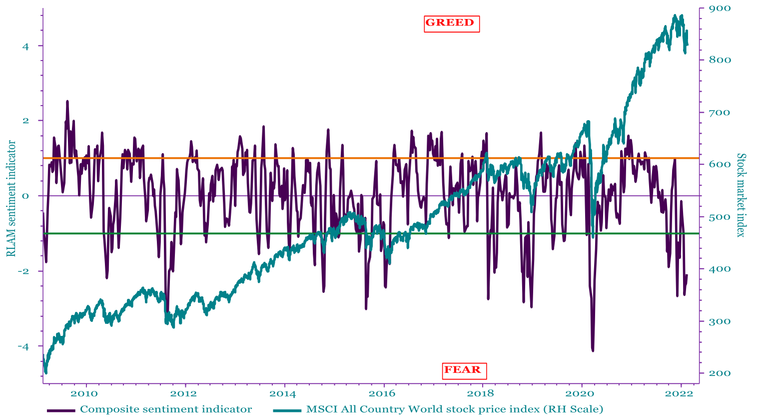


Source: ASR Ltd / CBI / Refinitiv Datastream

Seeing tactical opportunities amid the volatility

Tactical asset allocation will be an important tool when navigating what could be volatile markets. We are expecting stocks to trade in a wide range over 2022 as the tug of war between positive earnings news and higher interest rates plays out, and investors factor in the changing geopolitical backdrop. In the near term our caution is tempered by the fact that investor sentiment is already very depressed. Perhaps a lot of bad news is currently in the price.

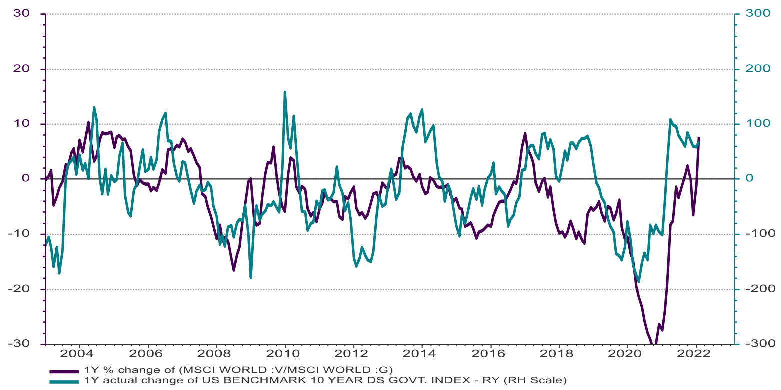
Figure 8: RLAM Composite Sentiment Indicator & equity markets



Source: Refinitiv Datastream, RLAM as at 15 February 2022.

We don't expect strong returns from stocks this year but there could be some good tactical opportunities at the sector and regional level. Value stocks tend to outperform growth stocks when bond yields rise sharply, though this is likely to be a saw-toothed pattern with sudden reversals to beware of. We'd also expect regions like the UK, which offer superior value, to outperform. The UK is currently our favourite market, having been a tactical underweight for most of the last 10 years.

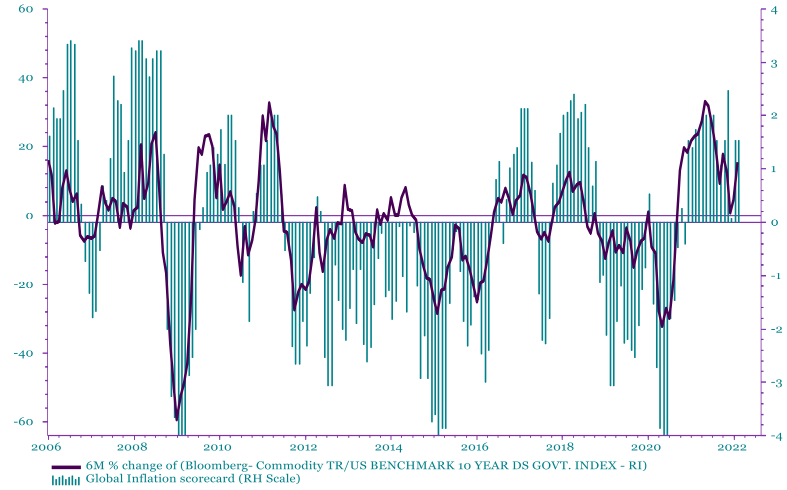
Figure 9: Change in US 10 year yields & value vs growth



Source: Refinitiv Datastream, RLAM as at 15 February 2022.

In a broadly diversified multi asset fund there are still some places to seek positive returns. We are overweight commodities versus government bonds and continue to expect strong returns from property this year.

Figure 10: RLAM Inflation Scorecard & commodities vs bonds



Source: Refinitiv Datastream, RLAM as at 15 February 2022

Broad diversification offers resilience to inflation

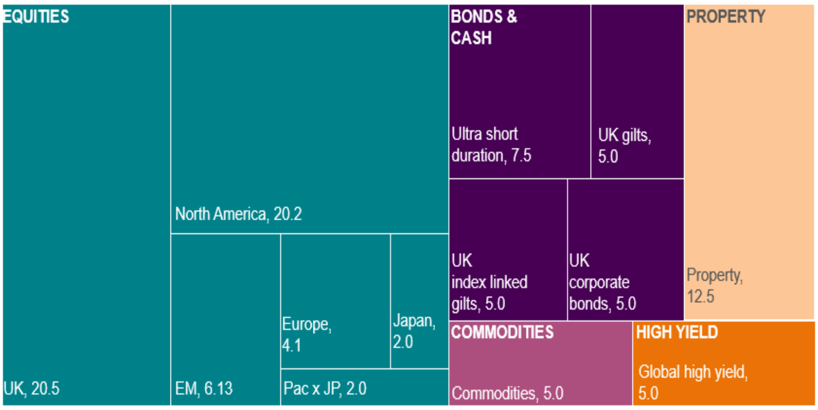
Old-style balanced funds, with 60% in market cap weighted global equities and 40% in UK investment grade bonds, performed well during the deflationary Covid shock. We would argue these funds are not sufficiently diversified to weather more inflationary conditions. A large US equity allocation, with technology a large part of that, could prove painful as interest rates rise, as could a large exposure to long duration sterling fixed income.

Figure 11: Old-style balanced fund strategic mix

Source: RLAM, for illustrative purposes only.

A broader mix of asset classes offers greater resilience to shocks, in our view. We favour a mix that invests as much in the UK as the US, with additional growth asset exposure invested in inflation hedges like commodities and property and with a low exposure to long duration bonds.

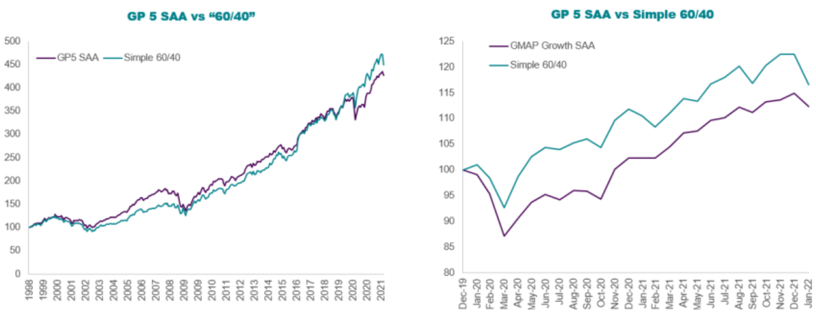
Figure 12: GMAP Growth mix / Governed Portfolio 5



Source: RLAM, for illustrative purposes only.

Over the longer term, diversified multi asset funds have performed more or less in line with simple balanced funds, falling behind in 2020. However, we are seeing strong performance from the multi asset funds during this more inflationary upturn and we expect this trend to continue.

Figure 13: GMAP Growth versus a Simple Balanced Fund



Source: RLAM, DataStream, as at 26 January 2022. Charts show a comparison of GMAP Growth strategic mix with 60% in global stocks and 40% in UK investment grade bonds. The returns from the GMAP Growth Strategic Asset Allocation (SAA) allow for the change in strategic weights as at 31/12/20

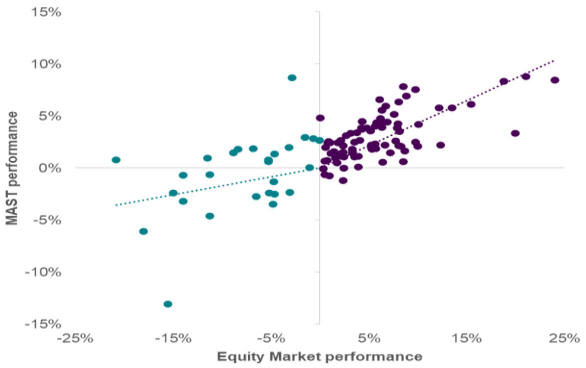
Managing downside risk with the Multi Asset Strategies Fund

Broad diversification can improve risk-adjusted returns and increase resilience to shocks. Launched in 2018, our Multi Asset Strategies Fund (MAST) goes further, combining a well-diversified core portfolio with:

1. Volatility management with a view to limiting downside risk when markets are turbulent; and
2. Tactical asset allocation to take advantage of opportunities irrespective of market direction.

Our simulation of the strategy since 1995 shows a good level of upside capture during positive market trends with limited peak to trough losses. Figure 14 compares MAST returns with equity market performance in different market conditions.

Figure 14: Capturing upside while limiting downside

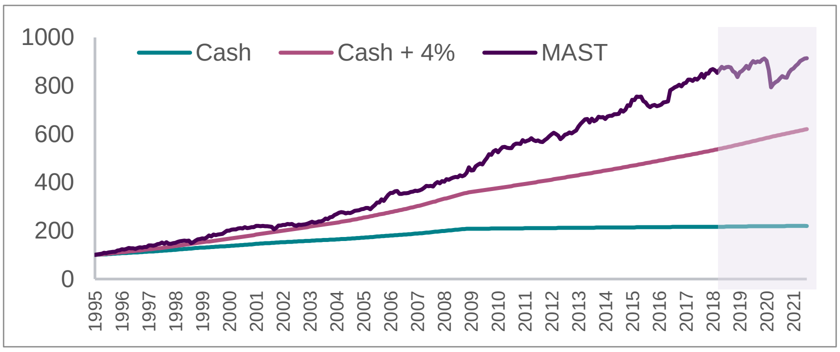


Source: RLAM. For illustrative purposes only. Returns from 1995 Q2 to 2021 Q4. Simulated data used prior to launch.

MAST has a return objective of cash (SONIA) + 4% per annum gross of fees on a rolling five-year basis, which was achieved or bettered around 70% of the time in the simulation, with cumulative returns in excess of this level (Figure 15).

We expect volatility in the 4-10% range. Peak to trough losses were less than 10% during market shocks, with a larger 15% loss in 2020 Q1. Return to high water mark has generally been relatively quick, especially when compared to equities.

Figure 15: MAST long term cumulative performance



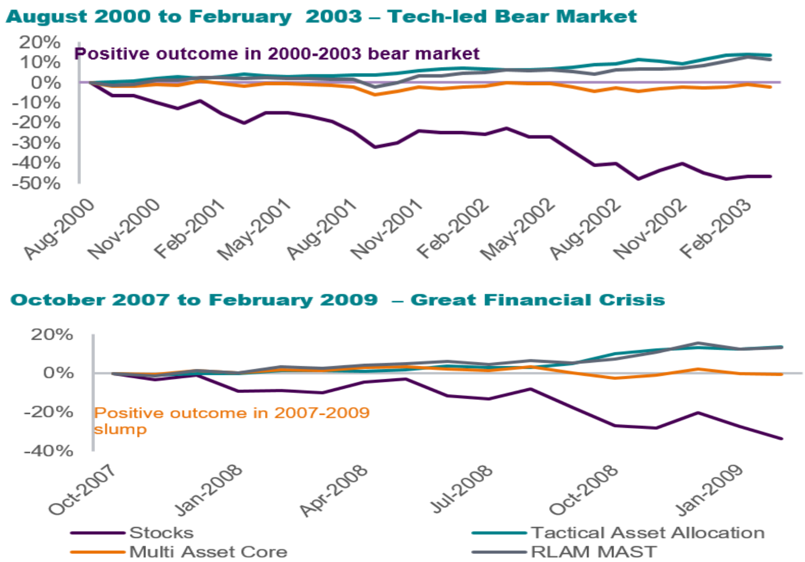
Source: Simulated data used prior to the inception on 23 November 2018. The simulation assumes fixed weight allocations to Multi Asset Core, with volatility management and constant risk budget for tactical asset allocation. The simulation for MAST is calculated using historical positions generated by RLAM's in-house tactical asset allocation models and signals from our volatility management process. Net of estimated fees and transaction costs.

Simulated data or historical data are not a guide to future performance.

MAST came into its own in the simulations during long, grinding bear markets with a persistent high level of volatility, posting positive returns of around 10% in absolute terms over both the 2001-2003 and 2007-2009 bear markets (Figure 16).

These bear markets were associated with recessions triggered by a combination of monetary tightening with energy price shocks. If this is the kind of environment we are heading into over the next few years, the disciplined and active approach to both risk control and tactical asset allocation embodied within MAST should be beneficial.

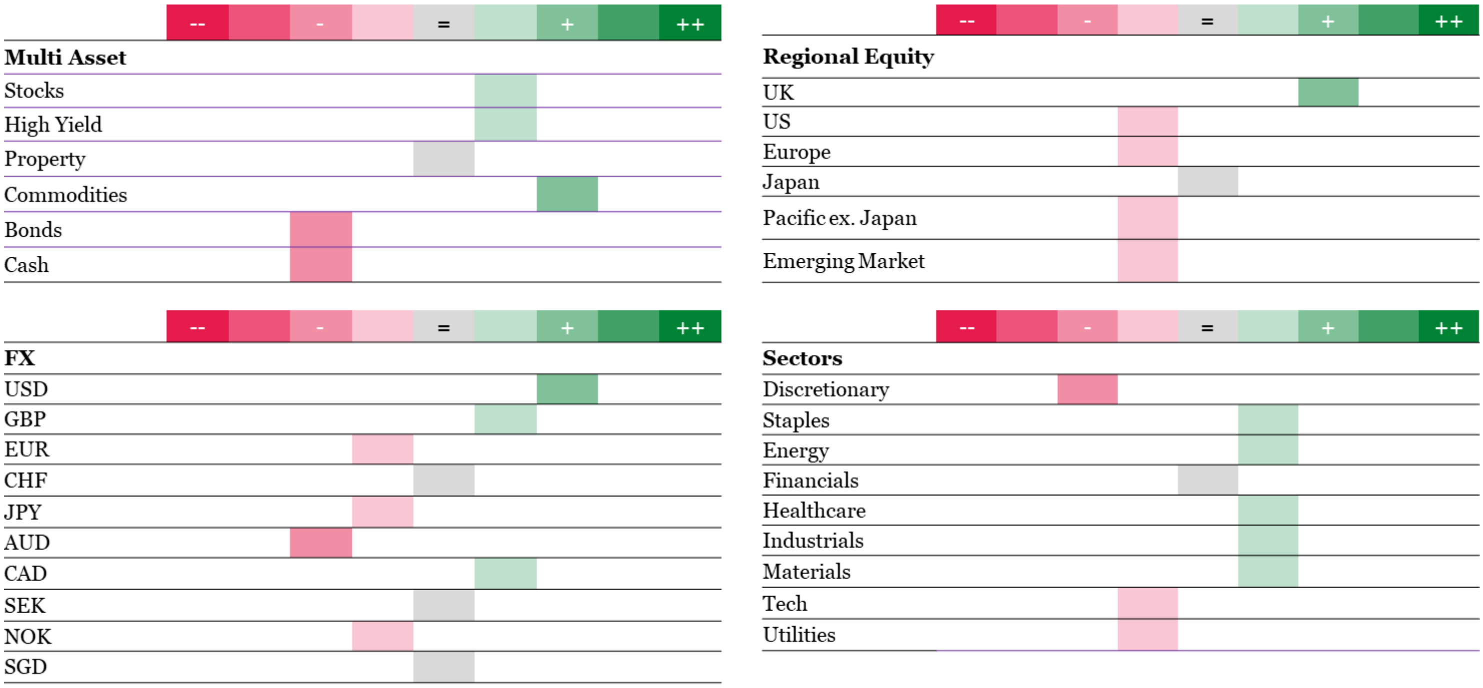
Figure 16: Behaviour during last two bear markets



Source: RLAM. For illustrative purposes only. Simulated data using same methodology as above. MSCI world total return index (£) represents stocks.

Where we stand: Overweight commodities and UK stocks

We maintain a small overweight in stocks, tilted strongly towards the UK. We remain underweight bonds and growth stocks, as we expect policy to tighten over the year. Elsewhere, we continue to hold an overweight position in HY bonds.



Cross asset: overweight stocks and commodities versus government bonds

- We remain slightly overweight in stocks. Equities could be challenged as the US Federal Reserve begin to tighten policy and geopolitical worries weigh on markets. However, investor sentiment is currently oversold, which is a bullish signal.
- We have a strong overweight position in commodities which we believe will continue to be boosted from high inflation and improvements in global demand.
- We maintain an underweight position in government bonds with yields at low levels and policy expected to be tighter over this year.

Equity regions, US Sectors and FX: overweight UK stocks and US Dollar, underweight Asia Pacific and growth stocks

- We have reduced our position in US equities; the relative earnings picture is worsening in the region and rising interest rates could present a headwind to the lofty valued region.
- At the sector level, we are underweight growth stocks such as technology and consumer discretionary, which could struggle as interest rates rise from their lows.
- We are overweight the US dollar given the positive interest rate differentials. We also remain underweight the euro; the European Central Bank remains dovish and lockdown restrictions are becoming stricter in the region.

Investment risks

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

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

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.

Exchange Rate risk: Changes in currency exchange rates may affect the value of your investment.

Interest Rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

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.

Emerging Markets risk: Investing in emerging markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

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.

Fund investing in Funds risk: The fund is valued using the latest available price for each underlying investment, however it may not fully reflect changing stockmarket conditions and the fund may apply a 'fair value price' to all or part of its portfolio to mitigate this risk. In extreme liquidity conditions, redemptions in the underlying investments, and/or the fund itself, may be deferred or suspended.

Liquidity and Dealing risk: The fund invests indirectly in assets that may at times be difficult to value, harder to sell, or sell at a fair price. This means that there may be occasions when you experience a delay in being able to deal in the fund, or receive less than may otherwise be expected when selling your investment.

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