29 June

Royal London Market update

Lorna Blyth provides an update on the impact of recent market events on the Governed Range.

Easing of lockdowns have begun across the globe, with the prospect of some form of normality returning seeming like a not too distant reality. This has helped push markets upwards, however, the virus risk has not disappeared with countries such as the US and Brazil showing spikes in number of confirmed COVID cases. With both economic and virus risk still a very real threat, heightened volatility is expected to continue in the coming months.

Year to date returns across the portfolios are ranging from -3% to -8% in the GPs while GRIPs range from -0.1% to -7%. All performance numbers quoted are net of a 1% charge and you can find returns for all the portfolios over the short and long term in the link at the end of this update.

All the portfolios continue to be well diversified across a range of asset classes. Equity markets continue to be volatile with market timing being a key factor in daily performance. Our durational bonds have performed well over the last year and year to date, all outperforming their respective benchmarks, except for short and long corporate bonds which have marginally underperformed. We continue to believe in the medium- and long-term value of global high yield bonds and closely monitor the assumptions backing these decisions.

The minutes from our Investment Advisory Committee meeting on 3 June are now available to view online here.

Lorna Blyth

Head of Investment Solutions

Royal London Intermediary

Trevor Greetham

Head of Multi Asset RLAM

Piers Hillier

Chief Investment Officer

RLAM

Please note that this is a fast-moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing.

Governed Range investment activity - Trevor Greetham, Head of Multi Asset Funds, RLAM

Markets have had positive momentum since March lows, based on fiscal and monetary policy measures designed to mitigate damage to the global economy and, crucially, diminishing virus risk. June has led to some increasing uncertainty regarding the global containment of the virus, particularly in Brazil and the US.

We remain slightly overweight equities in the Governed Portfolios and Governed Retirement Income Portfolios but are aware of the still uncertain path back to normality for the global economy. On the plus side, lockdowns are being eased and a broad range of monetary and fiscal stimulus measures are in place. However, the level of economic activity post lockdowns could disappoint markets, with many sectors of the economy probably staying weak and unemployment possibly staying higher for longer than some expect. In emerging markets like Brazil and India, there is concern that the virus is still spreading; the USA is also amongst the countries which do not seem to have got the spread of the virus under control – individual states, such as New York and New Jersey, are now imposing quarantines on people from other US states.

We are slightly overweight equities as the balance of evidence points to the global economy recovering as lockdowns are eased (even if there are setbacks on the way, as in Germany and China currently). We remain overweight high yield bonds, particularly short duration high yield, as we expect the asset class to be resilient over the medium term and the US Federal Reserve is directing its support towards US credit markets. We are underweight commodities, however, as demand is likely to remain weak and supply, for example of oil, is plentiful. We are also broadly neutral to slightly underweight UK commercial property across most funds as we expect rents could fall and capital values see downward pressure, particularly in the retail and leisure sectors; exposure to property gives diversification benefits to the portfolios. Given the significant quantitative easing we are seeing from central banks, we are modestly overweight government bonds. We remain underweight cash owing to negative real returns in that asset class.

Within equities we remain overweight US equities (including the tech sector) given the relatively defensive nature of the market and the resilience of technology earnings in the pandemic; we are also moderately overweight Emerging Markets, potentially a safer haven as the virus appears to be more under control in China than the US, for example. We are underweight UK equities, a long-term underperformer hampered by a heavy resource sector weighting and underweight financials. Our currency positioning is light. We have moved to be moderately overweight the economically-exposed Australian dollar but remain underweight sterling given ongoing political and trade uncertainty; we have reduced our position in the more defensive US dollar as confidence in the global economy has improved and are now slightly underweight.

Market outlook

Sustained recovery in markets will probably have to wait until there is more confidence that the coronavirus pandemic is under control globally and a serious second wave of infections hasn’t happened. We expect our Investment Clock model to reflect the eventual re-opening of the world economy by moving from its disinflationary “Reflation” zone, with weak growth and falling inflation, and into its equity-friendly “Recovery” zone, as growth improves with lockdowns being eased - but the timing of this move is uncertain. We intend to make full use of our active tactical asset allocation risk budget to add to equity exposure when we judge the time is right. Our investment process has weathered difficult markets in the past and we added significant value over the 2007-9 Global Financial Crisis. We believe a disciplined and active approach to both risk control and tactical asset allocation will be crucial in portfolios, as markets respond to the current crisis and the economic recovery when it comes.

RLAM Economic Viewpoint

Survey data, high frequency data and now increasingly the hard data too, continue to show that developed economies are in the 'recovery phase' of this crisis. Albeit this is the somewhat mechanical bit as economies are allowed to open up and you get a bit of pent-up demand set loose as well. Some of the recent data points have shown much stronger than expected improvements. This, however, doesn't tell us much about the next stage of the recovery that economists generally expect to be much slower. Social distancing, scarring (including permanent job losses, business closures and balance sheet damage) and residual fear of the virus (including as it relates to job security) will all influence the strength of that recovery and government policy still has a crucial role to play in all of them.

June business surveys improve substantially: Data in the past week or two has included several June business surveys and these have mostly seen solid improvements, with some notable upside surprises in European business surveys and US regional business surveys. However, the headline composite PMI business survey indicators for the US, eurozone, Japan and the UK remain below 50. Taken at face value, remaining below 50.0 would normally signal that these economies are still shrinking. However, mapping PMIs accurately to economic activity levels is somewhat hazardous after such a big shock to GDP (the survey asks whether things are better/worse, rather than by how much). Nevertheless, if you look at the commentary in the PMI surveys - social distancing has eased, helping many firms reopen and firms are more optimistic, but many companies also report weak demand as customers remain cautious. That is – so far – consistent with economies taking time (likely, several quarters) to get back to 'normal' levels of activity after a sharp initial recovery phase.

US data continue to suggest a strong start to the early stage recovery, but virus data more worrying: May retail sales, durable goods orders and some housing data have bounced significantly more than expected. However, US COVID-19 numbers have, in the meantime, become more worrying. The increase in virus cases in some states is likely to worry consumers, including the prospects of social distancing being reversed and the impact on job security. Meanwhile, Congress and the White House have still not agreed a package of economic support measures to replace those set to roll off this summer. US government policy interventions have so far done a good job in shielding household balance sheets (and therefore spending power) from the crisis. Reduced/disrupted fiscal support and the progression of the virus both have the potential to curb US recovery momentum.

Here in the UK, data also signal a solid start to the recovery phase but also a weak underlying labour market and an economy still in need of policy support: May retail sales were also an upside surprise, rising 12% in May. They are still 13.1% below February levels, but that's a solid start to the recovery phase, especially since it was only mid-*June* that saw 'non-essential' retail stores reopen. Just as in the US, however, the UK's early stage recovery has needed – and still needs – plenty of policy support. Government borrowing was also somewhat higher than expected in May and the levels of government debt as a percent of GDP, on the headline measure, moved above 100% for the first time since 1963. PAYE data meanwhile show the number of paid employees fell by 449K March to April. Early May estimates indicate another drop of 163K. Job vacancies in May fell to a record low. The furlough scheme is set to start unwinding from August, but this is a labour market that is far from out of the woods yet. That was recognised by the Bank of England who extended their asset purchase programme, though reduced the pace. They have become *more* concerned about *long-term* damage from the crisis. How the labour market evolves from here will be a key driver of their decisions going forward including, potentially, a decision around negative rates.

Market view from Piers Hillier, CIO, RLAM

The upwards trend in global equity markets was met with some resistance this week, resulting in sideways equity trading and moderate credit spread widening. Investors were perturbed by a sharp increase in Covid-19 cases in the US as the country reported a record number of new cases on Thursday. While the coronavirus appears to be under control in most developed countries at this stage, global new case numbers are at record highs; driven by the US, Brazil and India.
In an effort to mitigate the damage of a second wave, US regulators gave in to a long-sought demand for a relaxation of the Volcker Rule as they allowed banks to invest in hedge funds and private equity funds.

Markets have also been rocked by increased global trading tensions. There have been signs of further difficulties in the trade negotiations between the US and China. Meanwhile the US threatened to impose tariffs on $3.1bn of European products, prompting an angry response from the European Commission.

On a more positive note, numerous key economic data releases have been far stronger than anticipated recently. There have been strong improvements in US and UK retail sales and in the European and US business surveys. While activity surveys are still consistent with contractions in many economies, possibly reflecting the elevated corporate debt and unemployment levels, they show that businesses are markedly more upbeat as they emerge from the worst of the lockdowns.

Reflecting a perception that the UK economy is somewhat stronger than expected, the Bank of England surprised investors at its latest meeting. While it announced an additional £100bn of bond-buying, as had been expected, it slowed the pace of its purchases. The Bank said it would spend the £100bn by the end of the year, rather than by the end of August as the market had hoped. Of course, the very fact that spending was increased reveals the fragile state that the Bank considers the economy to be in, with serious concerns over the unemployment outlook.

The focus for many in the UK has been on further opening of businesses – both non-essential retail in mid June, and with the prospects of pubs, restaurants and others opening from early July. As investors we are pleased to see this – we are under no illusions that we as a society will return to prior habits in terms of spending; many of us will feel differently about being on a train, plane or in a restaurant for some time. And with other countries seeing flare-ups in the virus, it is clear that this road will have a number of bumps in it. However, it does appear that we are now through the first phase of this crisis, and returning to a more normal cycle of data and market reaction.

Sustainable Funds- Mike Fox, Head of UK Sustainable Investments

What is happening?

Equity markets have remained relatively resilient in the last two weeks, perhaps something of a surprise given there is plenty of evidence that Covid-19 is not yet under control in major countries such as Brazil and India, and seeing a resurgence in the United States. The most likely explanation for this resilience is that markets have been more focused on the shape of economic recovery as many regions come out of lockdown. The rate of economic recovery, albeit from very low levels and over a small time frame, has been better than expected. For the recent rally in asset prices to hold, corporate profitability needs to recover in a time frame of 12-18 months. We think this is a reasonable assumption, but wouldn't read too much into the recent economic data; at some point rate of change of economic activity will be replaced with consideration of its absolute level, and at what level that is. We do observe that there is no political will to re-enter lockdowns under all but the most extreme of scenarios. It may just be we all have to get used to living with this virus, rather than waiting for it to be eradicated by a vaccine.

There continues to be much discussion about the narrowness of equity markets, and their dependence on a small number of technology companies such as Amazon, Apple and Microsoft. We are often asked if this is a bubble, as we do own a number of technology companies in our sustainable funds. Our answer to this is a resounding 'no'. Fortunately (or unfortunately!) I started my career during the technology boom of 1999 and witnessed the subsequent bust. What is occurring now is nothing like what occurred back then. The size of technology companies back then, measured by market capitalisation, had become completely detached from their earnings and profits. Loss-making companies with unproven business models were valued at many billions of dollars. Today, technology accounts for about 26% of the US S&P 500, but critically also accounts for about 24% of the earnings of that index. Back in 1999, technology was 34% of the S&P Index and only 17% of earnings. The large technology companies are now hugely profitable and their increasing market capitalisations have, overall, followed their profits. The valuations, as measured by ratios such as free cashflow yield, of companies such Alphabet and Microsoft are similar to those ascribed to good quality UK mid-cap companies. Technology companies could turn out to be poor investments if their fundamentals deteriorate, due to maybe changing regulation or consumer trends, but I believe that their valuation today looks sensible relative to their fundamentals.

What will happen next?

As we look into the second half of 2020, there are no shortage of hurdles for economies and markets to overcome. Covid-19 and social unrest are notable as the issues of today, but we think the presidential election in the US and Brexit are two other factors to be considered too. It is easy to despair faced with this list of problems and wonder how on earth corporates, markets and economies can cope, but if investing was about buying when the sun is shining and selling when the rain comes then we would all be rich. In a long-term context, say the last 100 plus years, we have worked through world wars, pandemics, depressions, recessions and much much more. We have always come out the other side economically stronger and wealthier as a society. I believe it will be no different this time, and that context is useful in thinking about the right mentality to have regarding investing right now. Economic problems and fear are the friend of long-term investing. They have provided us compelling opportunities to buy shares in companies some way below what we think they are worth this year, and may do so again. Investing is about buying when it is raining. Although the economic outlook is less clear, we can say with a high degree of certainty that society will become more digital, less carbon intensive and more health aware in the coming years. So if the rain comes again this year and offers the chance to buy into these areas at much reduced prices, like it did in March, we will be happy to grasp the opportunity.

What are we doing?
Activity has been mainly investing cashflows into existing positions in the last two weeks. We think the broad structure of our portfolios is correct and represents where we see the risk vs reward equation across our range of opportunities. Opportunity is not present at all times during the course of a year, so at times we need to show patience and confidence in what we own. Our portfolios are filled with high quality corporates which we believe will find a way to come out of the current crisis, not unscathed, but in a stronger position than they went in. We couldn't find the logic in investing in marginal business models and companies in the good times, so we are certainly not tempted to try owning them now given the long list of issues every company has to work through. We do expect a small number of the companies we own to come back to us asking for more capital. We think this will from a position of strength, as we saw with Segro and their recent equity issuance, with the current dislocation happening in the economy an opportunity for some to accelerate their development. Just this week Unite, a provider of student accommodation, has raised £300m to fund three new sites, all with the potential for higher returns than if they'd bought them a year ago. Our asset allocation, which is always fixed for the multi asset funds, remains pro equity relative to its peers. Credit and cash provide very low hurdle rates of return for equities to beat to be relatively more attractive.

How are we performing?
Performance has been very good in the last two weeks. There are occasional days when 'value' has outperformed strongly, and since 'value' seems to exist in sectors we think are impaired by key social and environmental trends, we have no intention of going there. Despite this, better quality companies have reasserted themselves as the main driver of markets, and that suits us. We would also note that we have been impressed with the operational performance of the companies we invest in. We never cease to be amazed about the ingenuity of management teams who, based in their homes, are still able to manoeuvre their businesses thoughtfully through current circumstances. Year-to-date performance is very strong. Of course every strategy is prone to the ebbs and flows of performance, the price of an identity is that we cannot perform in all markets, so it remains to be seen if we keep all our outperformance. We do think the reasons behind it thought are structural and we take confidence from that.

Anything else?
This is my 19th year as a fund manager, and my 17th working on the sustainable funds. It has not always been plain sailing; no one starts a career in fund management with all the knowledge they need to succeed and some lessons have to be learned the hard way. That said, the funds have been blessed with more good years than bad, and overtime have accrued outperformance and good returns for our investors. We have an intern program at Royal London, and constantly recruit new, young, talent into the business. Many of these people ask the same question I did when I started: what is the secret to outperforming? Of course hard work is the answer no one wants to hear in their 20s, but beyond that we talk about is how far in life you can go making sensible decisions and avoiding disasters. The accumulation of long-term outperformance doesn't actually require outstanding decision making and significant risk taking. Indeed, those observing the Wirecard implosion can observe what reaching for the stars can sometimes do to fund managers. What is required however is an accumulation of sensible decisions over a long period of time, and the avoidance of disasters. We think that this approach manages risk well and accumulates reward for our investors.

Responsible investment

As with many of our clients, the RI team have been reading and watching the news around the Black Lives Matter protests and asking ourselves questions on how we can raise awareness both internally and externally. Last year, we identified both Diversity and Social & Financial Inclusion as two themes to help us shape and prioritise our company engagement. In choosing these themes, we recognised that companies succeed when everyone has an opportunity to participate and be a productive member of society, and that diverse companies are more innovative and create better outcomes for customers. This is now more important than ever. We have been refreshing our thinking and wanted to share some of our initial thoughts with our clients.

External research supports that both gender and ethnic diversity enhances company performance. Research findings show that more ethnic and culturally diverse companies outperform least diverse companies by 36% in terms of profitability in 2019; slightly up from 33% in 2017 (Mckinsey & Company, 2020). However, progress on gender diversity, which has been the focus of most investors, supersedes ethnic and socio-economic diversity and inclusion. At present, almost half of FTSE 100 boards are falling short of the Parker Review recommendation to appoint at least one director from an ethnic minority background by 2021 (The Parker Review, 2020). This increases to 70% for FTSE 350 boards. When assessing our top 10 FTSE 350 holdings across RLAM in June 2020, only 20% of holdings met the Parker Review target. A study also revealed that individuals who find themselves at the intersect of underrepresented groups (i.e. ethnic minority, female, disabled) experience the most barriers to career progression, demonstrating the human capital imperative for companies to consider the broader scope of diversity.

We recognise that, unlike gender diversity data, ethnic diversity data and reporting is in its infancy and remains sparse, so we intend to leverage our engagement efforts to encourage companies to improve disclosure practices on ethnicity in the workplace. This will allow for more comparable assessments across industries and sectors, as well as enhanced analysis of intersectionality going forward. As we seek to build out our ethnic diversity engagement strategy further, we will discuss ethnic diversity in the course of regular engagement with company management and boards. Our focus will be on company efforts at both the board level and within the wider workforce. We will seek to engage with both leaders and laggards in their approach to improve diversity, so we can learn from the best and also encourage others to make changes to benefit their business over the long term.

Performance year to date

Governed Portfolios

Portfolio Name	Percentage Growth 31.12.19 26.06.20 % Chg	Percentage Growth 26.06.19 26.06.20 % Chg
Governed Portfolio 1	**-6.13**	**-2.82**
Composite Benchmark	-5.06	-2.52
Difference	-1.07	-0.30
Governed Portfolio 2	**-4.68**	**-1.89**
Composite Benchmark	-3.81	-1.75
Difference	-0.87	-0.14
Governed Portfolio 3	**-2.84**	**-1.41**
Composite Benchmark	-1.85	-1.05
Difference	-0.99	-0.36
Governed Portfolio 4	**-7.79**	**-4.07**
Composite Benchmark	-7.18	-4.19
Difference	-0.61	0.12
Governed Portfolio 5	**-6.61**	**-3.28**
Composite Benchmark	-5.68	-3.14
Difference	-0.93	-0.14
Governed Portfolio 6	**-4.62**	**-2.53**
Composite Benchmark	-3.58	-2.20
Difference	-1.04	-0.33
Governed Portfolio 7	**-8.17**	**-4.14**
Composite Benchmark	-8.74	-5.25
Difference	0.57	1.11
Governed Portfolio 8	**-8.09**	**-4.31**
Composite Benchmark	-7.50	-4.41
Difference	-0.59	0.10
Governed Portfolio 9	**-5.46**	**-2.78**
Composite Benchmark	-4.76	-2.73
Difference	-0.70	-0.05

Governed Retirement Income Portfolios

Portfolio Name	Percentage Growth 31.12.19 26.06.20 % Chg	Percentage Growth 26.06.19 26.06.20 % Chg
Governed Retirement Income Portfolio 1	**-0.10**	**1.26**
Composite Benchmark	0.94	1.71
Difference	-1.04	-0.45
Governed Retirement Income Portfolio 2	**-1.90**	**-0.01**
Composite Benchmark	-0.83	0.44
Difference	-1.07	-0.45
Governed Retirement Income Portfolio 3	**-3.76**	**-1.32**
Composite Benchmark	-2.58	-0.74
Difference	-1.18	-0.58
Governed Retirement Income Portfolio 4	**-5.84**	**-2.88**
Composite Benchmark	-4.38	-2.11
Difference	-1.46	-0.77
Governed Retirement Income Portfolio 5	**-7.14**	**-3.71**
Composite Benchmark	-5.76	-2.97
Difference	-1.38	-0.74

Underlying Funds

Portfolio Name	Percentage Growth 31.12.19 26.06.20 %Chg	Percentage Growth 26.06.19 26.06.20 %Chg
RLP Absolute Return	**-0.21**	**0.85**
Benchmark	-0.33	-0.48
Difference	0.12	1.33
RLP Commodity-Pen	**-17.91**	**-19.34**
Benchmark	-16.07	-18.58
Difference	-1.84	-0.76
RLP Deposit-Pen	**-0.22**	**-0.35**
Benchmark	-0.33	-0.49
Difference	0.11	0.14
RLP Global High Yield Bond-Pen	**-4.53**	**-1.05**
Benchmark	-5.01	-2.14
Difference	0.48	1.09
RLP Global Managed-Pen	**-8.29**	**-3.36**
Benchmark	-9.54	-4.80
Difference	1.25	1.44
RLP Long (15yr) Corporate Bond-	**7.22**	**11.66**
Benchmark	7.39	12.29
Difference	-0.17	-0.63
RLP Long (15yr) Gilt-Pen	**11.72**	**12.48**
Benchmark	10.79	12.52
Difference	0.93	-0.04
RLP Long (15yr) Index Linked-	**8.44**	**6.16**
Benchmark	7.15	4.71
Difference	1.29	1.45
RLP Medium (10yr) Corporate	**4.21**	**7.50**
Benchmark	4.07	7.19
Difference	0.14	0.31
RLP Medium (10yr) Gilt-Pen	**7.28**	**7.75**
Benchmark	6.74	7.34
Difference	0.54	0.41
RLP Medium (10yr) Index Linked-	**5.05**	**3.04**
Benchmark	4.09	1.91
Difference	0.96	1.13
RLP Short (5yr) Corporate Bond-	**0.92**	**2.59**
Benchmark	1.41	2.93
Difference	-0.49	-0.34
RLP Short (5yr) Gilt-Pen	**3.14**	**3.14**
Benchmark	2.96	2.86
Difference	0.18	0.28
RLP Short (5yr) Index Linked-	**1.37**	**-0.31**
Benchmark	1.07	-0.66
Difference	0.30	0.35
RLP Property-Pen	**-4.38**	**-3.88**
Benchmark	-3.99	-5.43
Difference	-0.39	1.55
RLP Sterling Extra Yield Bond-	**-7.51**	**-5.08**
Benchmark	-0.38	3.02
Difference	-7.13	-8.10
RLP Short Duration Global High	**-3.61**	**-2.60**
Benchmark	-0.23	-0.34
Difference	-3.38	-2.26

Longer term performance

Please see **our latest performance**.

Past performance is not a reliable indicator of future results. 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.