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Royal London UK Smaller Companies Fund

Quarterly Investment Report

30 September 2024

Quarterly Report

The fund as at 30 September 2024

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

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. The Index is considered an appropriate benchmark for the Fund's performance, as the Fund's potential investments will predominantly be included in the Index. In addition to the benchmark for the Fund's performance as noted above (the "Index"), the IA UK Smaller Companies sector is considered an appropriate benchmark for performance comparison.

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

Fund value

	Total £m
30 September 2024	333.42

Fund analytics

	Fund
Fund launch date	20 July 2007
Base currency	GBP
Number of holdings	68

Performance and activity

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Quarter	(0.77)	6.21	(6.98)
YTD	4.35	14.91	(10.56)
1 Year	15.23	22.38	(7.15)
3 Years (p.a.)	(9.25)	1.42	(10.67)
5 Years (p.a.)	2.85	9.43	(6.58)
10 Years (p.a.)	6.18	7.53	(1.35)
Since inception (p.a.)	8.35	10.20	(1.85)

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 share class is 1 May 2012.

Performance commentary

UK equities rallied through the third quarter of 2024, with small and mid-cap stocks and more cyclical sectors leading the way. This followed sustained positive UK economic data, the removal of political uncertainty following the UK election, and the first rate cut by the Bank of England in over 4 years. The fund returned -0.6%, broadly in line with the UK Smaller Companies peer group return of -0.3%, but lagged the FTSE Smaller Companies ex IT index return of +6.0%.

The underperformance relative to the benchmark return is disappointing, however should be seen in the context of the substantial underperformance of FTSE AIM All Share, which declined -2.7%. Investors grew concerned during the quarter that the new government would change Business Property Relief (“BPR”). This a tax relief which can apply to some AIM listed companies (various conditions apply), rendering the owners of their stock exempt from UK inheritance tax. The AIM market is an important part of our UK Smaller Companies universe, with c. 700 companies compared to c. 120 within the FTSE Smaller Companies ex IT index. These companies are often faster growing, younger companies attracted to AIM’s listing and disclosure rules because they’re at an earlier stage of their lifecycle, or founder managed (with significant ownership stakes), or looking to be nimble when conducting M&A – as such the fund has always invested a significant minority of the portfolio in AIM listed companies. While it is impossible to predict the decision the Chancellor will ultimately make, changing how BPR may apply to AIM shares appears to conflict with the government’s ambition to support healthy UK capital markets, in turn providing a broad base of capital to support growing businesses.

AJ Bell, Cohort and Gamma Communications were amongst the strongest positive contributors to relative performance. AJ Bell released a positive third quarter update, with strong growth in assets driven by its direct-to-consumer platform as retail investors added to their portfolios. Defence group Cohort’s record full year results were overshadowed only by their record order book – crucially not driven directly by recent geopolitics but more a result of successful new product development leading to multi-year contract wins. Gamma also reported impressive results, following strong new customer growth in its UK corporate telecoms business, and raised full-year guidance. Hot on the heels of several small but strategically significant bolt on acquisitions – that together significantly improve their product portfolio – they acquired German peer Placetel, increasing their scale in the country as well as bringing them closer to technology partner Cisco.

Almost all the significant individual detractors to performance were companies within the benchmark that the fund did not hold. Often these were more cyclically exposed or carrying substantial debt such as Mobico (formerly National Express), challenger bank Metro Bank or contractor Capita.

Performance and activity

Top 10 holdings

	Weighting (%)
XPS Pensions Group Plc	2.61
Wilmington plc	2.57
Hollywood Bowl Group Plc	2.56
Alfa Financial Software Holdings Plc	2.55
Cranswick plc	2.54
Porvair plc	2.52
BOKU, Inc.	2.51
Chemring Group PLC	2.34
Gamma Communications PLC	2.25
Hill & Smith PLC	2.15
Total	**24.60**

Fund activity

The fund initiated new positions in Urban Logistics REIT, ME Group, and Niox. These were funded in part by the disposal of Big Technologies, which was sold following significant insider selling, and the proceeds from the takeover of consulting group Alpha FMC. The fund also added to a number of existing holdings including Norcros, Marshalls, and Restore.

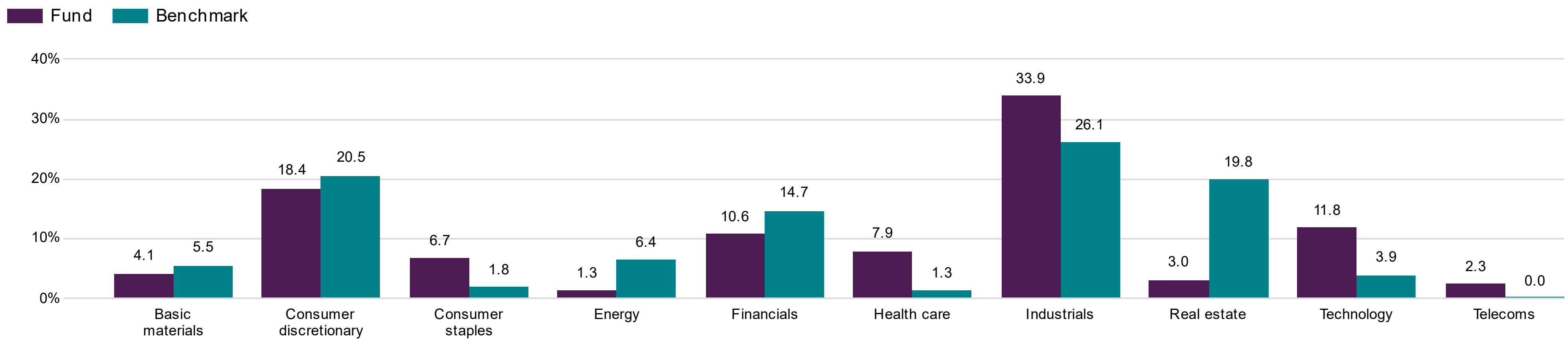
Urban Logistics owns and operates a portfolio of single-let warehouse assets which are used for “last mile” logistics. These assets are in short supply given competing use cases for land in these locations, which is why they have a long history of growing rental income and expect above inflation rental growth over the medium term. They serve a diversified tenant base and both the management team and board of the REIT have a strong track record of creating value in this sector. The REIT has a conservative balance sheet and is trading at a highly attractive c. 30% discount to Net Asset Value.

ME Group designs and operates a network of automated self-service vending machines, with an installed base across Western Europe (France and the UK in particular) as well as Japan. Their profits are mostly generated from photobooths and laundry machines, with the latter being a faster growing, less mature market with substantial opportunity for growth – comfortably funded by the cash flow from the mature Photobooth business. The company is founder managed and the founder retains a significant shareholding in the company. ME Group generates substantial returns on capital, and the low double-digit earnings multiple does not reflect the earnings quality nor the growth opportunity.

Niox is an innovative Medtech company, the market leader in medical devices used to measure FeNO (Fractional exhaled Nitric Oxide) in asthma patients. The technology is increasingly being included in the diagnostic pathway by key opinion leaders and clinical advisory bodies around the world, as well as for monitoring existing patients’ symptoms, because of the improved accuracy it provides. With many millions of people suffering from asthma worldwide, the addressable market is substantial. The high proportion of revenues from the sale of consumables (which repeat annually), and their distributor focussed sales model, makes the business model highly cash generative and scalable.

Fund breakdown

Sector weights



Market commentary

Market Review

UK equities rallied through the third quarter of 2024, spurred on by the Bank of England's interest rate cut, a steady stream of positive UK economic data and slowing inflation. As was the case during the second quarter of 2024, small and mid-cap companies outperformed their larger peers amid a flurry of takeover approaches, in a "risk-on" market which saw more cyclical companies and those with more financially geared balance sheets, outperform.

While we are not focused on analysing or predicting macroeconomics, rather we aim to build a diversified portfolio of companies which can perform through various economic scenarios, it is worthwhile taking a moment to reflect on the Bank of England's decision to cut interest rates. UK unemployment is low, core inflation has stabilised, consumer confidence has been improving, and household, corporate and bank balance sheets remain robust. The Office for National Statistics announced that the UK delivered a second quarter of real GDP growth in Q2. This all underlines our view that the central bank is cutting rates from a position of relative strength, and the UK economy appears relatively well set for steady growth compared to many developed market peers.

Keir Starmer was announced as the Prime Minister of the UK following a comprehensive Labour victory in the general election. This was a widely anticipated result, and as such there was limited reaction from the equity market. Unfortunately, the new government did not get off to a great start, undermining the stability which businesses and investors were looking to them for, by setting a late first budget and sending mixed messages about their intentions. Nevertheless, the political landscape in the UK and its relationships with key trading partners are clearer than has been the case for several years; stability should be highly supportive for corporate hiring and investment if the government choose to make a merit of it.

The M&A spree continued to be a feature of small- and mid-cap markets, with 11 further bids of meaningful size in the quarter, taking the year-to-date total to 40. Notable new takeover approaches included Rightmove, Ascential (held in the Mid Cap fund), Eckoh (held in the Smaller Companies fund), and Learning Technologies Group.

Outlook

Economic data in the UK was generally positive during the period, suggesting a steady recovery in activity following the shallow technical recession in 2023, although, there were a few concerning indicators in the US and the euro zone. Softer than expected US consumer spending, and higher unemployment data, caused a brief global equity market sell-off in August, albeit more positive data has since been released.

It has become clear that industrial and life sciences destocking still has some way to go in North America and Europe, as companies continue to reduce excess inventories – blue chip names which have commented publicly include Abbot Labs, Siemens and ABB. Civil aerospace companies have come under pressure as both Boeing and Airbus cutting production forecasts, while automotive manufacturers have generally been struggling with lower consumer demand.

Germany, the industrial heartland of the euro zone, is in difficulties for various reasons including soft demand from key trading partner China. The extent of the challenge facing China's economy, still struggling to accelerate following the impact of Covid, was made clear by the scale of stimulus measures announced by the central bank in September.

Many of these issues could well turn out to be transitory or backward looking. Certainly, the destocking cycle appears to be the last vestiges of Covid-related impact on supply chains. Softer US consumer demand is likely the result of a two-year cycle of interest rate hikes, just as central bankers start easing. However, it certainly makes the wider outlook more challenging. In this context, the relative stability and economic strength of the UK does appear increasingly attractive. This is one reason we have been increasing our allocation to high quality, well capitalised, UK domestic focused companies such as Norcros, Restore, Marshalls and Youngs.

As we have written before, we continue to believe UK small- and mid-cap equities offer good value in absolute terms, relative to history and relative to international equity indices. Our portfolio companies have well capitalised balance sheets which could be deployed on acquisitions or organic investment to accelerate profits. Through the quarter another slew of small- and mid-cap companies announced share buybacks, reflecting their balance sheet strength as well as their view of equity market valuations.

Given the often-conflicting macroeconomic data of the moment, we feel justified in our consistent approach of trying to filter out the noise and focus on investing over the long term. We continue to seek out companies with the key fundamental SIMBA attributes (Scaleability, Innovation, strong Management teams, Barriers to entry and unique Assets) that will allow them to take market share and prosper throughout economic cycles. We continue to believe that it is these fundamental attributes that drive earnings and thus stock prices over the long term and we remain excited by the opportunities currently on offer for UK small and medium company investors.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

Royal London voting and engagement

TCFD climate report

Find out more

In an uncertain geopolitical and economic environment, we recognise the importance of keeping our clients updated on our current investment thinking.

Articles, videos, podcasts and webinars giving the latest views of our investment experts 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.

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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 risk

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 risk

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 2024

Cumulative (%)

	3 Month	6 Month	1 Year	3 Years	5 Years
Fund (gross)	(0.58)	6.81	16.12	(23.55)	19.63
Fund (net)	(0.77)	6.40	15.23	(25.29)	15.13

Annualised (%)

	3 Years (p.a.)	5 Years (p.a.)
Fund (gross)	(8.55)	3.65
Fund (net)	(9.25)	2.85

Year on year performance (%)

	30/09/2023 - 30/09/2024	30/09/2022 - 30/09/2023	30/09/2021 - 30/09/2022	30/09/2020 - 30/09/2021	30/09/2019 - 30/09/2020
Fund (gross)	16.12	1.77	(35.30)	52.56	2.57
Fund (net)	15.23	0.99	(35.80)	51.40	1.78

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 2024. 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.