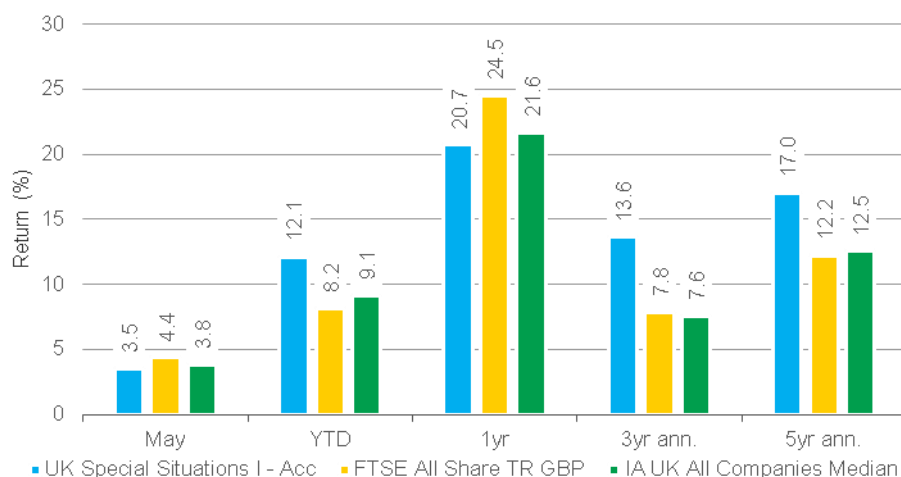


Legal & General UK Special Situations

Fund Update – May 2017

Performance



Source: Lipper, net returns 31/05/2017. Past performance is not a guide to future performance.

FUND COMMENTARY

Following a weaker April, the FTSE All Share rebounded strongly in May, closing the period up 4.4%. Large caps were at the top of the size table as equity markets enjoyed a better May than usual, helped by solid bottom-up earnings and sterling weakness. Despite recent evidence suggesting that the UK general election may not be the forgone conclusion that economists had predicted weeks ago, after a recent narrowing in the election polls, the market currently seems impervious to more global macro worries. It would appear the widely perceived defensive characteristics of the UK index have been well-earned. Companies at the top of this month's leaderboard are largely acknowledged as bond proxies.

Mid-cap leadership reversed sharply in the period as domestic cyclical rolled over in May. The P/E premium on the FTSE 250 has actually continued to increase ahead of any potential election boost to GBP and domestics. From a sector perspective, mobile telecoms, pharmaceuticals, utilities and oil & gas producers out-performed. Basic materials extended their downward streak as weaker China data weighed on mining sector performance.

The fund generated a return of 3.5% in the period, underperforming the benchmark by around 90bps. Stock selection acted as a drag on relative performance, predominantly driven by disappointing returns from our healthcare and financial positions. Whilst our selection in technology and consumer discretionary sectors was broadly positive. From an allocation perspective, our underweight in consumer goods and utilities detracted from returns.

ATTRIBUTION DRIVERS

At a stock level, NMC Health was our largest positive contributor. The Emirati-focused healthcare services provider confirmed it is set to benefit from regulatory changes announced on 27 April, which led to an improvement in earnings guidance from management. The latest trading statement also provided a reassuring update on the two new assets (NMC Royal and Al Zahra hospitals).

TMT specialist Zegona Communications rallied, after the group confirmed the sale of its Spanish cable asset TeleCable to Euskaltel. Although the proceeds of the transaction will take time to come through, Zegona announced they will return 'excess cash' to its shareholders. In line with the business model, management will now consider its follow-on transaction. Other notable contributors in the period included Paysafe Group, which announced solid full-year operating results and strong cash conversion.

Our largest detractor during May was Vectura following disappointing news in relation to the launch of the US VR315 generic Advair program. Based on conversations with management, the approval by the FDA and subsequent launch is likely to be delayed by at least a year.

Shares in challenger OneSavings Bank slipped after one of its key investors, JC Flowers, sold 10% of the company. The US private equity behemoth still owns 34% of the shares outstanding issuance.

Source: LGIM, 31/05/2017. All attribution is based on gross performance.

KEY FUND CHARACTERISTICS

Investment objective

The objective of this fund is to provide growth. The fund manager will typically invest between 80% and 100% in UK companies, although we may also invest in companies from Europe. We will invest in companies considered, in the manager's view, to be undervalued by the market.

Fund size

£274m

Benchmark

FTSE All Share Index

Target

+ 5% p.a. (rolling 3-year periods) vs. benchmark

IA sector

UK All Companies

Legal structure

UK Unit Trust, UCITS compliant

Ongoing charges

0.94% (I class)

Dealing cut-off time

12.00 (noon) GMT

ISIN

GB00B3DMY345 (I class – Acc)

Launched

10 November 2008

Active share

83.7%

Top 10 holdings

41.5%

No of stocks

36

Source: LGIM, 31/05/2017.

FUND COMPOSITION

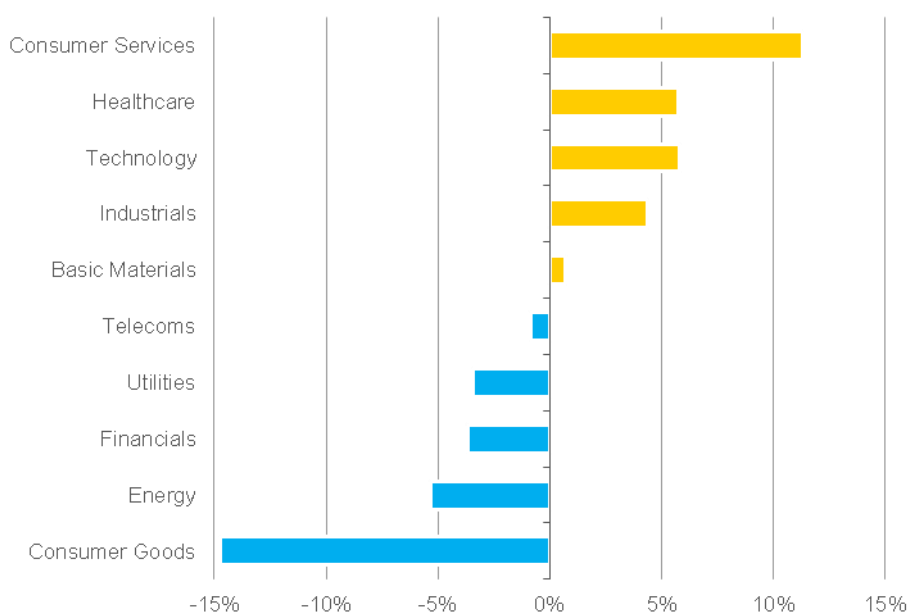
Top 10 Holdings

Prudential	Financials	4.8%
Playtech	Consumer Services	4.6%
St James's Place	Financials	4.4%
Smith & Nephew	Healthcare	4.4%
Carnival	Consumer Services	4.1%
DCC	Industrials	4.1%
Royal Dutch Shell	Energy	3.9%
GVC Holdings	Consumer Services	3.8%
Paysafe Group	Technology	3.8%
Lloyds Banking Group	Financials	3.7%
	Total	41.5%

Top Active Weights

Playtech	+4.5%
St James's Place	+4.2%
Smith & Nephew	+3.9%
DCC	+3.8%
Carnival	+3.7%
GlaxoSmithKline	-3.5%
BP	-3.7%
Royal Dutch Shell A	-3.9%
British American Tobacco	-4.3%
HSBC Holdings	-4.7%

Sector Positioning – Relative to FTSE All Share Index



Portfolio Characteristics

Top 10 positions	41.5%
Top 25 positions	83.9%
Active share	83.7%
# of Holdings	36
12m Forward P/E	14.9x
Forecast Earnings Growth	27.5%
Return on Equity	11.3%
Dividend Yield	2.7%
FTSE 100 Index	42.1%
FTSE 250 Index	38.8%
FTSE Small Cap / Other	19.1%

TRADING ACTIVITY

This month saw several changes to the portfolio. We sold our position in Vodafone, opting to buy Lloyds Banking Group as part of a mega-cap yield switch. As widely expected, the UK government has now completed the sell-down of its £20.3bn stake in Lloyds, which removes a technical drag on the shares. While this is unlikely to lead to a radical shift in strategy, Lloyds is now considerably better positioned in respect of dividend paying capacity.

We took advantage of the accelerated bookbuild to initiate a new position in Georgia Healthcare. The company are the largest healthcare services provider in Georgia, with significant market share of hospital beds, medical insurance and as a pharma retailer in the region. Elsewhere, we participated in the IPOs of Global Ports Holdings and Alfa Financial Software, which both listed on the stock exchange in the period.

MACRO

Despite the slower growth for the UK economy in Q1, the underlying economic picture remains solid. UK manufacturing expanded at its fastest pace for three years, helped by the boost to the UK's export competitiveness from sterling's depreciation. Business sentiment in the UK appears robust, though it will likely need to solidify in order for the mid-caps to carry on with this year's outperformance. UK retail sales and indeed consumer data in general continues to be distorted by timing effects and seasonal weather distortions, though unquestionably, online and discounters continue to feature as the all-encompassing growth drivers within the industry. Consumer confidence at this time speaks more of caution than collapse, though UK house market activity has remained sluggish, with the latest mortgage approvals data showing a seven month low. Finally, the latest minutes from the Bank of England monetary policy meeting indicate little has change. Inflation fears could be considered overdone, with the BoE in no immediate rush to change policy.

Legal & General UK Special Situations

Reasons to invest

DEFINING SPECIAL SITUATIONS

Special situations are undervalued opportunities, mispriced by investors, either in the early stages of recovery or suffering from indifferent performance. We categorise these into the following value and growth subsets;

- Refinancing (balance sheet repair, alignment of shareholder interests)
- M&A opportunities (enhancing growth, supportive market environment)
- Secular growth leadership (barriers to entry, strong product offering)
- Event driven strategy (IPO's, placings)

CONCENTRATED INVESTMENT APPROACH

A bottom-up approach to stock selection, leads us to construct concentrated fund of approximately 30-40 companies. We believe that a concentrated fund provides a greater opportunity to outperform the comparative index by giving the stocks we believe will deliver higher returns greater weighing. The fund is also relatively unconstrained, allowing the manager to deliver high 'active' share' rather than following the index. We do not construct the portfolio in line with a top down or sector view, but are very cognizant of the need to manage the increased idiosyncratic risk arising from a concentrated basket of stocks.

HIGH CONVICTION

We take a pragmatic approach to investment management, looking at individual company characteristics as part of our rigorous investment philosophy. As a bottom-up focused investor, we consider many factors to evaluate whether to place a stock in the portfolio. There has to not only be upside return potential, but also improving fundamentals or some other meaningful exogenous event which may cause the market to re-evaluate the company. The fund's high-conviction approach offers the potential to significantly enhance value for shareholders.

SIZE MATTERS

Academic evidence shows smaller companies have historically outperformed large-cap equities on a risk-adjusted basis. The same effects also persist in mid-caps, where there is potential for a great number of share price catalysts. We believe that investing in under-researched, less well-known companies can add alpha.

MANAGER TENURE

Fund manager Richard Penny has built a strong track record with more than 20 years of investment experience. Since taking over as lead fund manager of the UK Special Situations Trust, Richard has outperformed in eight out of eleven quarters. He is also co-invested in the fund.

LGIM CAPABILITIES


As one of the largest institutional asset managers in the UK, LGIM is afforded exceptional access to senior management teams of FTSE companies. Active engagement with management teams provides us with insight into company strategy, corporate governance and industry developments.



Richard Penny
Fund Manager (since May 2014)

Richard joined LGIM in 2003 and is a fund manager on the High Alpha desk. He is the manager of the award-winning L&G UK Alpha Trust and most recently, in May 2014, was also appointed manager of the L&G UK Special Situations Trust. Previously he worked for five years as a fund manager at M&G.

CONTACT US FOR MORE INFORMATION

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*Call costs may vary

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