Q2 2020

Standard Life Diversified Income Fund

Aberdeen Standard Investments

Commentary

After the sudden and extreme volatility caused by the COVID-19 crisis at the end of Q1, the second quarter was comparatively calm with risk assets as a whole producing positive returns. The main drivers of the rapid change in sentiment included the response of governments and central banks to the evolving pandemic, the gradual re-opening of some economies worst hit by lockdowns and economic data releases which highlighted both the impact of lockdowns on economic growth and the corresponding rebound in economic activity.

The fund produced a return of +8.0% during the quarter, gross of fees, with most asset classes contributing positively to performance. This compares to global equities which produced a return of +17.7%[1] over the period.

We continue to have a cautious near-term outlook for assets with greater sensitivity to the economic environment. We believe that economic conditions will remain challenging as we move into the second half of the year and therefore expect the market volatility seen in recent months may persist as the COVID-19 pandemic continues to evolve. In global equities, for example, the rebound seen in Q2 effectively factors in a sharp recovery in corporate earnings in 2021 and current valuation levels leave little room for disappointment.

Having reduced our exposure to areas of the portfolio that we perceived to be most severely impacted by the COVID-19 crisis in March, we re-allocated much of the cash raised to more attractively priced opportunities throughout Q2. This included increased allocations to corporate credit, asset backed securities and selected new opportunities in property and listed equities.

We continue to believe that in the case of many of our investments, the current crisis will have only a modest impact on the fundamentals of growth and income generation. As such, we believe that we are well positioned to deliver a highly attractive medium-term return for our clients in a relatively smooth fashion.

1: MSCI World (hedged to EUR) as at 30 June 2020.

Asset class review

Risk sentiment across most asset classes turned sharply positive during the quarter, supported by expansive fiscal and monetary policies, falling Covid-19 cases in a number of the worst-hit regions and the gradual re-opening of economies.

Listed Equity

Equity markets rebounded from lows experienced in March as investors looked through the initial impact of the crisis on corporate earnings and instead focused on the benefits of the monetary and fiscal stimulus. Volatility did however remain high as markets responded to spikes in Covid-19 cases, new economic activity data and comments surrounding the long-term impact of Covid-19 on economic growth.

Having outperformed during the drawdown in Q1, our Enhanced Low Volatility Equity exposure underperformed during Q2 as some of the themes which led to outperformance in Q1 reversed. Following a review, we decided to realign our approach to investing in equities as discussed below.

Asset Backed Securities

Having not rebounded to the same extent as other risk assets at the end of Q1, asset backed securities (ABS) delivered strong returns in the second quarter. Despite this rally, ABS bond prices still remain meaningfully lower than pre-crisis levels. We therefore believe that this represents an attractive opportunity in an asset class that can withstand significant levels of economic stress and increasing defaults. We have selectively been adding to our exposure.

Corporate Credit

Credit spreads on both investment grade and high yield bonds widened dramatically at the end of Q1 as liquidity declined sharply and investors became increasingly concerned by credit rating downgrades and defaults. However, steps taken by the Federal Reserve (the Fed) to stabilise financial markets such

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as the announcement of programs to purchase corporate credit and improving investor sentiment resulted in credit spreads narrowing meaningfully and markets re-opening for the issuance of new debt.

Towards the end of the quarter, we increased the allocation to higher quality high yield bonds within the sub-portfolio. This change reflected comparatively more attractive opportunities given positive price moves in some of the investment grade bonds held in recent months.

Emerging Market Debt

Emerging market (EM) local currency bonds produced a positive return in Q2 with both income and bond prices contributing positively to overall performance. This was partly offset by the performance of EM currencies against our funding basket (AUD, NZD, CAD, NOK, SEK and GBP) which had significantly dampened the impact of the drawdown during Q1.

Having reduced our exposure to EM bonds during March, our overall allocation to the asset class is now 12% having been 24% at the end of 2019. While we continue to see attractive opportunities here, we felt it was prudent to reduce exposure due to the potential for the crisis to have a more pronounced impact on some EM currencies. This reduction was used to fund other opportunities across the portfolio in Q2.

Infrastructure

Our allocation to infrastructure produced a positive return during the quarter which reflected the demand for sustainable income and long-term, government backed cashflows.

We continue to expect the COVID-19 crisis to have a limited fundamental impact on both social infrastructure and renewable infrastructure companies. Social infrastructure companies predominately invest in operational assets with long-term, government-backed revenues. Renewable infrastructure companies also have reliable long-term revenues through a mix of government subsidies and contracts with electricity companies and corporates. In addition, most enter into power price agreements which mitigate short-term power price volatility.

Property

While performance was positive overall, due to the diverse range of underlying exposures within our property allocation, the level of performance varied during the quarter.

Our social housing investments which include Triple Point and Civitas produced a positive return with investors recognising the limited impact of COVID-19 on the fundamentals of the businesses which have long-dated cashflows sourced from the UK government.

Logistics exposures including Tritax Big Box and ASI European Logistics also produced particularly strong returns during the period. Both companies experienced strong rental collections and continue to benefit from long-term lease contracts with strong tenant covenants and high quality counterparties. With demand for logistics assets remaining robust, we continue to see this as an attractive area of investment within property.

Special Opportunities

Special Opportunities includes allocations to a diverse range of exposures with differing return drivers. During Q1, a number of these were impacted by both the COVID-19 crisis and idiosyncratic factors. During the second quarter, a number of these trends reversed resulting in strong performance.

Litigation Finance

Burford Capital, the litigation finance company, announced full year results during the quarter which contained few surprises but included significantly enhanced disclosure. The company also announced a number of encouraging updates during the period including positive outcomes on some investments at the start to the year and progress on the Petersen case which has gained significant media attention in recent months.

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Specialist Credit

Our largest specialist credit exposure, Pollen Street Secured Lending (PSSL) produced a positive return over the period on the back of a number of positive news stories. The company released a number of updates which revealed relatively resilient performance over the period despite the broader macroeconomic shock. Later in the period, the Board of PSSL announced that the deadline for a potential bid from Waterfall Asset Management had been extended to allow for further due diligence.

During the period, the Board of SQN Asset Finance Income announced the conclusion of its strategic review and that it will seek to move the management to a newly formed entity, KKV Investment Management. The investment policy will remain the same, focusing on senior secured loans to low-to-mid-market SMEs, with the immediate focus on managing the existing portfolio through the challenges presented by Covid-19. After a consultation with shareholders, the appointment of the new management team effectively needs to be approved by a shareholder vote in July otherwise the fund will be put into run-off.

Royalties

Our exposure to both healthcare royalties and music royalties produced resilient returns during the second quarter. We continue to expect the fundamental returns for both companies to be largely unaffected by further periods of economic stress related to the COVID-19 crisis.

BioPharma Credit, a provider of debt capital backed by healthcare royalty streams, announced that they do not expect the COVID-19 virus to have a material impact on the credit quality of any of the loans. Hipgnosis Songs, which generates revenue from music streaming, produced a resilient return with the value of underlying music catalogues increasing during the period due to streaming growth and revenue ahead of expectations. Late in the quarter, the company announced an intention to raise further capital which highlights the opportunity to acquire attractive music catalogues and the strong demand from investors for revenue generation from uncorrelated sources.

Portfolio positioning and outlook

Having reduced our exposure to areas of the portfolio which we believed would be most impacted by the COVID-19 crisis such as listed equities and EM bonds in March, we identified a number of compelling opportunities to re-deploy the cash raised across the portfolio during the second quarter.

We increased our allocation to the corporate credit sub-portfolio managed by our US credit team by 7.5% in early April. The sub-portfolio invests in both investment grade and higher quality high yield bonds which, following dramatic spread widening in March, offers an attractive return for the level of risk.

Within equities we have evolved to a “core-satellite” approach. The core of our equity allocation now targets global equity returns with limited tracking error and a focus on sustainability. This includes having an ESG score of at least 110% of the benchmark, a carbon footprint of 50% of the benchmark and green revenue of 150% of the benchmark.

The core approach is complemented by satellite strategies which aim to add value through specific investment themes identified by ASI’s research teams. During the quarter we added a new green European infrastructure equity strategy managed by the ASI European Equity team. Commitments to meet EU emission reduction targets necessitate a multi-decade energy transition which may be accelerated if governments look to kick-start economic activity after the COVID crisis. We believe that this outlook is not currently fully reflected in the valuations of the companies which may benefit from this theme. In adding this strategy we also increased our overall equity weighting given the higher return potential on offer. We expect to add other new satellites to our equity allocation in coming months.

We increased our allocation to ABS during the quarter through our internally managed sub-portfolio and external ABS managers including Prytania DABS and Fair Oaks Dynamic Credit. We continue to see compelling value across ABS and are working closely with our managers to identify the best opportunities across the market.

In property, we made three new additions during the period. In late April, we initiated a position in Supermarket REIT via an attractively priced capital raise. The company provides exposure to long-term, upward only RPI-linked leases to Tesco, Sainsbury's and Morrison's. We believe that supermarkets will continue to perform well even during an economic downturn. We also re-initiated a small position in Unite Group, the UK's largest owner, manager and developer of purpose-built student accommodation. While uncertainly remains over the format of the 2020/21 academic year, we believe Unite is very well positioned to navigate this. Lastly, we initiated a position in TAG Immobilien, a German residential landlord specialising in high yielding 'B' markets and smaller cities in Northern and Eastern Germany. The company has a value-add strategy where it aims to acquire undermanaged assets and portfolios with scope to improve operating performance through targeted investments.

Having performed well over the period, we reduced our allocation to both social infrastructure and renewable infrastructure on valuation grounds. The proceeds from these reductions were used to fund other opportunities across the portfolio.

Outlook

The impact of COVID-19 on economic activity resulted in enormous supply and demand shocks and an unprecedented recession globally in late Q1 and Q2. Despite the severity, the period of the contraction has been relatively short-lived with many countries experiencing declining new COVID-19 cases and the phased easing of lockdown measures. As such, we expect a strong rebound in activity as we enter the second half of the year. We do however remain cognisant of the risk of second waves of the virus, new lockdown measures and the potential for permanent scarring of the global economy. We also remain acutely aware of the impact that liquidity injections from central banks have had on asset valuations. This is most apparent in equity markets where price appreciation in recent months has offset a large portion of the drawdown experienced in Q1 despite the more uncertain earnings environment for companies.

Despite the uncertain near-term outlook for risk assets, we believe that in the case of many of our investments, the current crisis will have only a modest impact on the fundamentals of growth and income generation. With many of these investments trading on cheap valuations we believe that the portfolio as a whole is positioned to deliver a highly attractive medium-term return for our clients delivered in a relatively smooth fashion.

[1] MSCI World (hedged to EUR) as at 30 June 2020.

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Cumulative and Annualised Performance as at 30/06/2020

	3 Months (%)	1 Year (%)	3 Years p.a. (%)	5 Years p.a. (%)	Since launch p.a. (%)
Standard Life Diversified Income	7.6	-3.1	N/A	N/A	-5.4

Discrete annual performance - year to 30/06

	2020 (%)	2018 (%)	2017 (%)	2016 (%)	2015 (%)
Standard Life Diversified Income	-3.1	N/A	N/A	N/A	N/A

Fund performance has been calculated net of Annual Management Charge
Source: Aberdeen Standard Investments (Fund).

Past performance is not a guide to future results. The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. This investment may be affected by changes in currency exchange rates.

Performance attribution

Most asset classes produced a positive return with the largest positive contributions coming from listed equities, asset backed securities, infrastructure and crossover credit.

Property, special opportunities and emerging market bonds also all contributed positively to performance

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Important information

Investment involves risk. The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. Past performance is not a guide to future results. This investment may be affected by changes in currency exchange rates.

Risk factors you should consider before investing:

- The value of an investment and the income from them can fall as well as rise and is not guaranteed. An investor may get back less than they put in. Past Performance is not a guide to future performance.
- Investing globally can bring additional returns and diversify risk. However, currency exchange rate fluctuations may have a positive or negative impact on the value of your investment.
- Bonds are affected by changes in interest rates, inflation and any decline in creditworthiness of the bond issuer. The fund's portfolio may have significant exposure to bonds that typically have lower ratings. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may not be able to pay the bond income as promised or could fail to repay the capital amount used to purchase the bond. Where a bond market has a low number of buyers and/or a high number of sellers, it may be harder to sell particular bonds at an anticipated price and/or in a timely manner.
- Contingent convertible bonds can automatically convert into shares or be written down if the financial strength of the issuer falls in a certain way. This may result in substantial or total losses of the bond value.
- The Sub-fund can use derivatives in order to meet its investment objectives or to protect from price and currency movements. This may result in gains or losses that are greater than the original amount invested. The fund does not make extensive use of derivatives.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. This may mean your money is at greater risk. The Fund may also invest in Frontier Markets which involves similar risks, but to a greater extent since they tend to be even smaller, less developed, and less accessible than other Emerging Markets.
- Investments in REITs and companies engaged in the business of real estate may be subject to increased liquidity risk and price volatility due to a variety of factors, including local, regional and national economic and political conditions, interest rates and tax considerations.

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