# Rathbone Enhanced Growth Portfolio

Quarterly investment update, April to end June 2021

Rathbones
Look forward

# Hot topics — 'Top-down' (market and macroeconomic)

**Yo-yo yields.** After a rapid rise in the first quarter, government bond yields deflated again in the three months to 30 June. The US 10-year yield leapt from near 1.00% at the start of the year to 1.74% three months later, to 1.47% at the death of the second quarter. Other nations' debt has generally followed suit. These are significant moves, and the latest direction is not the one you would expect. Bond yields are still extremely low, and inflation is high and rising. We still believe inflation will be transitory, but

even if it lasts for just a year or two that would eat up a substantial part of your real return on bonds that yield much less than the 2% inflation that central banks target. The large drop in yields suggests that bondholders believe central bankers will make a policy mistake by hiking rates to keep inflation in check, pushing the global economy into recession. But there is also a risk that inflation is higher and more persistent than anyone expects. And with yields so low, you stand to lose more on that scenario than you could gain if inflation does fall away. With so much at stake, investors seem unable to decide which way to go, thus the yo-yo yields. For us, we're trying to limit the duration, or interest rate sensitivity, of our investments while retaining a small position in a spread of governments' bonds as part of our portfolio protection. Meanwhile, we are constantly challenging ourselves on our belief that inflation is just a passing phase. We are watching for hidden transaction costs here in the UK due to Brexit, global supply dislocations from the pandemic, and keeping tabs on labour markets worldwide. This last is the greatest threat, in our view, and it's also where data is most lagged and messed up by the *annus horribilis*. We discuss this in the first episode of our new monthly podcast, ***The Sharpe End***, so tune in if you fancy it!

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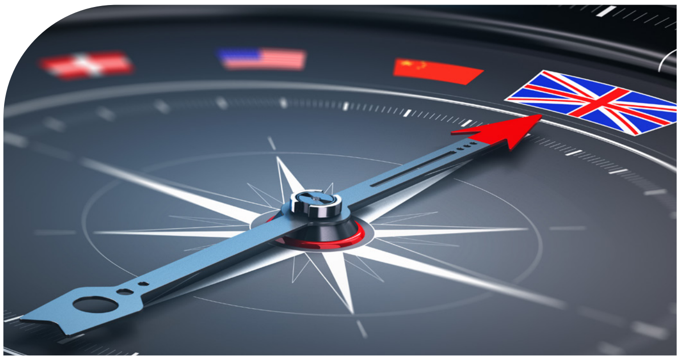
**British bargains.** It has certainly been an up and down year so far in the British Isles. Yet with a strong vaccination drive and a vibrant reopening economy, the country looks open for business. And after several years of chronic neglect by global investors, UK shares are looking very good value indeed. We have continued steadily adding to our UK exposure to take advantage. Private equity has certainly noticed too. So far this year private equity firms have bought out 131 publicly traded companies in the UK, totalling £25.7 billion, greater than in the whole of 2020. And the crazy part is that last year's £17.5 billion of deals was a record for Britain. This flood of deals could push the government to step in and stop more foreign acquisitions. We think any greater state intervention is likely to cluster in sensitive areas like technology, medical equipment, pharmaceuticals and the stock exchange, rather than supermarkets or purveyors of cleaning products. Also, geopolitics seems more likely to come into play too. A proposed



takeover by a Chinese company may hit the skids where an American or European suitor would be waved through. Just shows how much has changed since the Cameron and Blair years…

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**Modern merchants.** Retail isn't dead, it's different. Many people think retail isn't a thing anymore — or that there are no good retailers — but that's only because so many retailers are terrible. Stuck so far in the past, these companies don't understand the present, let alone see the future. Perhaps the dire situation of many retailers all around the world is the result of decades of flipping from public ownership to private and flopping back again. All the while, piling on debts. More than any other industry, retailers can be viewed as two businesses fused together: they are a series of cash flows from selling sofas or groceries or whatever; and they are also a large portfolio of real


estate. You can see why private equity traditionally sees lots of potential in retail for buying up, leveraging up and selling up. The bidding war for Morrisons comes to mind! This fixation with their properties made it really hard for lots of retailers and their investors to adapt to the modern age that demands a different strategy. Having shops on every corner isn't necessary anymore; instead you need to focus on laser-efficient warehousing, the ability to deliver to the doorstep and create fewer, nicer stores that people want to travel to. But it's hard to make big changes and investments when you're squeezed by large interest payments or keeping one eye on the value of your property relative to that of your cash flows, worried about the chance of getting raided and chopped up. The good news is that this dire situation makes the good retailers really stand out. Take our holdings **Nike** and **Ulta Beauty**, both of which have nailed the modern retailing strategy. They make their customers feel like they are a part of the business, through memberships, fun social media use and targeted marketing. Stores are eye-catching and designed to be experienced, not simply a place to pick up goods. Online ordering is slick, delivery smooth and they take advantage of the digital realm to encourage repeat business. This was why both businesses dealt well with a lockdown-ridden year and posted fantastic numbers during the reopening. In short, they are modern retailers.

## Portfolio activity

| Key purchases/additions | Key sales/trims |
| --- | --- |
| Morgan Stanley (new purchase) | CTS Eventim (sale) |
| Tomra (new purchase) | Baillie Gifford Shin Nippon Trust (sale) |
| Live Nation (new purchase) | Dexcom (trim) |
| UBS Resettable S&P 500 Put Option (new purchase) | US Bancorp (trim) |
| Taiwan Semiconductor Manufacturing Company (addition) | Schlumberger (trim) |

Source: Rathbones

In keeping with our expectation for greater short-term economic growth, potentially accompanied by inflation fears, we bought US investment bank **Morgan Stanley**. If bond yields continue to steepen (yields of longer-dated bonds rise more than shorter-term ones), then the bank should be able to make money off that. There has also been a raft of new listings, bond issues and M&A, which are the bread and butter of investment banks. Above all of these reasons to buy, however, is that Morgan Stanley has been expanding its wealth management business, significantly improving the quality of its earnings. By 'quality', we mean the fluctuations in its earnings are lessened by the smoother recurring wealth management fees. When this happens, it leads investors to put a higher value on the earnings, boosting a company's price-earnings multiple.

Another purchase was **Tomra**. This Norwegian company takes recycling to the next level. It makes reverse vending machines that encourage the recycling of bottles, cans and newspapers. It also designs sensor systems that help food supply chains reduce waste and improve hygiene.

We added to computer-chip manufacturer **Taiwan Semiconductor Manufacturing Company** during the quarter. Meanwhile, we took profits from oil industry engineer **Schlumberger**, medical devices manufacturer **Dexcom** and main street lender **US Bancorp** after some big moves.

We swapped European ticketing company **CTS Eventim** for American events and ticketing giant **Live Nation** during the quarter. We did this because Europe's pandemic recovery has faltered, while the US has been reopening at lightning pace thanks to its successful vaccine rollout. Live Nation carries more risk than CTS Eventim, in that it owns a considerable number of arenas and venues whereas CTS is solely a ticketing agent. We are comfortable taking that extra risk with Live Nation, because its vertical integration gives it a larger share of the potential profits from concerts and festivals. Considering the different responses to COVID-19, we are happy swapping German folk festivals for Taylor Swift gigs in the Midwest.

We're expecting a bit more volatility as the world seesaws between concerns about higher inflation and higher COVID-19 infections. When you expect higher risks it often pays to take out insurance, so we bought the **UBS Resettable S&P 500 Put Option** structured product. This works just like a normal put option: it gives us the right to 'sell' part of our US equities at a set price in the future, effectively creating a floor for the value of our holdings to protect us against market falls. And like with any form of insurance, we pay a fee for the privilege. Where this product differs is that the price we can 'sell' at can reset higher each quarter if the market continues to move upward.

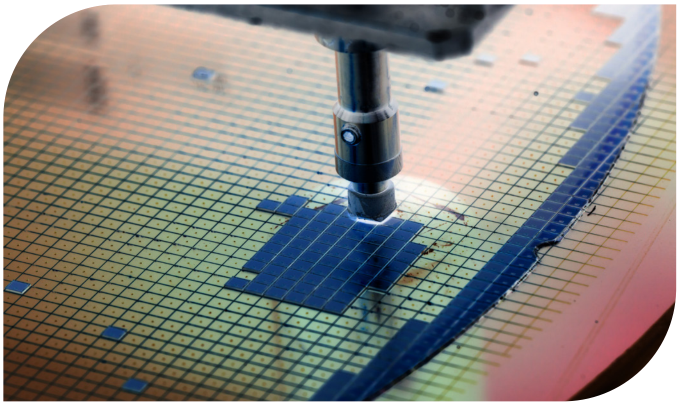
In this quarter, the spotlight is on our holdings **SIG Combibloc** and **ASML**.

**SIG Combibloc**

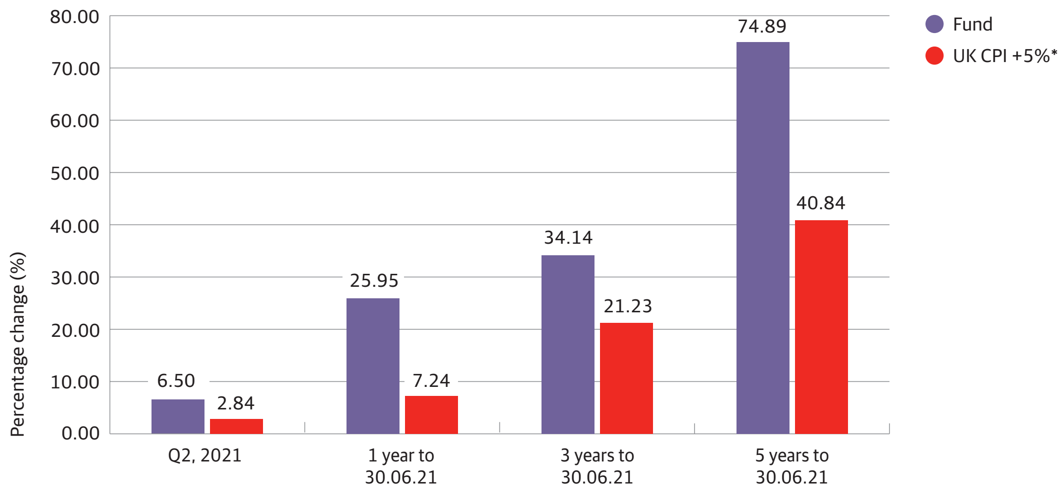
- A global leader in aseptic packaging solutions and systems used for a number of consumer food and beverage products including milk and juice cartons
- The company has a number of specialist sustainable food packaging solutions which helps eliminate the need for aluminium, along with the world's first aseptic pack that is 100% linked to plant-based renewable material
- SIG's cartons have a significantly lower environmental footprint than other solutions and focus on renewable wood as the main material in their packaging
- Unique and innovative technology helps to retain nutrients, flavours and colours of food and drink and extends the shelf-life without the need for refrigeration – importantly saving both transportation and storage costs
- SIG's are well positioned to benefit as companies and consumers continue to shift their focus to more affordable, sustainable, and convenient packaging, areas in which SIG leads

**ASML**

- The blue-chip player globally in the manufacturing of the equipment required to make chips found in a wide range of products including computers, smartphones and medical equipment
- ASML possess significant technological expertise and the deep pockets required to drive innovation to enable microchips to be smaller, cheaper, and more powerful and energy-efficient – this expertise and financial strength drives out competitors
- The design of their products extracts the maximum value from the materials they use, and their equipment systems can last for decades supporting the transition to a more circular economy
- ASML is committed to help make microchips greener by reducing the energy use of their equipment systems through investing in hydrogen systems and more efficient pumps
- Structural shifts to more technology-enabled products should lead to a significant expansion of opportunities for ASML through chip-hungry areas such as electric vehicles, industrials, and artificial intelligence



## Fund performance




Performance (based on 'S-class' shares).
Net of expenses and tax. Net income reinvested.

Data source: FE fundinfo

*At 1 October 2015, the benchmark measure changed to CPI+5%. Price performance based upon bid to bid prior to 21 January 2019 and single price (mid) thereafter. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.

| Discrete annual performance | | | | | |
|---|---|---|---|---|---|
| **Year to:** | **End June 2017** | **End June 2018** | **End June 2019** | **End June 2020** | **End June 2021** |
| Fund | +21.43% | +7.36% | +4.70% | +1.72% | +25.95% |
| UK CPI +5% | +8.02% | +7.54% | +7.08% | +5.57% | +7.24% |

| Top performers (%) | | |
|---|---|---|
| **Holding** | **Performance** | **Contribution** |
| Shopify | +31.74 | +0.32 |
| Discover Financial Services | +24.97 | +0.25 |
| Edwards Lifesciences | +23.88 | +0.25 |
| SIG Combibloc | +23.73 | +0.21 |
| Adobe | +23.34 | +0.26 |

| Bottom performers (%) | | |
|---|---|---|
| **Holding** | **Performance** | **Contribution** |
| UBS 10114 S&P 90% Resettable Put April 2022 | -33.84 | -0.15 |
| Travelsky Technology | -8.68 | -0.07 |
| Clorox | -6.21 | -0.07 |
| Nidec | -5.24 | -0.06 |
| Vodafone | -4.43 | -0.05 |

Note: Top and bottom performers are taken from the list of all holdings of 0.25% and above of the portfolio.
Performance and contribution data shown above is based on unhedged GBP capital returns.

Source: Rathbones

It was a fairly positive quarter for all asset classes and so most elements of the portfolio were positive contributors to the return with equities leading the way. Within equities our US exposure was the biggest contributor with a few names like **Equinix**, **Schlumberger**, **Discover Financial Services**, and **Adobe** all being significant parts of that performance. European equity made a very solid contribution too with **Eurofins Scientific**, **SIG Combibloc**, and **LVMH** providing the larger contributions to that.

**Nike** saw a sharp rise in its share price after a stellar set of results driven by outperformance in their US and EMEA (Europe, the Middle East and Africa) businesses along with China not decelerating as much as may have been feared. The strong sales didn't just look good against the COVID impacted 2020 numbers, but they materially beat the pre-COVID 2019 numbers as well. This was a similar picture to what we saw from **Ulta Beauty** during the quarter too where they reported strong beats of both the depressed 2020 numbers but, arguably more importantly, their 2019 numbers too. These results offer some level of proof that retail sales are coming back in certain areas and those great companies who offer market leading products and customer experience are attracting more of that spending.

## Fund performance (continued)

As you would expect in rising markets, the put options were the largest drag on the portfolio. The price of the newest put option with the resettable feature fell, but not by as much. That resettable part of the option means that we don't lose as much protection at the outset if the market rises as the strike can reset higher. So long as you have been sensible about the price you have paid for your put options and the shape of the protection it offers, getting a drag from put options isn't necessarily a bad thing given that it should mean that your risk assets are performing well. The price element of this is so important though as this protection is never really cheap as you've heard us say a number of times. If you're profligate with put option use then you end up with far too much going down the drain and it does become too much of a drag to bear.

## Asset allocation ranges

| Liquidity | Equity-type risk | Diversifiers |
|---|---|---|
| 0% to 20% | 70% to 100% | 0% to 20% |

## Asset allocation

We increased our exposure to UK equities during the quarter.

| Asset allocation split | 31.03.21 | 30.06.21 | % Change | 12 month change |
|---|---|---|---|---|
| Liquidity assets/lower volatility | 5.75% | 3.75% | -2.00% | 0.30% |
| Equity-type risk (economically sensitive assets) | 92.40% | 94.43% | 2.03% | 0.09% |
| Diversifiers | 1.85% | 1.82% | -0.03% | -0.39% |
| | 100.00% | 100.00% | | |

| Asset class split | 31.03.21 | 30.06.21 | % Change | 12 month change |
|---|---|---|---|---|
| Equities | 86.46% | 88.15% | 1.69% | -1.52% |
| Index-linked bonds | 0.00% | 0.00% | 0.00% | 0.00% |
| Conventional government bonds | 0.00% | 0.00% | 0.00% | 0.00% |
| Corporate bonds | 0.14% | 0.00% | -0.14% | -0.59% |
| Emerging market debt | 4.03% | 4.61% | 0.58% | 2.49% |
| Private equity | 1.77% | 1.67% | -0.10% | -0.29% |
| Alternative investment strategies | 0.30% | 0.36% | 0.06% | -0.31% |
| Property | 0.00% | 0.00% | 0.00% | 0.00% |
| Commodities | 1.55% | 1.46% | -0.09% | -0.08% |
| Cash | 5.75% | 3.75% | -2.00% | 0.30% |
| | 100.00% | 100.00% | | |

## Investment outlook

Uncertain times can often make people cocksure of their beliefs. That certainly seems to be the case this year.

Everywhere you look, data is patchy, unclear and heavily distorted by the greatest disruption to people's lives and global commerce in the better part of a decade. Comparisons are difficult because a year ago most of the world was locked down. The future is difficult to discern because we're yet to see which changes to shopping, transport and working habits will stick and which will fade away in time. We still don't know how long we will be living with COVID-19 lurking in the background. A year ago, we thought the pandemic would be over in a month or so. Six months ago, we fell into the same trap. The rise of the Delta variant, despite inoculation programmes, just highlights how hard it is to limit the spread of a highly infectious disease, let alone eradicate it.

The good news is that, as societies and businesses, we have shown once again just how adaptable we can be. The pandemic shocked businesses and people, offering us all the chance to pause, take a breath, and rethink how we work and live. Flexible working has been technically possible for years, yet its benefits for focused work and reducing unnecessary travel weren't recognised. Now that they have been proven, this should have huge benefits for productivity, living standards and congestion. Shuttered businesses had to shovel money into technology to ensure they could operate remotely and to ensure they could sell online. Arguably many companies were very slow in embracing the digital age, but the pandemic suddenly made it an imperative.

These dynamics, both positives and negatives, have whipped up the whirlwind of change that makes forecasting so difficult. We have started to become a little uneasy about just how adamant many investors have become about what the future holds. There seem to be two camps, equally sure that they are right. The first, and probably largest, group are those who believe the recent spike in inflation will be "transitory" and growth will return to pre-pandemic levels without any requirement for central banks to hike interest rates. The other group believe that we are entering a new era of persistent inflation above 2% that will send rates higher, squeezing high-valued stocks and bonds.

We think inflation will be a passing phase, but we are constantly challenging ourselves on this assumption. Also, we're not so sure what other investors consider to be "transitory". For us, we think it's quite likely that inflation will still be slightly above the 2% target in a year's time. But other people may think that "transitory" means it will have all died down in a few months. That misunderstanding could spark some panic and market dislocation.

Given all this, we've been carefully building our portfolios to protect ourselves in case the world doesn't take the path we expect. This means we will probably not deliver another year of the outsized returns we enjoyed in 2020, but we shouldn't be upended by the unexpected either.

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Rathbones
Look forward

**Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.**

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