

Rathbone UK Opportunities Fund

Quarterly Update, December 2018

While 2018 started off on a strong footing for the global economy, markets and optimism became fragile in the second half. We were right to be more cautious as the year progressed, but we weren't cautious enough. Our mandate requires us to invest in growth areas, so it's difficult to avoid knee-jerk selling of them without abandoning our strategy. But in hindsight we could have done more to reduce risk in the portfolio.

The worries around Sino-American trade tariffs finally came to head as Chinese economic data deteriorated and US vital signs and company results came off the boil. In autumn these concerns combined with a blasé statement from the US Federal Reserve about monetary policy tightening, sending global sentiment plummeting and markets with it. And if you were a UK domestic investor Brexit was just another sickening barrel of laughs.

The Brexit rhetoric ramped up considerably in 2018; unfortunately any concrete progress was missing. We can see now the obvious impact the 'implementation' has had on shopping habits leading into Christmas. We will see it in the cash flows of our businesses too: having to stockpile food, medicine, ingredients and components means tying up cash that could otherwise be working harder for shareholders. Globally, trade talks between China and the US barely budged, although we are more confident of a resolution now. China's economy is slowing and people are starting to fear that the US will not be far behind, exacerbated by interest rate rises. After 10 years of markets rising, this jump in risks around the world has understandably hit investors hard.

Your fund returned -19.3% over the fourth quarter, compared with the FTSE All-Share's 10.3% fall. Over 2018, your fund fell 19.4%, underperforming both its IA UK All Companies sector peers and the market (-11.2% and -9.5% respectively). From an index perspective, this was due to our heavy overweight position in FTSE 250 and AIM names, and underweight position in FTSE 100 stocks which proved more resilient during the turbulence.

We had become incrementally nervous about Brexit-induced sleepiness for UK businesses over the summer and so sold our early-cycle industrial positions (engineering company IMI, instruments and gauges manufacturer Spectris) and topped up on more predictable, highly profitable investments (business outsourcer and distributor Bunzl, safety tech company Halma, software developer Ideagen). This enhanced the fund's return until autumn. We didn't go far enough, however; during the final quarter stocks capitulated and investors pulled record sums of money from UK funds (none from this fund, however). Given this set-up, it was unsurprising that defensive parts of the market outperformed into year end. The sell-off was particularly acute in names that had run up strongly in the first part of the year and now looked 'expensive' – technology niches and growth stocks, both areas where your fund is very overweight. This dynamic was the biggest headwind to performance during the year, alongside two stock-specific issues that we will discuss later. Large companies fell the least (driven by international earners in the FTSE 100), but all sized UK indices were down

over the year – a further headwind for your fund, as our benchmark is over 80% FTSE 100 compared with our 30% weighting.

Our FTSE 100 positions (through miners and oils) did give us some protection, but being so underweight dampened the benefit considerably. AIM was the worst-performing index, reversing the trend of last year. AIM is our biggest overweight due the number of interesting growth companies we find there. After many years of strong performance, it is not wholly surprising to see the index take a breather, but the number of stock-specific potholes during the year was unnerving.

Healthcare, another of our underweights, was the only UK sector in positive territory by the end of year. We own neither AstraZeneca nor GlaxoSmithKline, which is also a good part of our FTSE 100 underweight. We have added to our healthcare exposure via **Abcam**, which sells antibodies to science researchers. Oil and gas had a relatively good year, despite the year-end falter. We continue to own no stocks in Tobacco, banking or telecommunications – the worst-performing sectors of the FTSE. Our big overweights in technology, consumer services and industrials (where a large proportion of UK growth businesses sit) were sold down due to strong prior performance and some stock-specific issues discussed below. Technology remains our largest overweight position relative to our benchmark.

Financials is our biggest sector exposure, despite owning no banks. The majority of our holdings are specialist operators, such as alternative asset manager **Intermediate Capital Group**, litigation financier **Burford Capital**, student housing developer **Unite**, as well as selected insurance companies.

Our top contributors were design software business **AVEVA**, which was subject to a reverse takeover, industrial rubber belt business **Fenner**, which was bought by Michelin, and Burford.

Our biggest detractors both suffered from large and unexpected profit warnings. Legacy software consolidator **Micro Focus International** issued a spectacular profit warning in March 2018, although the worst case outlined has in fact not transpired (the stock is +50% since then). Online fashion retailer **ASOS** sharply cut expected profits in December, blaming nervous shoppers ahead of Christmas and failing to discount enough over Black Friday. Additionally, we held a 2.3% position in **Patisserie Holdings**, which is now in administration. We have marked down the position to zero.

Outlook

Looking back, 2018 felt like something of a perfect storm – the flip in investor sentiment led quickly to a sharp reappraisal of multiples that investors were willing to pay, particularly for growth names that had performed very well until then. Additionally, Brexit headlines meant that neither your fund's style, market nor size were in favour. Our confidence in the long-term attractiveness of the mandate is undiminished despite its current unfashionable status, but given the outlook for the global economy we must work harder to find more businesses than can thrive whatever the macro and the politicians throw at us.

Brexit *still* means more moving parts are out of our control than normal, which doesn't feel comfortable. We would welcome increased certainty around the outcome for the UK. For businesses to start investing again and consumers to feel confident, we need more clarity than the Westminster bubble has provided so far. But for the long term investor, we believe the opportunities revealed by swathes of global investors deserting the UK will be enriching. Once again we have elevated levels of cash. We must be patient.



Alexandra Jackson, CFA
Fund Manager

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Source performance data, Financial Express, bid to bid, net income re-invested.