Cracking on

10 more years of evolution

Rathbones
Look forward

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.

You're crazy, they used to say 10 years ago. Why would anyone want a fund that aims for a set return above inflation or interest rates and a certain amount of risk? What about the 'lights'? Investors want to see them shot out!

We thought differently when we designed our multi-asset range a decade ago. It was a hard slog getting many people to understand us at first.

Yet it turns out we were onto something by setting a concrete target for returns and risk that investors could measure us against. Investors were actually less inclined to "shoot the lights out" than many fund managers and advisers thought. Especially after the credit crunch and the huge market falls of 2007/08, investors craved certainty.

People want investments that they can rely on to deliver the money they need to achieve their dreams. Mostly, these aren't earth-shattering aspirations: seeing their kids off to university knowing the cost is all accounted for; retiring in good time to the Dorset countryside for some much-earned rest and relaxation; perhaps buying a holiday home on the Continent. But to the people achieving these dreams, that *is* shooting the lights out.

Sometimes fund managers can focus so much on returns and volatility and stocks and bonds and yields that they forget that our job is simply a means to an end. This isn't an intellectual game or an abstract challenge, this is real people's money. We're not the reason, we're the method. And the best methods – the best tools – are the ones you can be sure of.

It's no good if something is exceptional one week and virtually unusable the next. You can't plan a picnic with something like that, let alone your life.

It took a good few years, but now virtually everyone is following our lead. Now it's not crazy to offer people a steady return, dampen the ups and downs of markets and let compounding do its work. Now, it's a bit old hat and "the only sensible way to do things, of course". This is undoubtedly a good thing for the investment industry and the people it serves.

There's always more to do though. We've continued to reassess our strategies to ensure they give investors the best possible result. That includes constant reappraisal of our portfolios and how a complex world changes the interaction between assets. Over the past 10 years we've moved from portfolios of funds to investing directly in stocks, bonds and alternatives. We've cut costs considerably and refined the unique way we categorise investments. We've bolstered our team and boosted our communication with investors too. It's imperative that we say what we mean and deliver on what we say. Transparency and reliability are crucial, always have been. And they will continue to be for the next 10 years that we spend helping our clients get the future they want.

Here's to your future, whatever it may be.

David Coombs
Head of Multi-Asset Investments

Market themes 1

China, emerged

May 2010

Flash Crash

Now the hub of one of the greatest manufacturing supply chains the world has ever seen, China sucks in more raw materials than most other countries combined. And a cornucopia of daily necessities and modern extravagances flow from it in return.

China has the second-highest number of billionaires in the world and more than the next five nations combined (one of which is the UK, by the way). We believe China is only getting started; the next decade will see it soar yet higher. But this exceptional expansion doesn't mean the country is still a developing market – in our eyes it is most definitely developed. Index providers' definitions of 'developed' are Western constructs; we doubt the Chinese would consider themselves anything other than a major, developed player on the world stage.

We think you should be investing in China like the developed nation it is. It vies with the US as the world's largest economy and accounts for about a third of global GDP growth. And yet Chinese shares make up just 5% of the emerging market index, itself a very small part of investors' global portfolios. This is a huge market to ignore and doing so could hurt investors over the coming years.

At least once a year for the past decade, pundits have warned that China was about to collapse; every time they have been wrong.

That's not to say that China doesn't have problems, and that those problems tend to be of the 'emerging' kind. Chinese company governance is below par, its economic data is skewed by the ruling party and it racks up debt like its late cousin, the USSR. But this Frankenstein of communism and capitalism is vibrant, dynamic and resilient. At least once a year for the past decade, pundits have warned that China was about to collapse; every time they have been wrong. It continues to move from being a state-dominated, heavy-industry economy to one of private enterprise, services and consumption. This shift has been remarkable – luxury sales and travel is booming there – more so for knowing that much of country remains extremely poor.

There's a lot of road for this growth to continue. Chinese e-commerce blows many Western attempts out of the water. Chinese developers have developed technology that allows people to buy clothes they like while watching a catwalk video of the release. Western online shopping frenzies like Black Friday pale in comparison to China's equivalents: last year, the US spent almost $8 billion versus China's $30.8 billion.

Meanwhile its entrepreneurs are fast, sharp and brilliant. In October 2017, Luckin Coffee opened its first stores in China, a market dominated by Starbucks, the US giant that is shorthand for coffee. Luckin offered cheap coffee through an app that allowed workers to order and pay from their desk (or factory or building site) and told you when it was ready to be picked up. For a bit extra, you could have it delivered to you. A simple idea, but a good one. And one that Starbucks missed. Luckin Coffee now has around 3,000 outlets, making it the second-largest coffee company in China behind Starbucks, and plans to list the business in New York value it at almost $4 billion. It has out-America'd America. Not bad for 18 months' work.

Market themes 2

Politics matters now

For a decade or more, centrist governments and laissez-faire policies meant that developed world politics were effectively irrelevant. Whether you had the blue or the red flavour, the taste was virtually the same. And it tasted pretty good for investors. These days that's out the window. We think the next 10 years will be dominated by more public grievances, more government intervention and more market volatility.

Since the global financial crisis especially, asset values have soared as central banks kept interest rates low and poured trillions of dollars (and pounds, euros and yen) into government debt markets. Many governments helped boost markets yet further by cutting taxes and reducing public spending through austerity programmes.

This last point may be a bit counter-intuitive – economic textbooks tell you that cuts to government spending should lead to less household spending, lower GDP growth and just general gloom all round. However, as often happens in economics, this doesn't always come true. Recent research by the US National Bureau of Economic Research has an interesting theory about why. By cutting the ranks and after-inflation salaries of public servants, governments push down wages for the whole economy. And that means higher margins for companies who are then more inclined to invest, which boosts the economy, offsetting the lost spending from now-redundant public sector workers. And even with extra investment there's been plenty of cash lying round for share buybacks and higher dividends. With low unemployment, muted wage growth and elevated business margins in much of the Western world, the glove appears to fit.

Beware of anything that looks 'unfair' to a crowd. Anything that is a quasi-monopoly, anything that bewilders customers to boost profits, anything complicated that looks too clever to be kosher.

A favourable political environment for capital has been very good for, well, capitalists. The rich have got much richer as their stocks, bonds and properties have soared, while the poor have stagnated or gone backwards. Not only that, but technological and trade changes have been hollowing out many middle-income jobs for decades. Between 1971 and 2016, the proportion of American households classed as middle-income dropped 10 percentage points to 51%. According to the Pew Research Center, roughly half these people moved to the upper-income group, while the other half slipped into the lower-earning group.

August 2011

US credit rating downgraded and European Debt Crisis picks up pace

It's perhaps no surprise that a shrinking middle ground in terms of income has led to a shrinking political centre. Today, fringe politics have been swelling at the expense of centrist parties as the alt-right (extreme nationalism) and alt-left (socialism and extreme environmentalism) sweep across America and Europe. Regardless of whether they are on the left or right, these movements have similar economic policies: interventionism, protectionism and redistribution to those that have been left behind. This has led mainstream parties to bend one way or the other like trees in a gale.

This is not just a passing gust, either. We believe this is a political storm that will continue for much of the next decade. Beware of anything that looks 'unfair' to a crowd. Anything that is a quasi-monopoly, anything that bewilders customers to boost profits, anything complicated that looks too clever to be kosher. All of these things will be in danger of government intervention over the coming months and years.

Market themes 3

White collar robots

Automation and digital disruption cut a swathe through manufacturing and we are all now watching retailers buckle under the strain of change.

We believe IR4.0 (the fourth industrial revolution) has a way to go yet. Lawyers, accountants, hell, even asset managers, bankers and dentists' assistants could be replaced by robots and algorithms. Of course, the people won't be replaced – only their jobs. They can go on to do more interesting roles in their industries or perhaps do something completely different. Only a cracked person or a clinical optimist would argue that everyone will fall into a better future because of this wave of change.

More than a few of us will be enraged by these changes (which will intensify the political shifts we spoke about earlier). Most of us define our identity by our profession, always have done: that's why so many of us have surnames like Smith, Fletcher, Turner and Cooper. And the more senior the casualties of IR4.0, the more invested in the vocation they are likely to be, therefore the greater grief.

May 2013

Taper Tantrum

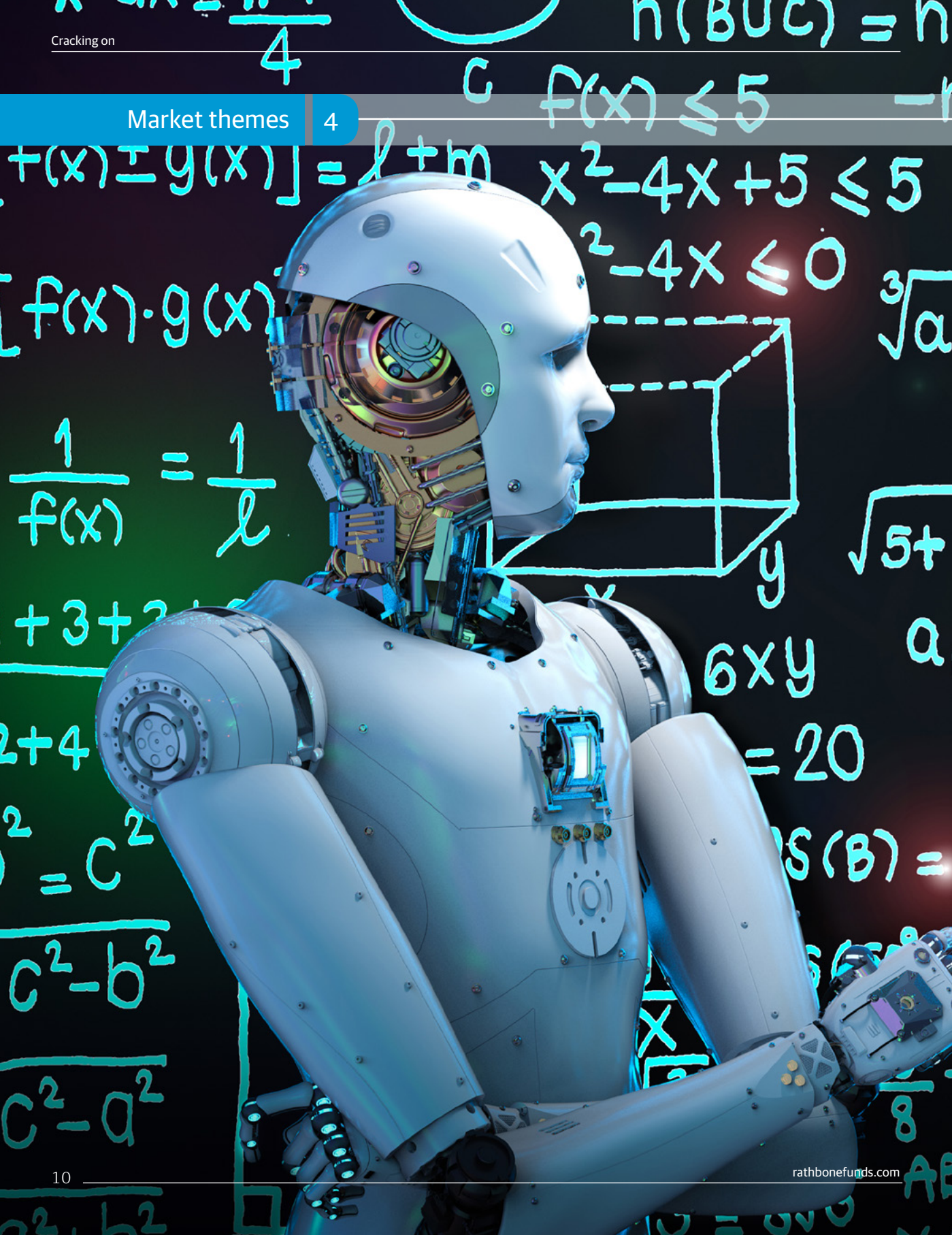
It's all a bit concerning and gloomy. Many people find uncertainty unsettling, so it's no surprise that tales of future woe make an impression on people. The future is inherently unknowable. Yet hope is always best. The future has a habit of flowing into the present without much fanfare while people do what they have done best for millennia: adapt. Many of us still carry with us the legacy of our forebears' trades, yet few of us fire horse shoes, make arrows, work a lathe or build barrels for a living.

You have to be the cheapest supplier in your market or you have to offer the best-quality alternative that people with more cash cannot resist.

We believe IR4.0 won't spell the end of the human touch. Instead, it will deepen a dynamic we've been following for some time; you have to be the cheapest supplier in your market or you have to offer the best-quality alternative that people with more cash cannot resist – the middle is and forever will be toast.

It seems likely that artificial intelligence and greater automation will be a way to cut costs and make it alluringly easy for customers to deal with a business. But there are many areas where it will make sense for these savings to subsidise skilled humans. Whether to sort out complaints, help with unusual queries or offer a luxury service. It could be a winning strategy...

Market themes 4



Rise of passives

Tracking indices has become a popular way of investing in the past few years. Quantitative strategies have also been on the rise. That's where computers are let loose to read news reports, old price data and relationships between assets and then trade on their inhuman hunches thousands of times a day. Both have had profound changes on markets.

Momentum, as a factor, is supreme. And a wave of passive investors buying stocks based on how much they went up yesterday has no doubt played a part in that. There are other effects. To us, at least, it feels like assets get lumped together for superficial or artificial reasons much more frequently and to a greater degree than in the past. We reckon this could be due to the multitude of funds that simply track a basket of stocks put together passively to suit a certain theme (usually cooked up by investment bank research desks). It could be all UK stocks moving as one, even though few of them make much cash in the UK: let's call it a 'Brexit basket'. Or perhaps any business with half a hand in Artificial Intelligence or automation is bundled together as a 'Next Gen' ETF, it means the prices of all those companies start to become more correlated the more people buy into the story. And there are a lot of these stories around at the moment – with ETFs to 'play' them.

Nowadays, one telco posts poor results and every company with some masts seems to sink along with it – sometimes even the shipping companies! This creates problems, but it also creates opportunities for the patient investor.

When a whole sector is sent lurching downward because a competitor's bad result snowballs into a mass sell-off by quant and passive funds, active fund managers can buy the quality companies at a much better price. When you're taking the long view, you can ignore some short-term confusion; passive investors and quants can't.

These dynamics are only going to increase in the coming years, we believe. As the amount of passive and quantitative trading gets closer to matching that of active managers, markets could start to look very strange indeed. At the moment, most trades are active ones, compelled by company fundamentals like honest earnings, prudent borrowing and sustainable growth opportunities. When passives and quants take the lead, the underlying financials of a company may have less significance for markets. Companies may start to adjust their financial accounts to manipulate specific metrics that passives and quants use blithely to determine what to buy. As soon as discretion is removed from decisions, things tend to go awry.

Fighting the last war

We've all lived under the shadow of the global financial crisis for the past 10 years. Its consequences have been our day-to-day realities for so long that it's hard to break free of the conditioning.

For many investors, low interest rates, high price/earnings multiples and muted inflation are all they know. That and the belief that recessions and economic crises stem from debt bubbles alone.

Many companies are managed by people who have only known the debt-fuelled years leading up to the financial crisis, the great pop that resulted and the decade of cheap money that followed. The unique era they have lived and learned through will have created a new set of weaknesses, biases and blind spots that will no doubt contribute to the next great global stuff-up, whenever it arrives.

Ultra-cheap money is a pretty cosseting wet nurse. But it hasn't always been this way. I still remember running money in the brutally bad old days of the early 2000s. A river of red ticker tape that flowed on for years. Terrible. No future in this world is written, however. And falling into lazy traps of past thinking can be painful. Thinking that things must go back to the way they were before is just as dangerous as thinking debt bubbles are the only way for an economy to crash. What if we're at the peak of interest rates in advanced economies for the boom-bust cycle? What if US rates stall below 3%, UK rates don't even make it to a whole number, and Europe and Japan remain in negative territory.

Lower interest rates support higher price/earnings multiples for stocks and lower yields for bonds because future earnings aren't eroded by time as much as when rates are higher. Low rates also affect the risk you have to take for the return you require. Over the past 10 years, many investors have benefited from a rising tide of asset prices as they adjusted to lower interest rates. But that is a one-time move and unlikely to be repeated. We have already warned investors that future returns may be much less than they have come to expect and that people may have to take more risk to achieve their goals.

Today's obsession with markets 'returning to normal' may be misplaced. If the wave of AI and automation replaces Chinese manufacturing as the 800-pound gorilla sitting on global inflation, then easy money and low rates could be here for another 10 years or more. That would mean an adjustment in investors' attitude to risk. And managers who focus on hunting for debt-driven risks may ignore some mightier issues staring us in the face (populist politics, for one). We should learn the lessons of history, but we shouldn't be blinded by them.

November 2016

Trump elected US President

December 2018

US yield curve inversion

We should learn the lessons of history, but we shouldn't be blinded by them.

Changes to the funds

1

June 2009

Inception of Rathbone Strategic Growth and Total Return Portfolios

August 2011

Inception of Rathbone Enhanced Growth Portfolio

Will McIntosh-Whyte
Assistant Fund Manager

Craig Brown
Investment Specialist

Putting the band together

As our portfolios grew and we were preparing to invest directly, it was time to increase the headcount. I got Will McIntosh-Whyte on board because he was an eminently qualified investor with a completely different view on the world. Well, not completely different – we're both cynics at heart – but he is a good 20 years younger than me and of a Millennial vintage. That was important for me.

I wanted someone with a different eye for the world who was confident and experienced enough to tell me if he thinks I'm wrong. Although, at the end of the day, I believe there should be one person who has to make the final decision and own the consequences. For the time being, that's still me. Will has been a great head to have around. Without him, the funds, their offshore variants and many of the interesting niche investments we've made wouldn't have been possible.

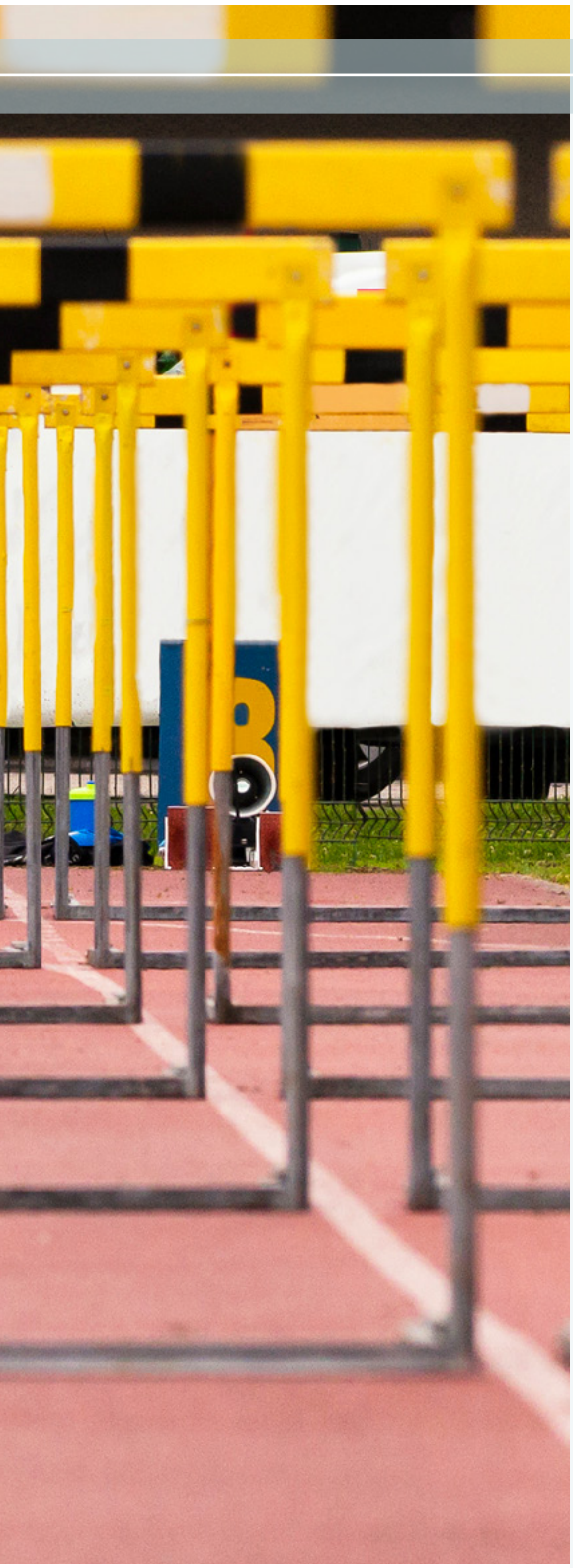
It's not just the two of us doing the due diligence on investments either. Rathbones' research team has grown substantially since we launched our first two funds 10 years ago. We can take the counsel of internal experts on equities, both here and abroad, fixed income geniuses and on-point fund analysts. This gives us an enormous breadth of information, ideas and options across all types of assets.

Recently, we've added Craig Brown to the team as well. As our fund range has ballooned, so has the FCA's rule book. The combined effect is that the amount of behind-the-scenes work – following regulatory requirements, keeping investors informed all around Europe and hearing their feedback – means we needed someone else to help share the load and ensure we can do our jobs properly. Our aim is to offer funds that do what they say they will, and to ensure that our investors completely understand what they are investing in. We continue to invest to ensure we have the team to do just that.

Changes to the funds 2

At what cost?

There's been a race to the bottom on fees and charges of all kinds. What started as a well-intentioned push by the regulator to kick-start competition and shake up the industry has morphed into a crusade for low costs at any... well, cost.



October 2015

Move to direct investing

Inception of Rathbone Strategic Income Portfolio

November 2015

Will McIntosh-Whyte joins

Focusing on getting services for as little as possible with no regard for the quality of service or product leads to one terrible place, in our opinion: a compromised result for the customer.

We have got our costs down to a highly competitive place for the right reasons.

We, as an asset manager, began paying research costs on behalf of the funds. We invest directly in underlying investments, which strips out many double-tiered costs. Where we do use funds – for those specialised areas where we levy the expertise of others – we are like Cockneys on market day. As our funds have grown in size, that's created economies of scale that have allowed us to further shave the charges that our investors pay. That inverse relationship between portfolio size and cost hasn't come to an end yet either.

If costs continue to be slashed across our industry and value not appreciated then expect corners to be cut and resources to dry up. Returns will be patchy, portfolios will become more volatile and less robust. And eventually an investment industry scandal will arrive which will destroy the public's regard for investment management even further. That would leave our industry and investors in a worse position.

Changes to the funds 3

March 2017

AUM reaches £500m

April 2017

The funds join the IA Volatility Managed sector

Risk requires precision

The feedback we get is that having a clear philosophy and investment approach that can be easily explained to private investors and advisers' clients is indispensable.

As our internal research team got larger, it meant we could swap our multi-manager-style funds, which invest through other funds, for buying underlying stocks and bonds directly. This was a big deal for me.

Direct investment is a much more accurate way to build portfolios. It gives us better control of exactly which risks we take, as well as the returns we chase and the correlations between them. It's also a cheaper method, which is a great thing to be able to pass on to our investors, too. When we made the change three and a half years ago, some people worried about 'style drift'. This is one of the key sell signals for fund analysts. It's where a fund manager's strategy and performance is altered, either by constraints on the portfolio (say, it gets too big to buy small-cap stocks) or because of backroom adjustments or a lack of discipline (like perhaps straying into new investments that they don't fully understand). We were never concerned by moving to direct investments. In a past life, working for Barings, I dealt directly in stocks and bonds rather than funds. As did Will, who used to be an investment manager in Rathbones' charities team.

In fact, direct investing has gone pretty much the way we expected: it's allowed us to be more precise with our style than ever before. And instead of losing investors, we've gained many more. We think the ability to spell out exactly what we are doing with our portfolios, and why, is pivotal for a fund range like ours. There are so many different ways to run a multi-asset strategy that it's enough to make your head spin. But the feedback we get is that having a clear philosophy and investment approach that can be easily explained to private investors and advisers' clients is indispensable. This will only become more vital as the regulator's demand for investment managers to show the value they add and better explain themselves to clients comes into force.

Scale matters

Our larger portfolio size (we now run more than £1 billion) has also given us a purchasing power that has unlocked more interesting and unique ways to make investments. We have enlisted investment banks to create specific investments that suit our needs, been able to manage currency risks in more nuanced ways and even bought protective options when we felt the time was right.

All of this allows us to dial up specific risks, dial them down, or simply avoid them entirely – whatever the situation calls for.

We have been able to buy put contracts as markets crept ever higher. These derivatives simply give us the option to sell our US stocks at a set level to an investment bank. This means that we get some protection when markets fall in return for a small upfront payment. In essence, an insurance policy on our US equity portfolio. These contracts have already paid off more than once.

We have bought Australian government bonds to get low-risk cash flows that offer higher yields than their UK counterparts. So far, so simple. However, we then swapped the Aussie dollars for sterling so the income is fixed in sterling terms. That strips away the largest risk of buying foreign debt: when a country's interest rates fall, the currency tends to follow suit. If you own a foreign bond where the interest rate falls, there's a good chance that the rise in your bond's price from falling yields will be gobbled up by losses from converting the money back into pounds at a worse exchange rate. We think this trade is a good way to make money if worldwide growth falters, because natural-resources-heavy Australia is highly sensitive to global growth, particularly Chinese expansion. If growth slows, it will reduce the demand for coal and copper, which would hurt the economy Down Under. When economic growth slows, inflation tends to decelerate and central banks cut interest rates. That boosts the value of bonds and sends the currency lower, which brings us full circle to our Aussie government bonds.

More recently, we bought a bespoke structured product (essentially an investment contract linked to a bond and derivatives) to help us hedge a pivotal risk for our portfolio. Historically, the FTSE 100 Index has been inversely correlated with sterling, i.e. when sterling rises the FTSE falls and vice versa. That's because most of the index's earnings come from overseas, so fluctuations in the pound alter its value more than most equity indices. We believe a soft Brexit would encourage foreign investors – who are avoiding the UK like the plague – to swarm back to British stocks. We suspect foreigners will disregard a soaring pound and buy the FTSE 100 anyway (the most liquid UK equity index), leading the inverse FTSE/sterling correlation to break down, for a short while at least. Our structured product would pay us handsomely if it does so. In this way, we can participate in any FTSE rally without having to buy companies that we consider dubious long-term prospects.

We are very particular about our investments because we long ago came to terms with a universal truth: the future is impossible to predict. Rather than try to make large roulette-style bets on black, we try to position our portfolios so they should produce returns regardless of what happens. Picture a lattice of different investments and possible futures that weave together to make a bunch of losses and gains as some things come to pass and others don't.

We fill our portfolio with the bonds and shares of solid, quality companies with honest earnings – those that are backed by real cash rather than accounting tricks – and without more debt than they can handle. We want to own businesses that focus on making returns for shareholders through making customers happy. Companies which are growing on their own merits, rather than simply coasting on the ups and downs of wider economic growth. We then add further diversification using the best tools to combat the biggest risks in our portfolios. It's simple, really, it just takes patience, experience and a steady hand. We hope we live up to your expectations.

To the next 10 years...

When I'm 64

Just because it's impossible to read the future, doesn't mean it's no fun trying. Here are my lucky-dip predictions for what the world may look like when I celebrate my 64th birthday in 2029.

If you're a regular reader of our *In the KNOW* blog, you'll know to take some of these forecasts with a dump truck of salt...

1. The Bank of England will change its inflation target to a rolling average rather than its absolute 2% one; that could mean the 10-year gilt yield remains below 2.50% throughout.
2. Asia Pacific will deliver the best stock market returns of any major region.
3. UK house prices, adjusted for inflation, will be lower in 10 years' time.
4. American stocks will continue to outstrip European ones.
5. By the end of the decade, only a quarter of UK 18-year-olds will go to university.
6. Passive investing will be falling out of fashion as the next 10 years wind down.
7. EU regulators will abolish fund performance fees.
8. After Britain joins 'EU Lite' (a new common market) with Turkey, Norway, Greece and Italy, Nigel Farage will found the EU Litexit Party.
9. Scotland will be a part of France, as the Auld Alliance succeeds in the very long game.
10. John Bercow is replaced by Amazon's Alexa as speaker of the House of Commons in 2029.

Get in touch

For more information, contact the team on 020 7399 0399, rutm@rathbones.com or visit rathbonefunds.com

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Rathbones

Look forward

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