Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone UK Opportunities Fund

Monthly update May 2020

After the enormous global stock rally from the lows of mid-March, many stock markets are starting to look fully valued. One area that remains undervalued and offers meaningful upside is UK companies, particularly mid and small-caps. But you have to choose carefully.

We are past the nadir of the pandemic, economically speaking, so markets are re-rating in anticipation of a recovery in earnings, even though it is unlikely to really kick in till next year. This bounce-back won't be even: a lot of damage has been done and the UK is lagging. We don't believe this is the time for broad FTSE exposure. But looking at positioning and valuations, there's still an opportunity in quality mid-caps with reliable prospects and healthy balance sheets.

Over the month, our fund rose 3.3% versus 3.4% for our FTSE All-Share benchmark. Year to date, your fund is down 12.9%, compared with the FTSE All-Share's 18.8% drop.

Economic stimulus seems to have worked so far, with investors concluding that central banks have done enough to hold the line between a public health crisis and a financial crisis. Greater liquidity has been driving global stocks upwards, and there is more to come. And until recently it's been the large-cap growth names that have been in the vanguard, typified by the FAANGs (Facebook, Apple, Amazon, Netflix and Alphabet).

But liquidity alone can't support a bull market forever — at some point an improvement in fundamentals needs to take over for the pace of downgrades to slow, for the rally to broaden. And, of course, some good news about vaccines would also help.

We are now starting to see this improvement in fundamentals and circumstances: infection rates have peaked in the West, and lockdowns have so far been eased with only localised new outbreaks. Macro indicators like PMI surveys are bouncing off very deep lows. I have even spotted a couple of analyst upgrades. I think we will see this big short-term bounce in business surveys from a low base as company order books are run down and some pent-up demand from the lockdown is worked through. As this happens, we should get a strong rotation into the more cyclical areas of the market, into the sectors that need economic growth to pick up. We are seeing the initial stages of this rally now — in energy, industrials, the lockdown losers, airlines and even debt-laden zombies. This is likely to be a short-term headwind for our fund as it is not our preferred hunting ground. We do own some higher-beta industrials such as **Melrose**, which rallied hard in May, helping our performance. Airport café operator **SSP** has doubled from its low.

However, after the initial 'V' spike, we think investors will find that material earnings uncertainty will persist especially those in economically sensitive areas. That's why we are continuing to buy businesses that reliably beat their cost of capital, that aren't dependent on a commodity price, and can grow regardless of the economic cycle. When growth is scarce, buy growth.

Over the last two months we have been gently topping up a very few of our favourite holdings. They have rock-solid balance sheets and the potential to come out of this quickly. They are in industries such as IT services, where companies have had to rapidly bulk up remote working capability or improve their comms, and also construction, where infrastructure spending is an easy splurge for the government to get the country back to work.

And we still like those selected high quality industrials — here we find companies that should allow us to rise with a 'value'-driven market, yet also avoid the issues faced by banks and energy providers. We believe you should get similar cyclical upside from industrials, yet with more visibility and less regulatory pressure. We own the defence and security business **Chemring**, a stock troubled in the past by cash issues. We know the CFO from his previous job at Avon Rubber so we knew he could turn this one around. In early June Chemring told the market that all its businesses remain open and they've been taking new orders for its kit. Its cash generation was superb. The shares rose 26% on the day, which illustrates how stability and delivery can still be handsomely rewarded by investors.

And we've been adding some more UK all-stars where valuation has finally given us an in — more on them next time.

The valuation opportunity we see in UK mid and small-caps right now is as a result of renewed Brexit uncertainty, but also dividend cuts and the heavy 'old economy' skew of the FTSE 100. If we can sidestep those technical headaches, and pick selectively, there are game changers and world leaders on offer here at a discount.

Alexandra Jackson
Fund Manager

***We aim to deliver a greater total return than the FTSE All-Share Index, after fees, over any five-year period. Total return means the return we receive from the value of our investments increasing (capital growth) plus the income we receive from our investments (dividend payments). We use the FTSE All-Share Index as a target for our fund's return because we want to offer you a better return than the UK stock market. We also compare our fund against the IA UK All Companies sector to give you an indication of how we perform against other funds in our peer group. Apart from investing exclusively in the UK, the funds in this sector aren't always similar to ours.**

This is a financial promotion relating to a particular fund. Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments may go down as well as up and you may not get back your original investment. Source performance data, Financial Express, mid to mid, net income re-invested.

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