Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Heritage Fund

Quarterly update June 2020

Over the quarter, your fund returned 15.5%, unsurprisingly trumping the benchmark of UK CPI +3%, which rose just 0.6%. By comparison, the FTSE World index gained 19.9%. Despite the turmoil in world markets, valuations remain high so cash levels in the fund have stayed elevated, at over 20%. This turbulence is reflected in a more subdued year-to-date record, with the fund down 0.6%, the FTSE World index up 0.6%, and CPI +3% generating a notional return of 1.5%.

By mid-July, global equities had climbed almost 40% since their March low, leaving them around 10% below the all-time highs reached in February. This recovery evidences the truly extraordinary amount of government spending and central bank largesse. It also directly impacts a product like the Rathbone Heritage Fund, whose premise is established on disciplines of value at a market and an individual stock level. Whatever social, economic and political environment we find ourselves in, we have to look for and exploit margins of safety wherever we can.

There are always a lot of moving parts to equity valuations. The prospects for GDP growth, the outlook for inflation, longer-term trends that change business environments, to name a few. All these sorts of things will have varying effects by nations and markets, so every company's experience is different depending on its specific mix of regions and business lines. And that's before you start accounting for all the information and circumstances that are unique to every company: the processes and products it owns, its networks and staff, debt levels, cash flow and business opportunities.

Right now, it feels like every single thing that could affect a business valuation has been amplified by the pandemic, government and central bank responses to it, and the responses of people to the whole situation. Some people are worried about the arrival of crippling deflation because of the current worldwide slump in demand for goods and services. At the same time, others are terrified of runaway inflation driven by a tsunami of cash flowing from the public sector, combined with widespread business bankruptcies that curtail the supply of goods and services. Companies that have shown themselves capable of operating remotely and offering smooth digitised services have been rewarded by investors. Those that appear behind the accelerating digitisation and flexible-work trends have been sold aggressively.

Emerging from all of the above is extraordinary the phenomenon of the "Tera-caps", the three companies each with a market capitalisation above US$1 trillion: Apple, Microsoft and Amazon. These businesses were giants at the start of the year, but on average they outperformed the global market by 45% in the first half of the year. The biggest just got bigger, and this outperformance has continued into the second half of this year. Any fund investing in the global equity space is facing the challenge of this narrow market leadership and choosing whether or not to participate.

Performance review

We own Microsoft in the fund, but we do not own Apple or Amazon. Nor do we own Alphabet, the other global technology giant knocking on the door of this exclusive club, but we have considerable technology exposure across a spectrum of products and industries. We have bought businesses where we felt we had two things in our favour: an insight into what the market as a whole might have been missing in our investment analysis, and therefore some sense of value upside. Our five biggest contributors to performance in the second quarter are all technology oriented.

Spotify is the global leader in music streaming services, hitting the headlines this spring. When Joe Rogan, arguably the hottest podcast talent out there, announced that he would take his act to Spotify for a deal reportedly worth $100m, investors got excited. A few weeks later, it was revealed that Kim Kardashian had also signed with the company, further increasing their non-music content with a new talkie focussed on wrongful convictions and criminal justice reform. Importantly, enthusiasm for the shares has been further stoked by strong operating results during lockdown – it seems that Spotify have priced their offering well, so that younger listeners regard their service as an affordable necessity, not a luxury. It is difficult for us to make substantive judgements as to whether these deals represent value-accretive allocations of capital, but in a period when investors have shown considerable support for unblemished technology names, the shares have soared. We have reined in our excitement, and have trimmed our position. Nevertheless, the shares have been the primary contributor to returns this quarter.

Dutch semi-conductor manufacturer ASML has continued to excel, as have US software enterprise Adobe Systems and Chinese business Tencent. ASML and Tencent are two more technology giants whose sheer weightings in global indices have propelled these indices even higher. We have also prospered by owning Cadence Design Systems, a relatively new entrant into the fund. The company develops what they call “Computational Software for Intelligent System Design” and have their fingers in the hottest technological pies: Artificial Intelligence, System Optimisation, 5G and Cloud Computing to name a few.

Of course, there have been laggards, but very few negative performers. CTS Eventim is an obvious candidate for weakness in this world of lockdowns and social distancing, being one of the world’s biggest live events groups. Although global, their core exposure is Germany, Austria, Switzerland and Italy; and while they may get involved with superbands at major stadia, their bread and butter is much more low-key and parochial, less Rolling Stones and Radiohead, more German folk-music. COVID-19 clearly blows a hole in their business model, but federal funding has supported staffing costs and we believe that their balance sheet can withstand a further 12 to 18 months of strife. The situation can deteriorate further and we are on a watching brief, but the live event industry is globally important, and CTS is well-placed to take advantage of any revival.

Otherwise a trio of US names, industrial group Wabtec (which we added back into the portfolio in June), food manufacturer JM Smucker (which we have trimmed) and purveyor of software and services to the dentistry sector Henry Schein inched back. All three are currently integral to the portfolio.

Finally, as mentioned above, cash at over 20% acted as a brake on relative performance in soaring markets.

Investment review and outlook

There exists a polarity of views with regard to many things these days, and investor sentiment is no different. For the bulls, there’s the argument that quantities of easy money need to find a home and generate a return. The vast amounts of liquidity that Central Banks are pumping into the system will further inflate markets, and buyers of risk assets should enjoy an exciting and lucrative ride. The bears, however, contend that this liquidity is necessary due to the dire straits in which the global economies collectively find themselves: the global pandemic; the political, social, and economic troubles in the US; the increasingly fractious relationship that the west has with China; the future of the EU (difficult, but with some grounds for optimism – discuss) and in the UK, Brexit. Equity markets have shrugged this all off in the second quarter of 2020.

The cash position of your fund is there as an insurance policy for when bad things happen. However, over the last few years, bad things have had little effect on stock market exuberance. Indeed, we are not afraid to think about whether our cash allocation bands are appropriate in the modern low rate, low growth environment. However, this does not distract from the fact that prices are distorted by the sheer scale of Central Bank stimulus since the Global Financial crisis. It is painful to sit on cash when markets are going higher, but that is the cost of insurance. If at any point the elastic band breaks, and markets correct, we must be in a position to take advantage.

Tactically, we have been disciplined in harvesting profits when appropriate, and there have been many winners this quarter. We have looked to pivot ever so slightly towards a value and cyclical style and have introduced US chemical business Linde as part of this process. We are underweight the US because that market is expensive, and underweight the dollar. A combination of pre-election uncertainty, massive stimulus, economic weakness and tension with China augurs further weakening of the green back. Interestingly, for the first time in many years, Europe may prove to be a more rewarding hunting ground.

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