Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Global Opportunities Fund

Quarterly update September 2020

During the dark early days of lockdown, investors embraced companies with high revenue and earnings growth, combined with resilience and visibility. Stocks with high earnings dispersion significantly underperformed (see chart below), those were sectors such as airlines, hospitality, leisure and other social distancing laggards.

Source: Cornerstone Macro

The size and speed of the fiscal and monetary stimulus has cushioned the fall in many sectors and triggered a V-shaped earnings revision from analysts who were (uncharacteristically) too bearish on the depth of this crisis. Usually recessions build over many months as the scale of the macro hit is often not visible for some time. There's lots of time for downward earnings adjustments, hence not being early against earnings revisions is a good discipline. The economy hit a wall, but the size and speed of policy support prevented unstoppable contagion. And because the solutions – such as easing lockdowns – had an almost immediate impact on economic activity, the snapback in earnings revisions has been V-shaped (see chart top right).

Exhibit 6: Global FY1 earnings revision

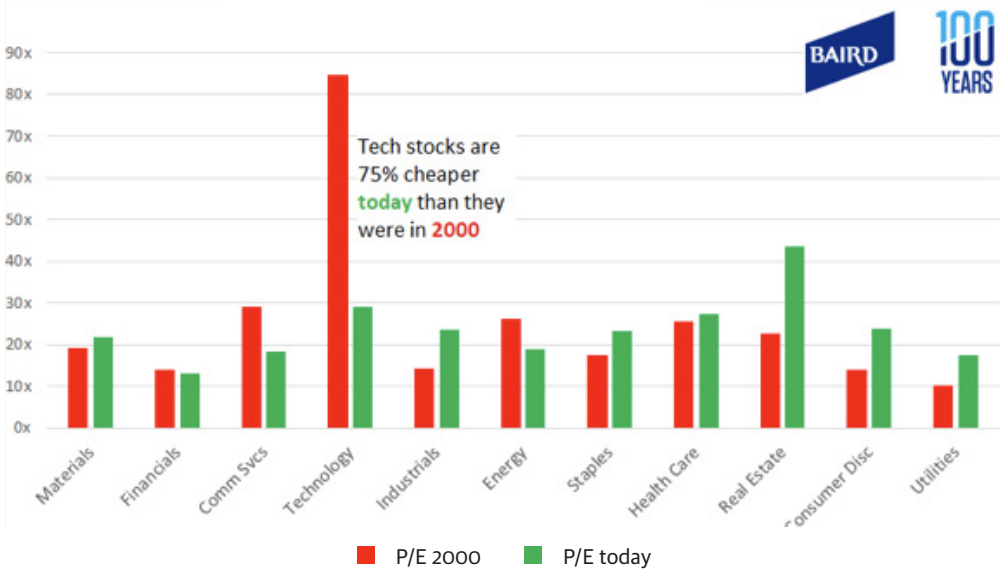
Source: FactSet, Jefferies

But many investors remain circumspect of the recovery, citing second waves, the upcoming US Presidential election and rich valuations of COVID winners, such as tech, as reasons to stay bearish. Almost one third of investors over the age of 65 sold *all* of their equity holdings during lockdown (according to data from Fidelity) and are reluctant to pile back in at a higher price, so the bar for the volte-face is even higher.

The top performers in our fund over the third quarter hint at a change in leadership as investors are willing to place bets on 'opening up' beneficiaries, despite a surge in new cases. Stocks such as **Rational** (commercial ovens for restaurants), **Cintas** (uniform rental) and **Next** (clothing retailer) would all benefit from a return to normal. By the tone of their gloomy corporate updates, they're certainly not seeing any green shoots but that's what markets do... they anticipate. We have added to all three of these holdings during the quarter. We want to maintain a balance between the long-term structural winners that have driven returns during lockdown, and the earnings snapback stocks which are high-quality businesses but were temporarily smothered by the pandemic.

Despite significant concentration outperformance of a handful of stocks in tech, we're not convinced that this is a sign of impending doom or that valuations are even that rich. Having read sell-side analyst reports for the past 20 years, I know that high valuation is the most frequent bear point and the most often wrong. In fact, valuation is a very poor predictor of performance, but it's held up as the intellectuals' holy grail despite its many flaws. Many investors fear the outperformance of tech has echoes of the dot.com boom in 2000. According to analysis by Baird, a sell-side boutique, tech stocks are actually 75% cheaper than they were in 2000. Back in 2000 they accounted for 46% of market cap but were just 17% of revenue and 23% of net income. Today, tech is 40% of market cap, but 24% of revenue and 41% of net income!!

Median P/E by sector: today vs 2000



Source: Baird

As a 'growth' fund, we will probably always have significant exposure to a broad church of technology companies (today around 25%) diversified by product, end market and demand drivers. Our top contributor to performance during the quarter was **Nvidia**, a semiconductor company which has significant exposure to gaming and datacentres; some of the fastest-growth areas in the chip sector.

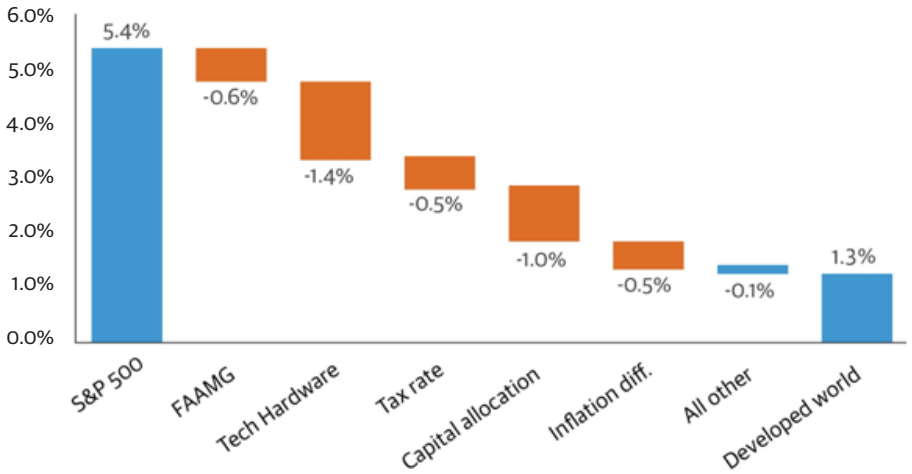
Another key contributor, this time in healthcare, was drug equipment maker **Sartorius**. We are moving away from a world of mass-produced little pills and entering one of tailored medicine, where biological drugs are produced in small batches which can later be modified or expanded. In future, monocolonal antibodies, cell and gene therapies might actually be able to cure the disease and not just treat the symptoms; this is where the major breakthroughs in cancer and Alzheimer's will likely come from. Sartorius makes the filters, fermenters and bioreactors for the drug manufacturers. They are also a key partner in the production of vaccines and are working with over 80% of the COVID-19 vaccines currently in trials. I don't know which one will be successful, but my chances are pretty good for the company that supplies the vital equipment to almost all of them.

Finally, we benefited from one of our few holdings in the UK and our only grocery stock, **Ocado**. Just a tiny fraction of groceries are delivered to our door... why? The UK is leading the charge for online groceries, but the rest of the world is about to follow. Ocado just reported a 50% increase in sales and is planning to increase its total capacity by 40% in 2021.

Our worst performers this quarter were the COVID beneficiaries whose fundamentals didn't keep up with the hype. **TeamViewer**, a remote-working software provider, has certainly benefited from widespread working from home, but investors are concerned that growth will now normalise. As a provider of corporate telephony and video, **RingCentral** has also benefited from remote working, collaboration and the flexibility of cloud-based platforms, but competition is rising all around them. Finally, our holding in financial services digital solutions provider **Jack Henry** stumbled as its clients delayed digital transformation upgrades to battle the COVID crisis. Undoubtedly, however, the acceleration of digital services in banking will only accelerate as a result of this crisis in the medium term.

Despite the ugly politics and the expectation of a contested election, we still believe the US should form the largest part of our portfolio... because that's where the growth is. As the chart below shows, US companies have consistently grown profits more than four times faster than the rest of the developed world over the past 15 years. Part of that is a permanent competitive advantage as they are home to the FAAMG (Facebook, Amazon, Apple, Microsoft, and the artist formerly known as Google) and tech hardware companies that the rest of the world simply doesn't have.

Why American earnings growth is so much higher



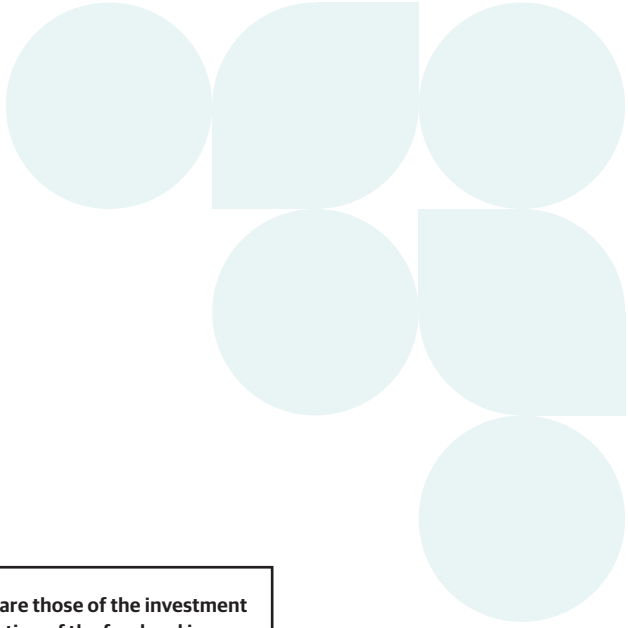
Source: Raymond James

The upcoming US election will create volatility in the days ahead, but we can't think of any outcome that would permanently impair the US outlook. Remember that US elections are won by convincing swing voters in swing states and they change their minds and make decisions late, often heavily skewed to the outcome of near-term events. There's also a streak of anti-establishment and shyness going around, meaning that what the voter tells the pollster might not be the way they vote in the anonymity of the polling booth.

Overall, most investors are expecting the unexpected; disputed results, lawsuits and civil unrest cannot be taken off the table. Actually, I think the outlier event – the one that people are expecting the least – is a smooth vote, a clear result and a calm transfer of power. This would be good for all global stock markets, but it probably wouldn't be the same stocks that outperform. We could see a pretty significant change in stock market leadership, perhaps continuing the hints of a change in trend that we saw this quarter.

James Thomson
Lead Fund Manager

Sammy Dow
Fund Manager



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Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000
Fax 020 7399 0057

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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