Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Greenbank Global Sustainability Fund

Quarterly update September 2022

There have been breakneck market shifts aplenty in recent years, yet they pale in comparison to the third quarter.

Equities around the world tumbled back after getting more than a little overoptimistic about the US Federal Reserve (Fed) shying away from interest rate hikes. The trouble began in bond markets, with the US 10-year government bond yield rising about 150 basis points from its August low to 4% in the dying days of September. The benchmark bond yield had started 2022 at 1.50%, so borrowing costs have increased dramatically in a relatively short space of time. This increased cost of borrowing also pushes the cost of *equity* higher (this is also known as the 'discount rate'), which means stock prices fall to levels that should compensate investors for the returns they expect. And so it has been a really awful quarter – and year – for stocks too.

	3 months	6 months	1 year	3 years	Since launch (16 July 18)
Rathbone Greenbank Global Sustainability Fund	-0.4%	-15.2%	-22.5%	18.2%	25.0%
IA Global Sector	1.8%	-8.4%	-8.9%	20.3%	30.8%
FTSE World Index (GBP)	1.8%	-7.4%	-3.0%	26.6%	42.5%

	30 Sep 21-30 Sep 22	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19
Rathbone Greenbank Global Sustainability Fund	-22.5%	22.3%	24.7%	6.9%
IA Global Sector	-8.9%	23.2%	7.2%	6.0%
FTSE World Index (GBP)	-3.0%	24.0%	5.2%	7.9%

Source: FE Analytics; data to 30 September, S-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future performance.

The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

The end of unconstrained energy

The number one biggest upset to the world today is the considerable rise in the cost of energy.

This is tremendously broad brush – the world is a mess of different causes, effects and complexities. Yet it really does seem that much of the upheaval and strains of 2022 have their roots in a world that became accustomed to cheap and abundant energy, which was then suddenly taken away. Power is a crucial input for virtually everything. Without it, there's no technological uplift, so the progress of centuries is discounted. And when it becomes more expensive and rationed, it means less output is possible or profitable, and less fun can be afforded by everyone. There is actually one of those 'theory of everything' sort of arguments that says booms and busts can be mapped solely on the cost and abundance of popular energy sources.

Our current energy crisis has its basis in climate change, really. It's a dirty secret of Western nations that, to reduce carbon emissions, they became ever more dependent on gas for heating and electricity generation. While a much cleaner option than coal, it is still bad for the environment and requires long-term infrastructure that binds you to specific suppliers. Not only that, but in Europe in particular it meant countries were dependent on regimes that became politically troublesome.

This year Russian President Vladimir Putin jumped the shark and invaded Ukraine. It was perhaps inevitable that this decision would lead to the gas pipes being turned off to Europe (the cognitive dissonance, for both sides, of continuing this trade relationship while effectively in a proxy war was simply too great). And so, finally, this quarter Putin turned the taps off, sending gas prices spiking once again. Meanwhile, oil prices remain relatively high, especially given the monumental strength of the dollar, and coached that way by the OPEC cartel. Because of the need to reduce the carbon intensity of our societies, supply of hydrocarbons is politically constrained, so the era of low-cost energy is probably behind us. At least until the next energy source comes along. That requires some adjustment from everyone – people, businesses and governments.

Adjusting the portfolio

We bought French-listed **Schneider Electric**, which has a comprehensive portfolio of energy efficiency and renewable technologies. These include utility grid automation, fail safes for keeping mission-critical power running and energy storage. Schneider also has a strong digital business – the software to ensure the smooth operation of smartgrids that allow households and businesses to both receive power and give surplus supplies back to the market and allow for better storage, monitoring and conservation of energy. This will be crucial for developing next-generation power infrastructure and has been enhanced by a close relationship with Aveva Group, which it has been slowly acquiring since 2018. In September Schneider agreed to buy the remaining shares of AVEVA for £3.9 billion. The breadth of Schneider's portfolio is important because it encourages long-term and 'sticky' relationships with customers, underpinning stable profits. Schneider gives us increasing exposure to the future of energy, which we think will offer massive long-term opportunities.

We increased our position in **Legal & General**, the UK insurer. We have held this company since launching our fund in 2018; recent market volatility was, to our mind, simply an opportunity to own more of it. Management have delivered consistent revenue growth in a tricky environment and we think this should continue in the next few years as well. Legal & General continues to build its business in the US and while recent issues in the UK pensions market have created short-term concerns, we believe the company will be able to navigate through them. The valuation is extremely attractive, in our view, for a quality franchise.

We bought more shares in California-based wealth manager **First Republic Bank**. This is another long-term holding for our fund, and again the price has become increasingly attractive in recent months. First Republic is focused on relationship banking and enjoys a relatively simple business model. The company invested heavily in new technology through the pandemic which helped it strengthen its links with customers. Loan and deposit growth remain robust, despite market wobbles, and we still think its high-quality client base are good credit risks.

We reduced our holding in **DSM Group**, the Dutch supplier of enzymes and cultures to health food and medicine manufacturers for people and animals. DSM remains a core holding in our fund and we believe the recent merger with Firmenich (which was a privately held Switzerland-based flavours company) broadens the portfolio without diluting its quality. The decision to reduce was driven by potential short-term volatility in profit margins in the next few quarters, but our long-term view is unchanged.

We cut back our position in US speciality diagnostics and equipment company **Thermo Fisher Scientific**. Thermo is still one of the largest holdings in our portfolio, we have just trimmed our holding after strong relative performance in 2022. We believe the company can continue to compound revenue growth and earnings at an attractive rate and many of its long-term drivers are still under-appreciated, in our view.

We also reduced our holding in **TSMC**, the Taiwanese semiconductor foundry. We think its competitive positioning remains extremely strong in a world where semiconductor manufacturing is becoming increasingly complex. The decision to cut our holding was driven by shorter-term volatility for global chip demand as recession fears dog the global economy, but we believe the long-term thesis remains robust.

A parade of surprises

Investors' hopes that the Fed would be cutting rates by early next year always seemed a bit fanciful to us. So when they pushed stock markets higher in August, we took the opportunity to trim some of our winners and increase cash. Now that investors have decided the Fed really isn't for turning, prices of stocks and bonds have dropped significantly lower. Broadly, that makes us buyers at current levels.

The UK mini-budget was an own goal of epic proportions. New Prime Minister Liz Truss and her former Chancellor Kwasi Kwarteng admirably tried a bold dash for boosting flagging economic growth – a particularly apt idea given the nation is headed for recession. However, the fiscal set-piece was bungled from the start by a lack of communication, a cocksure disregard for the fiscal watchdog and a failure to read the room politically. The announcement of unfunded tax cuts for the wealthiest went down like a lead balloon with investors and voters alike. Sterling plunged, government bond yields soared (taking mortgage rates with them) and Labour took a 30-something-point lead in the polls.

After all the turmoil – which spread to the UK pension industry, causing the Bank of England to intervene to prevent spiking yields upending the UK's financial stability – the government will abandon virtually everything announced at the mini-budget. All of this is a clanger case study on the importance of leadership, communication and listening to your stakeholders.

There are still lots of risks out there and we think a global recession is almost a foregone conclusion (if it's not already here). The question is how deep will that downturn be? At the moment, it seems likely to be mild, with shallow GDP contraction for two or three quarters. Then, if inflation falls back toward central banks' target levels, it will give policymakers more flexibility to help drive the economy forward once again. The risk is that inflation simply doesn't quit, that it gets baked into the collective psyche and central bankers must continue hiking rates to the point that it leads to a deeper and harsher recession. We are keeping extremely vigilant for this scenario, even though we think it's not the most likely outcome right now.

David Harrison
Fund Manager

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