Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Greenbank Global Sustainability Fund

Quarterly update December 2022

The story of 2022 was the US Federal Reserve (Fed) rapidly hiking interest rates as it chased after runaway inflation.

The benchmark US rate jumped from 0.25% at the start of the year to 4.5% by its end, the sharpest one-year US hike fest since the early 1980s. Inflation started falling in the second half of the year, but it's still very high, both in the US and the rest of the world. So the story of 2023 will depend on just how much further the Fed – and the other central banks – will go with tightening.

Inflation at between 7% and 11%, depending on your locale, is a long way from the 2% target. Central bankers will want to see inflation shrinking undeniably before they ease off. However, they, more than anyone, know that it takes between one and two years for the full effect of a rate movement to hit businesses and households. That means the American economy is still digesting the first 25-basis-point rise of March 2022. There's another four percentage points coming down the pipe.

Investors sniff that the Fed must have to halt soon before it overdoes its tightening (we think it has already). Yet every time bonds and stocks rally in anticipation of a 'pause', the Fed is quick to talk tough, battering prices back down. It's confusing and a major cause of the volatility in both bond and stock markets in recent months. We think the Fed won't hike much more from here, despite its rhetoric, yet we think forecasts of rate *cuts* in 2023 are fanciful. Inflation should continue to fall steadily from here, but it will plateau higher than policymakers' targets. Meanwhile, the risk of recession in the US, Europe and the rest of the world is very high. It should be shallow, but looking at the economic data and the tightening yet to be felt, a downturn seems inevitable. Hopefully the Fed will see sense.

	3 months	6 months	1 year	3 years	Since launch (16 July 18)
Rathbone Greenbank Global Sustainability Fund	3.2%	2.8%	-24.1%	16.3%	29.0%
IA Global Sector	2.2%	4.0%	-11.1%	20.6%	33.7%
FTSE World Index (GBP)	2.3%	4.2%	-7.2%	27.8%	45.9%

	31 Dec 21-31 Dec 22	31 Dec 20-31 Dec 21	31 Dec 19-31 Dec 20	31 Dec 18-31 Dec 19
Rathbone Greenbank Global Sustainability Fund	-24.1%	15.6%	32.5%	25.1%
IA Global Sector	-11.1%	17.7%	15.3%	21.9%
FTSE World Index (GBP)	-7.2%	22.1%	12.7%	22.8%

Source: FE Analytics; data to 31 December, 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.

A tough year, but exciting new stocks

The upshot is that equities tumbled in 2022, yet rallied aggressively as the year ended on hopes that the Fed's regimen of stiff rate rises is coming to an end. We're sorry that we couldn't shelter you more from the storm, despite our best efforts. It's hackneyed but true: investing is a long-term game, and we're confident that fortunes will turn in the fullness of time. Be careful about believing the market's short-term optimism about the Fed though — inflation is still high and it's their job to bring it under control (which they do by raising rates).

We reduced our holding in California-based wealth manager **First Republic Bank** to spread our American financial exposure to **Huntington Bancshares**. First Republic remains a long-term position for our fund; however, we felt it made sense to diversify into a main street bank that is less exposed to the stock market and with a greater range of different lending and corporate services for businesses. Based in Ohio, Huntington has 1,000 branches spread across the Midwest, with Colorado and some eastern states in the mix as well. Its retail banking pitch is skewed to those who prefer in-person banking, and it scores highly in customer satisfaction (something it shares with First Republic). Huntington is trying to parlay that into cross-selling, especially of investment products. Huntington also has a strong business and commercial banking operation, with a growing speciality in supporting vets and dentists. Despite its down-home feel, Huntington is no luddite, sporting the top-rated mobile app among its regional bank peers. Less than 1% of its loans are to oil and gas businesses and it has a strong community spirit. Huntington has earmarked $40 billion over five years for lower-cost loans and mortgages to disadvantaged people with poor credit ratings, as well as to invest in underserved communities. The plan is to boost the wealth and vibrancy of poorer areas by offering a helping hand to get businesses off the ground and help people get a secure home. If they are successful it's good for the economy, good for the neighbourhood and good for a lender's business. It just makes sense.

Another new purchase was **Atlas Copco**, a Swedish manufacturer of compressors and parts for vacuums, water blasters, chillers, industrial gas and water gear, and the like. Atlas had been on our radar for some time, so we took advantage of European market volatility to buy in. Compressors are a critical cog in more industries than you could imagine and Atlas is the clear global leader. The business has generated strong organic growth over several economic cycles, with a few sensible bolt-on acquisitions to enter new markets along the way. Compressors are crucial for improving the efficiency of industrial processes and thereby reducing CO_2 emissions. Atlas works closely with its customers to improve these processes, which helps companies reduce costs and emissions and improve profits. This close partnership makes it much less likely that customers will shift to a competitor, which improves Atlas's business retention.

We bought **Waste Management**, the largest listed rubbish and recycling contractor in the US. There are only a few truly national players in the US waste market, with high barriers for would-be rivals to get into the business. Waste Management's contractual cash flows are highly reliable and sales growth tends to be forecast with strong accuracy because of this. Despite its incumbent advantages, Waste Management is investing significantly in its recycling technology and it has a growing focus on finding ways to re-use waste rather than sending everything to landfill. It is working with large consumer brands to better address the issues of plastic waste, using big data to help them create circular economies for their products. Its management team is also thinking outside the box: the gas created by the decomposition of landfill at 124 of its sites is being harvested and used to generate power that is sold to the energy grid. The scheme is generating 600 megawatts of renewable energy annually, enough to power 400,000 homes.

Another interesting company you may not have heard of is **Lonza**. It's a Swiss pharmaceutical manufacturer that creates drugs and specialist medicines and nutritional supplements for other pharma companies that have the intellectual property but not the production capacity or the laboratory muscle. Lonza is a critical partner to many of the world's leading pharmaceutical brands in both drug discovery and outsourced production. We have followed the business for some time; when the market sold off this quarter its valuation became attractive to us and we jumped in. The pharmaceuticals business has lots of rules and regulations — as you would expect — so Lonza has few global competitors. Its expertise in biologic drug development (using live substances like enzymes, viruses and proteins, rather than traditional chemicals) could help drive consistently strong organic growth for Lonza. We think this potential is not fully represented in its current price.

AstraZeneca is a pharmaceutical business that you will most definitely have heard of. We bought the household name because we like its well-diversified portfolio of medicines, particularly its strong position in oncology, its largest division representing 35% of its sales. Oncology is the study, diagnosis and treatment of cancer. Astra has consistently developed new products over the past 10 years, creating quality new business lines. And the future pipeline is attractive too. In a more uncertain market, Astra's record of delivering on earnings promises and generating healthy cash flow is extremely attractive. It also fits well with the other healthcare holdings already in our portfolio.

We sold our holding in **Trimble**, a US-listed GPS tool manufacturer that has expanded into helping customers in many different industries track and monitor data. That's everything from ensuring a building is placed where the plans say it should go, to helping farmers track moisture levels, to inspecting bridges and railways' structural integrity remotely and by the second. Trimble is an exciting business and has been held in our fund since we launched four and a half years ago. However, it has significant exposure to the construction and agricultural industries, which could be affected by a global recession. We were concerned that Trimble may find itself sitting on more equipment than it can sell in 2023, if demand for its products falls. That would hurt its return on capital employed, which would put its valuation at risk at the same time that sales slow, which would be a painful double-whammy for the share price. We also became less convinced that Trimble could sustain its current profit margins for a long order backlog. Put simply, the prices for these orders were set in the past while the costs of production in parts and labour are rising rapidly. Because of this, we reluctantly sold.

We cut back our position in heart valve manufacturer **Edwards LifeSciences** because elective surgery rates are still relatively subdued. We thought that many people would jump at the chance to book in surgeries after COVID prevented thousands of these operations from taking place. But elective heart operations still haven't bounced back, so Edwards is growing its sales more slowly than anticipated. It is beginning to become clear that staff shortages in key markets, such as the US, are now the sticking point. This is not a quick fix, so we have reduced our position to see how this develops in the next few quarters.

Another reduction was pan-Asian insurer **AIA**. This company performed well for us, relative to the wider market, in a rocky year for stocks. This meant its size in our fund had grown higher than we wanted it to be for diversification and risk management reasons, so we trimmed it back. AIA remains a core long-term holding for us and we believe it should benefit from China's re-opening in 2023.

What will 2023 bring?

As 2023 dawns, most people expect another extremely tough year. While falling, inflation is still very high, squeezing everyone's living standards. The war between Russia and Ukraine grinds on, complicating the supply of everything from oil and gas to food and metals. While the outlook is grim, we should remember the lesson of 2022: no one knows what tomorrow will bring. And when everyone is expecting the worst, there's a greater chance that things won't be as bad as they feared.

A year ago, the prevailing belief was that the global economy would disintegrate if American interest rates rose above 2% or so. The US benchmark rate should be 5% by early February and while economies are slowing, the world is far from economic Armageddon.

The UK and the Eurozone are likely already in the midst of a downturn because they are at the epicentre of the energy crisis caused by the Ukraine war. While the European recession shouldn't be very deep, it is expected to be prolonged — especially in the UK, where it may even last all year. The US is still holding up, but it seems destined to slow over the coming 18 months as the economic handbrake that is all those rate increases starts to be felt. Exactly how much is the big question. Post-pandemic economic data is hard to decipher because of the stark demand and supply changes in all sorts of markets from labour to cars and raw materials. We will be watching our investments carefully as the year progresses, but there's a lot of great progress being made in technology and science. We see it every day in the companies we speak to. It's easy to get despondent in tough quarters and years, but you should always try to take a breath, look at the longer view and see how far we've all come.

Here's to a happy and prosperous 2023 for us all.

David Harrison
Fund Manager

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

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