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Rathbones
Look forward

Rathbone Heritage Fund

Update, Q3 2019 update

It's been a turbulent time for markets lately. Stocks have surged higher year to date, but most national indices are still below their highs of 2018. Put simply, it has been a reluctant sort of rally.

Much of the rise in index values has been driven by a global slump in government bond yields which continued in the third quarter. In the UK they hit all-time lows along the way. The 10-year gilt dropped from 0.83% to 0.49%, bottoming at 0.406% in early September. This downward march has been driven by lower GDP growth estimates and generally weakened inflation around the world. The US Federal Reserve (Fed) cut interest rates twice during the quarter, taking the benchmark borrowing rate to 1.75%-2.00%. Meanwhile, the trade war continues to roll on between the US and China, with half-hearted pauses and regular rhetoric fraying confidence in global commerce.

In the UK, the whirlwind that is Boris Johnson's premiership has whipped up excitement. Getting off to a rough start, the new Prime Minister barrelled straight into renegotiating the UK's Brexit deal with the EU. He lost a slew of votes and banished a score of Conservative MPs from his party for undermining him. Sterling took it hard, dropping 3.2% over the quarter and hitting a 34-year low against the dollar in early August. Then, in October, Mr Johnson sealed a deal that satisfied the EU. He won a parliamentary vote to adopt the deal, but was defeated in an attempt to ram the detail through in just three days. If the deal is done, it will remove the big rusty anchor that has held down sterling, UK GDP growth and bond yields.

Over the quarter, your fund returned 0.5%, compared with the 1.7% gain of UK CPI+5%. Our cash level remains well over 20%.

ASML had a particularly good quarter, rising more than 20%. This Dutch company makes machines that print the computer chips that go in everything with a digital pulse. Its share price has bounced around this year because the semiconductor industry's future earnings are considered to be heavily reliant on global GDP growth and that expansion has been a bit wobbly of late. It's true that computer chips are a volume industry, which means that weaker growth will reduce the amount of goods the world needs (and therefore the chips that go in them). But we own ASML because it is more than simply surfing on the rolling waves of GDP – rather it is the shop on the beachfront selling surfboards to the people taking the risks. The company is not simply a play on semiconductor volumes and the pricing cycle, or a second derivative of the economic cycle. Rather, it benefits from more sustainable secular trends such as the transition to higher computing power. Its absolute technology leadership makes it the only supplier of the next-generation extreme ultraviolet lithography (EUV) chip machines. As the major chip makers – TSMC, Samsung, Intel – are in an arms race to manufacture smaller, more powerful chips, ASML should continue to benefit from its dominant position in EUV for many years to come. Virtually everything has a computer chip in it these days and this is only the beginning. As the Internet of Things takes hold, the need for smaller, more powerful chips should boost demand for ASML's chip-writing machines, which are far and away the best in this field.

We're tortoise lovers over here. Slow and steady compounders excite us more than hares whose earnings and share prices go off on massive tears (both up and down). Companies like **CTS Eventim** don't get a lot of press attention, but investors certainly value its ability to execute on its strategy. The business sells tickets to shows all over Europe, from stadium venues for perennial tourers like AC/DC or Beyoncé to niche German folk festivals. It has a particularly entrenched position in non-English markets, which have proven beyond larger rivals' ability to break into. CTS reported another strong quarter, driving its share price higher.

Another of our investments whose quarterly performance went down well was US aerospace company **Lockheed Martin**. The weapons giant beat its earnings target and raised guidance for the current year. This company is embedded in the American government's defence plans and institutions, so it's bound to benefit from increased military spending. An example of this is Lockheed's recent headway with early-stage contracts for hypersonic programmes. Much faster than the sound barrier (Mach 1), these weapons travel at Mach 5 to 10 and could be used to shoot down supersonic invaders (potential applications are still being developed). Lockheed has invested in this new technology on its own for some time, so the Federal programmes are a strong endorsement that they could be a solid leg of growth in the 2020s.

A few of our companies disappointed this quarter, however.

Software developer **Micro Focus International** announced yet another profit warning, cutting its expectations for the year to October. Added to that, the managers have started reviewing the company from the ground up. The strategic review aims to ensure that the business's assumptions are sound and that its current plan makes the most of its assets. Micro Focus makes money by purchasing older business software and then cutting costs and improving its clients' service. If everything goes right, they can boost their earnings by charging more and spending less, and extend the life of the 'legacy' software beyond original predictions. When it goes awry, it can cause complete hostility among investors, some of whom start to question whether the software has any value at all. At the moment, after several stuff-ups, the company's shares suggest investors believe cash flows will shrink steadily over the coming 35 years until the business winds up. We find that hard to believe. Before recent missteps with HPE – perhaps biting off too much too quickly – Micro Focus had a long record of buying undervalued software and making money. The business still converts 95% of its profits into cash. That's a lot of money to reduce debt and get back out there picking up quality assets to polish and squeeze profits from. We have grumbled deeply about this company over the past couple of years, but we believe there is still value here.

Ulta Beauty is one of the few hare-like businesses we own. Its share price history looks like a rollercoaster and a few of the bigger dips happened over the past 12 months, including one last quarter. However, we believe the large gyrations in its share price are due to over-emotional short-term investors. Despite the ups and downs, this beauty mecca has a consistent record of steadily rising profits as it rolls out new stores across the United States. The recent sell-off was driven by a disappointing quarter for make-up sales across the country and across retailers. Other products, like skin cream, haircare and fragrance, have been doing well – as have salon services. Long-term, Ulta is the kind of company we want to own. It is by far the largest retailer in the American beauty market and it is investing to entrench this advantage further. Not only that, but it commands immense loyalty from its customers.

Music streaming service **Spotify** also stumbled last quarter. Most analysts focus solely on how many new subscribers it racks up, with a particular bias to the US market and how Spotify fares compared with competitors such as Apple and Amazon. Last quarter, Spotify ceded the crown for largest American music streaming service to Apple Music and missed its user growth by one percentage point. Frustratingly, this was partly due to the botched marketing of a student deal, something that should have gone off without a hitch. Spotify's share price seemed to be weakened because Netflix, a superficially similar business, struggled in the quarter. To us, these concerns are irrelevant. We believe Spotify is different to Netflix in some crucial areas. First, you're less likely to subscribe to multiple music services. You will find the one that carries most (if not all) your favourite tunes and styles, and stick with it exclusively. And the more playlists you create on that service and the more its whizzy algorithms keep serving up music you enjoy, the more likely you are to stick with the subscription. Spotify's subscriber churn rate seems to corroborate this: it has fallen to just 4.6% from 8% a year a few years ago. This is no doubt driven by constant investment in its technology. But, unlike Netflix, this investment is kept in rein. And it scales more easily. Netflix must essentially set up studios in virtually every country to penetrate a market. In contrast, Spotify

provides content; it doesn't create it. Its research and development efforts are focused on improving the user's experience which is easily spread across all its subscribers. Where they live and listen is of little effect beyond simple translation and local taste (something that plays to its algorithms' strengths). We believe the prospects for this business are bright, so we're happy to hold it through the thick and the thin.

We added two new companies to our portfolio this quarter: American packaged food producer **JM Smucker** and marketing and advertising conglomerate **WPP**.

JM Smucker makes peanut butter, jam, coffee, pet food and strange branded snacks that you will never have heard of but which are in 90% of American pantries. This business is like a small Kraft Heinz – a household brands company but one completely focused on the US. JM Smucker is a recession-resistant "bullets and beans" investment that we believe is prudent, given the recent deceleration in global GDP growth. We also find it appealing that the business is run by the fifth generation of the Smucker family, who are still material shareholders. Unlike Kraft Heinz, JM Smucker has not sacrificed product innovation or marketing to increase operating margins at the expense of sales. We believe its longer-term approach bodes well for maximising long-term profits.

WPP likely needs no introduction. This marketing giant has been well and truly mauled over the past 18 months. Founder and CEO Martin Sorrell resigned (was pushed) earlier this year after a run of terrible performance, which has allowed his successor to clean up shop. It is received wisdom today that advertising companies offer nothing and their business is quickly getting gobbled up by Silicon Valley upstarts, such as Facebook and Alphabet. We think this overstates the case a bit. WPP makes adverts; Facebook and Google don't. They provide platforms on which ads can be published and analytics to make ads more effective. WPP's customers are very large businesses that can make use of its scale. WPP has been analysing consumer behaviour for decades and has time-proven creative skills that social media businesses and consultants simply do not provide. WPP was the victim of the zero-based budgeting craze that swept across consumer brands companies – particularly US ones – over the past few years. This led to companies questioning every expense each year and looking to slash anything possible in order to improve margins. In that environment, agencies like WPP may as well paint a cartoonish target on their back. Spending on this sort of business was badly squeezed; however, zero-based budgeting hasn't been as effective as many companies thought – and in many cases it has actually been detrimental to the revenue generation of businesses that slashed spending with abandon. It seems likely that agency relationships may see a resurgence in the coming years.

The global investor mood is pretty glum right now. It's not quite despair, but it's definitely pessimistic. Global PMIs – a mixture of upcoming orders, hiring intentions and general mood-taker of economies – have been poor around the world for the past few months. As these numbers glide below 50, the level which separates growth and decline in business activity, concerns about a worldwide downturn rise. Chinese GDP growth is slowing. The UK is expected to dodge recession, but only just. Germany is looking like it will be less lucky. Even the US, that shining light of economic activity, has appeared to fade lately.

The Fed cut its benchmark interest rate twice in two months. It is widely expected to cut rates further over the next months. If it does, the central bank will have, in just a few months, reversed a third of all the interest rate increases that it took three and a half years to implement. Looking around the global economy, it's hard to tell whether we are sinking into recession or if this is just a temporary fluctuation in economic activity that will pick up again. We feel it's just too early to say. US employment is strong, household spending is skipping along and the American housing market has been doing well. These are atypical signs of impending doom for the US economy, which is the predominant driver of worldwide economic growth.

We have balanced our risks recently. We've added some investments that should hold up well if the world tumbles into a recession, but overall we believe global commerce will keep growing over the coming year or so. If we are correct, then lower-but-positive growth should push investors into buying the companies that can provide that scarce growth. With a bit of luck, we should benefit.

The Rathbone Heritage Fund team

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Source performance data, Financial Express, mid to mid, net income re-invested.

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