Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Heritage Fund

Update, Q4 2019 update

An extraordinary year of omnipresent doom and gloom ended as one of the best for investors on record.

In the UK, more than three years of political impasse and rancour was washed away by a resounding electoral victory for Boris Johnson. The Conservatives' massive majority in the House of Commons has paved the way to the resolution of Brexit and dispatched the risk of a Labour government led by Jeremy Corbyn ever coming to power. Mr Johnson's Brexit deal is much harder than businesses would like – and there's plenty of work still to be done – but the feeling of progress after so many years of stasis has led many people to welcome it.

On the Continent, the German economy faltered under the strain of a global manufacturing recession that has hit carmakers particularly hard. Much of this slowdown seems to have been driven by the trade war between the US and China, yet the 'phase one' ceasefire may not be enough to pull European carmakers out of their funk. US President Donald Trump has already fired a few warning shots over the Atlantic, a trade war between the US and the EU could soon be in the offing.

And yet, through all the trade tussles and panics, the US economy was resilient. After the sharp drop in stock markets in late 2018, the US Federal Reserve (Fed) was unequivocal about its stance: it was going to cut interest rates to make completely sure that recession didn't arrive. American economic growth has decelerated from its tax cut-driven 2018 peak, but it remains in good order. Mr Trump has done his utmost to push the Fed into cutting rates yet further in his bid to juice GDP growth ahead of the November election, but the central bank has held firm.

There have been a few cracks in the US façade, however.

During a short-lived midsummer panic about GDP growth and weak inflation, the US 10-year government bond yield dipped below that of the 2-year yield. When yields are turned upside down like this – inversion in the parlance – it is often a signal that a recession is coming. The indicator isn't always correct, though, and any downturn could still be anywhere from six months to two years after inversion.

Then, in September, the US repo market went haywire, leading the Fed to pump billions of dollars into this obscure area of the American financial system as stop-gap measure. Four months and half a trillion dollars later the flow of billions continues. At its heart, the problem is that there's not enough short-term cash in the system for the amount of US treasury bonds. This demand/supply mismatch briefly sent the repo rate into double-digits (it should be similar to the Fed's benchmark interest rate, currently 1.5-1.75%). And with the US public deficit headed for levels not seen since World War II, the number of bonds issued to pay for all that spending is set to accelerate.

Despite these concerning developments, the US economy – and wider global growth – seems likely to continue chugging along for some time. Interest rates and unemployment remain low all around the developed world, which should support investment and consumption.

Our fund's performance over the fourth quarter was 1.5%, in line with our benchmarks, the FTSE World Index (+1.4%) and CPI+3% (0.8%)*. We were helped along by strong performance from a few of our holdings.

*We aim to deliver a greater total return than the CPI measure of inflation + 3%, after fees, over any rolling 10-year period by investing with our valuation-linked cash management mechanism. Total return means the return we receive from the value of our investments increasing (capital growth) plus the income we receive from our investments (dividend payments). We use the CPI + 3% as a target for our fund's return because we aim to grow your investment above inflation.
We also compare our fund against the FTSE World Index so that you can see how global stock markets have performed.

Following the Conservatives' victory in the UK election, real estate investment trusts (REITs) shot higher. We are wary of some of the retailer-focused REITs, as we believe they may be entering a long and dangerous spiral. Many of these companies are highly leveraged and reliant on unrealistic property prices to keep them from breaching debt-to-equity levels agreed with lenders. Weaker retail spending on high streets would reduce the income these trusts get from their estates, leaving less cash to pay down borrowing and reinvest to entice shoppers. We've been avoiding this area of the market and focusing on areas that should we believe are in a much stronger position. Storage provider **Big Yellow** fits that bill. We took profits during the quarter after a strong run.

Another strong performer was music streaming platform **Spotify**. While still in all-out growth mode, Spotify actually made an operating profit in the fourth quarter. The company has been cautious about the outlook for its expansion in 2020, but it is still adding users at a phenomenal clip. Spotify keeps coming up with plenty of ideas to improve the service it offers its 207 million users as well as ways to make more money too. Little things like allowing bands to pay for pop-up advertisements about new albums that don't feel like ads to users yet pay just the same. We believe this ability to make money from artists as well as user subscriptions could be very lucrative indeed, increasing the growth potential for the company. As this business gets bigger and more complicated, it is attracting greater aspirations from its shareholders and therefore increasing the chances of disappointment. This business is likely to be volatile over time because of this, something we've taken into account.

We added a new stock to our portfolio last quarter: German auto-parts company **Stabilus**. We haven't increased our exposure to the automotive sector overall, instead we've tried to diversify ourselves a bit in what can be a volatile sector. Another of our automotive holdings, **Aptiv**, had done relatively well, so we reduced our investment and used the cash to buy Stabilus at a lower valuation. We feel this offers a better risk-reward trade-off for our portfolio.

The semiconductor industry roared back in the fourth quarter after 18 months of lacklustre returns. These businesses supply the world with the computer chips that make dumb products smart. Everything from the latest iPhone to cars, watches, computers, fridges and televisions are full of these silicon wafers nowadays. That means the total market for these computer chips is extraordinarily large and growing further every day. That comes with some problems though. The equipment needed to print computer chips is very expensive yet the cost of making the chips themselves are negligible. That can lead the industry to saturate the market with chips, especially when GDP growth starts to slow. This is the second problem: when everything has a computer chip in it, semiconductor companies become ever more sensitive to changes in the economic cycle. We own **ASML** because we think it manages to mitigate some of these risks. First up, ASML designs and sells the machines that print the computer chips to the manufacturers. It is also on the forefront of technology too, making computer chip printers that can print at extremely microscopic sizes. For gadgets, size is everything. By making smaller chips with more components on them, you can increase the computing power (and therefore potential) of the device you're putting them in. That's Moore's Law in a nutshell and also a nice base for our investment case in ASML.

America's largest bank, **JPMorgan Chase**, posted solid results last quarter. For lenders, it really does pay to be the biggest fish in the pond. It certainly gives JPMorgan a staggering amount of cash to throw at its digital services. The company has been spending billions on its technology as part of its strategy to outgun its rivals in the 21st century and it seems to be paying off. Investing in banks is tough though. When things go awry it can seem like the end of the world, yet when they are doing well everyone complains that they are making too much money and must be gouging the little guy. Given its recent results, this is something we are increasingly watching out for. Who knows, maybe we're just superstitious.

The general outlook for 2020 sort of lends itself to such feelings. The world appears to be the kind of place where a sneeze could cause a tornado. Everyone stay very still and hope that the world isn't thrown off its axis … Of course, this is just the way it feels. The world is always uncertain and things are always going wrong – and right, too – in chaotic and alarming fashion. We're just lucky enough to be alive in the most technologically advanced era of our species. You have to take the good points (fantastic TV, super-cheap networks, awesome new technologies and amazing consumer products) with the bad point (information overload, paralysing consumer choice and a struggle for society to adjust to a rapidly changing environment).

In the UK, the election has finally given the country and its people a Brexit path to start down. It may not seem like much, but it took the better part of four years to agree on it. We're nowhere near finished of course. Some rapid-fire and likely feisty negotiations are set to begin in March as the UK and EU try to hammer out a deal for 10 months' time. It will be difficult and messy, but it's in both sides' interests to ink something that allows the deep trading and cultural ties to continue while respecting the political split.

In January, the US and China came to terms over 'phase one' of their trade war ceasefire. The deal was extremely one-sided, however, which doesn't bode well for its longevity. Now it's down to whether US President Donald Trump wins a second term when the nation goes to the polls in November. The rumour is that he wants to unleash a second tax cut as a pre-election sweetener, which would be great for stock markets as well as voters. That would take some doing, though. The US Federal deficit is soaring to levels not seen since World War II under the strain of increased public spending and reduced taxes. To get his tax-cut sweetener, Mr Trump will have to sweet talk the Democrats who control the House of Representatives.

The way we see it, we can't control any of that stuff. We're keeping an eye on the confidence and spending of American households because a slowdown there could be canary for any future recession. Instead, we're focusing on finding great companies that should do well over many years, regardless of what happens with politics.

The Rathbone Heritage Fund team

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