Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Heritage Fund

Quarterly update June 2021

The first six months of 2021 delivered further progress in the fortunes of equity investors. It has not all been plain sailing, with the narrative of 2021 twisting and turning. COVID-19 is with us still, and the optimism engendered by the promise of inoculated societies opening up is tempered by the threat of more virulent strains of the virus.

Economic data has generally improved, with PMI (Purchasing Managers' Index) numbers across the US, UK and Europe strongly suggesting economic revival. But the mood music continues to be determined by the actions of central banks, and the debate around future levels of interest rates and inflation. These numbers are as crucial for the valuation of assets, future earnings streams and forecasting returns on your investment as they are impossible to predict. And so, inevitably, there has been no clear consensus among investors about the best way to be position themselves.

	3 months	6 months	1 year	3 years	5 years
Rathbone Heritage Fund	5.0%	7.3%	14.2%	18.2%	41.8%
CPI Inflation + 3%	2.3%	3.3%	5.2%	14.4%	27.9%
FTSE World Index (GBP)	7.5%	11.9%	25.5%	46.6%	97.0%

	30 Jun 20-30 Jun 21	30 Jun 19-30 Jun 20	30 Jun 18-30 Jun 20	30 Jun 17-30 Jun 18	30 Jun 16-30 Jun 17
Rathbone Heritage Fund	14.2%	1.4%	2.0%	3.9%	15.4%
CPI Inflation + 3%	5.2%	3.6%	5.0%	5.5%	6.0%
FTSE World Index (GBP)	25.5%	5.8%	10.4%	9.4%	22.9%

Source: FE Analytics; data to 30 June , I-class, mid price to mid price.

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

The value of your investments and the income from them may go down as well as up, and you could get back less than you invested.

From autumn last year through to spring this year, there was a rotation of money away from areas of the market that offered either earnings predictability ('quality') or reliable 'growth', into more cyclical industries offering greater 'value'. The promise of an uptick in earnings now became more highly prized than the possibility of earnings upon the distant horizon. Latterly, the tide has swung in the other direction, with growth and quality more in the ascendant. Rest assured, what happens in the second half of the year is being hotly debated.

Performance review

Markets have been strong, so very few of our equity positions have held us back. Three names though have been weaker than others, and therefore deserve comment. **DCC** has drifted back, after a very strong start to the year. This global distributor of petro-chemical, technology and healthcare products remains a core holding. We like its business model, laser focused on cash flow returns on invested capital, and we regard its management as excellent. Nevertheless, more than 50% of its business is exposed to the wider energy complex; this presents risks even though the company argues, correctly in our view, that it is going to end up part of any green energy solution. Investor sentiment has waxed and waned.

The share price of China's state-backed travel tech company **TravelSky** has drifted a long way from its recent peak in March, as the delayed recovery in air travel has hurt sentiment. Latterly, worries about pandemic resurgence in Guangdong have further pressured analysts to revise down earnings forecasts as poor June trading, after a healthy spring, has taken its toll. However, the long-term story is intact. TravelSky still enjoys the monopoly position in the world's largest air travel market, and therefore offers strong recovery potential in a post-COVID world. We think that the shares are cheap, but on the basis that the market does indeed revive.

Chinese technology giant **Tencent** has faced more complex challenges. Chinese tech companies in general have come under increased pressure, with data and anti-trust oversight laws and regulations being tightened consistently by the country's regulatory bodies. Although Tencent has tried to keep a low profile, it is unlikely to emerge unscathed. For example, Tencent Music, the music streaming service that's been spun off and listed in the US, is likely to face a Chinese anti-trust fine. However, the company's core business has avoided regulatory scrutiny. We recognise these concerns and they worry us. However, it is the fact that Tencent is so deeply embedded in Chinese consumers' lives that makes it an attractive investment. Its games business generates cash, there is cyclicality in its advertising revenue streams and its cloud and fintech enterprises enjoy growth potential.

The spread of gainers tells its own story, comprising a mix of growth, cash generation and defensive quality. As markets rotated back into growth, we saw a recovery in three core technology plays, US software entities **Adobe** and **Microsoft** and Dutch semiconductor giant **ASML**. Adobe and Microsoft have continued to prosper. Over the last 18 months, investors have been buffeted by many dramatic storms, notably the economic effects of COVID, plummeting oil prices, inflation fears and huge government and central bank intervention. Amid all of this, these businesses have just carried on doing what they do best and the shares have marched ever higher, albeit with some sudden drops along the way. These are the markets we live in. Other challenges have confronted ASML and these highlight difficulties we must recognise across industry sectors. Supply chains have been severely fractured by the pandemic. Companies that want semiconductors cannot necessarily get them. We love ASML because it supplies the whole industry, not any specific segment. But we should not ignore wider stresses across the system.

The other two principal winners are very different. US credit card business **Discover Financial Services** has been buoyed by thoughts of economic recovery and the possibility of a steepening yield curve. By contrast, Swiss pharmaceutical giant **Roche** has enjoyed clinical success and a general recovery in investor appetite for this particularly defensive sector.

Outlook

We still don't know how long we'll be living with COVID lurking in the background. A year ago, many seemed to think the pandemic would be over in a month or so. And six months ago, plenty seemed to fall into a similar trap. The rise of the particularly virulent Delta variant, despite inoculation programmes, highlights how hard it is to limit the spread of a highly infectious disease, let alone eradicate it.

As investors have come to terms with this harsh reality, the initial euphoria triggered by vaccine rollouts seems to have cooled somewhat amid creeping concerns about the durability of the reopening rebound. These concerns have been heightened by growing awareness of the myriad ways in which the virus may continue to disrupt normal business activity and trade. In particular, the most recent wave of global infections has raised concerns about the impact on growth (and inflation) if isolation measures keep huge numbers of workers at home, exacerbating the supply chain bottlenecks that have already fuelled inflationary pressures.

Meanwhile, stock markets have (more or less) continued to make relentless gains, with many recording record peak after record peak. But there has been considerable uncertainty about the kinds of stocks likely to perform most strongly. Investors have vacillated between quality and growth stocks and those offering value and cyclicality. We continue to balance our exposure, while noting that shares with cheaper valuations still have a long way to go before regaining ground on more expensive growth companies. In addition, stocks that tend to do well in periods of rising inflation or bond yields are more likely to be found in sectors with a higher representation in value indices.

Because markets as a whole are expensive, we are sitting on a lot of cash, as dictated by our valuation-linked cash management mechanism. The higher that markets go, the more painful this may feel. We continue to believe that the 'cost' of any shorter-term underperformance will be outweighed by our efforts to deliver attractive risk-adjusted returns over multi-year investment horizons.

The Rathbone Heritage Fund team

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