Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Heritage Fund

Quarterly update December 2021

The final quarter of 2021 began with investors preoccupied by the seemingly relentless rise in inflation, fuelled by supply chain shortages, spiking energy prices and tight labour markets. US consumer price inflation soared to 7% in December – its highest level since 1982. And the Bank of England (BoE) expects UK inflation to peak at 6% in April.

The new Omicron strain of COVID-19 then struck, raising fears of yet more lockdowns and closed borders. Worries about the variant's potential impact dominated markets and investor sentiment for much of the rest of the year.

	3 months	6 months	1 year	3 years	5 years
Rathbone Heritage Fund	4.2%	6.3%	14.0%	40.3%	39.7%
CPI Inflation + 3%	2.9%	4.9%	8.3%	16.9%	30.9%
FTSE World Index (GBP)	6.9%	9.1%	22.1%	69.0%	85.6%

	31 Dec 20-31 Dec 21	31 Dec 19-31 Dec 20	31 Dec 18-31 Dec 19	31 Dec 17-31 Dec 18	31 Dec 16-31 Dec 17
Rathbone Heritage Fund	14.0%	5.8%	16.3%	-9.7%	10.2%
CPI Inflation + 3%	8.3%	3.4%	4.4%	5.4%	6.3%
FTSE World Index (GBP)	22.1%	12.7%	22.8%	-3.1%	13.3%

Source: FE Analytics; data to 31 December, 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.

By the New Year, investors seemed to accept that while Omicron was causing huge infection numbers (and major disruption), it was not resulting in mass hospital admissions (at least among the vaccinated).

They then started to grapple in earnest with the prospect of an end to more than a decade of ultra-low interest rates and quantitative easing (QE) following surprisingly hawkish policy pivots from both the BoE and the US Federal Reserve (Fed). The BoE was the first of the world's big central banks to hike rates, while the Fed made it clear it was ready to ramp up the pace of tapering QE. The Fed has since upped the ante, suggesting that QE (where the central bank buys government bonds to keep yields, and therefore borrowing costs, low) is highly likely to be put in reverse. This is called quantitative tightening (QT) and means the Fed will stop reinvesting money from coupons and bond redemptions.

Bond and equity markets held pretty firm in December, but investors have since been scrambling to reposition themselves for higher rates and the end of QE. Bond yields – which rise as prices fall – leaped to pre-pandemic levels this month.

This has led to volatility in equity markets. More highly valued 'growth' stocks – whose promises of stellar growth ahead have yet to translate into tangible profitability – have come under particular pressure.

Higher rates and higher inflation diminish the present value of future earnings (and therefore share prices, all else being equal). The prospect of QT rather than QE and the prize of economic recovery have combined to empower a rotation into more 'cyclical' (and likely more value-oriented) areas of the market, at the expense of 'growth'; a greater need to own the earnings of the present, rather than the promise of something in the more distant future. Now, of course, we've been down this road before, and growth has recovered even more strongly. But some commentators are sensing a difference this time.

Performance review

As was the case in 2021 as a whole, our strongest performers in the final quarter were all companies that investors perceive as commanding dominant positions in economic sectors enjoying sustainable and longer-term structural growth and which, therefore, look well placed to withstand higher rates and inflation, as well as continuing supply chain snarl-ups. Key outperformers included three technology stocks: US mega-giant **Microsoft**, Dutch semiconductor supplier **ASML** and US software designer **Cadence Design Systems**. Against all the ups and downs of last year, these businesses carried on doing what they do best and their shares marched up, albeit with some volatility along the way.

Indeed, Cadence and ASML could arguably be viewed as benefiting from post-pandemic supply chain woes. Semiconductor chip manufacturers around the world are keen to ramp up production capacity to ease their reliance on the long semiconductor supply chains that were disrupted by COVID. Both Cadence and ASML enjoy virtually unique positions in the chip manufacturing process. Cadence provides the software design technologies required to design new chips, while ASML supplies high-end equipment to chip manufacturers. Both companies, therefore, benefit from burgeoning global demand that's creating huge, multi-year order books.

Plumbing and heating business **Ferguson**, which now generates all its revenues in North America, also powered ahead last year. Its September results highlighted its strong sales growth, but more importantly, an impressive ability to pass on costs, crucial at a time of inflation and supply chain issues across all industries.

Likewise, industrial gas and engineering group **Linde** has faced higher raw material costs, but has managed to pass them on to its customers. It has little direct competition and is underpinned by inelastic demand from its core customer base. This gives Linde plenty of pricing power to maintain its profitability.

In terms of laggards, some of the weakest performers during the quarter and the year as a whole were united by a common thread: they were all listed on Hong Kong's Hang Seng market. The Hang Seng had an awful 2021: it fell by 14% as it was hit by weakening economic growth and new COVID lockdowns in China, Beijing's surprise regulatory crackdown on the tech sector and worries about the repercussions of the potential collapse of embattled property developer Evergrande.

Pan-Asian insurer **AIA** had a poor run for its share price. It was hurt by COVID-driven border closures as mainland Chinese customers buying insurance in Hong Kong account for a significant proportion of its business. The share price of China's state-backed travel tech company **TravelSky** drifted a long way as the delayed recovery in air travel, again as a result of COVID curbs, hit sentiment. Tech giant **Tencent** came under intense pressure as the tech sector crackdown widened to impact its business directly. Tencent's WeChat social networking and payments app was hit by tougher data security protection initiatives. The crackdown then sought to impose curbs on gaming (one of Tencent's core business activities) aimed at safeguarding children, pressuring the company into restricting the amount of time children can spend on its gaming sites.

Outside these Hang Seng stocks, Danish speciality cultures and enzymes business **Christian Hansen** had a difficult year, pushing us to sell our shares. We became increasingly frustrated with the volatility of its growth in sales and earnings and we were concerned that its capital allocation discipline had deteriorated so we exited our position.

Outlook

We ended last year placing a higher premium on earnings visibility, global sector leaders and investments underpinned by structural themes for which the ebb and flow of the business cycle is a little less relevant. Surveys of business confidence are strong, the labour market is booming, household balance sheets are in rude health and corporate cash piles are hefty (especially in the UK). In other words, we believe that the risk of a recession is low and that means so is the risk of a bear market. Markets reflect a reasonable amount of pessimism and consensus profit expectations for 2022 are beatable if economic growth remains above average.

We remain hopeful that January's volatility will prove a timely reminder that corrections are a normal function of markets and needn't send us into a panicked retreat.

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 still look expensive, we are continuing to sit on a lot of cash, as dictated by our valuation-linked cash management mechanism. 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. If there is to be a major correction in global markets, which is always a possibility at times of heightened valuations and volatility, it is of major comfort to be in a position to deploy substantial firepower if the opportunities arise.

The Rathbone Heritage Fund team

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