Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone UK Opportunities Fund

Monthly update May 2022

The opening act of 2022 has been a real parade of volatility, with stock markets roiled by inflation fears, a European war, supply chain issues, Chinese lockdowns and the start of a rate hiking cycle in both the UK and abroad.

For many, it may seem like economic uncertainty is higher than it's been in years, when actually a little more nuance is required. Accepting such a mantra implies that the future was more predictable in the past (and we know that isn't true). As behavioural finance expert Morgan Housel puts it: "what changes isn't the level of uncertainty, but the level of people's complacency."

We don't shy away from either macro or idiosyncratic challenges to our holdings. Tough times present us with opportunities to test the quality of our investments and to avert complacency risks. We must consistently test assumptions and check adjustments that we see in accounts. Ensuring that the numbers (particularly cashflow) back up the narrative is essential.

The inflation outlook

The UK Consumer Prices Index rose by 9.0% in the 12 months to April 2022 to hit its highest level in 40 years. Some veteran fund managers have been busy claiming that most of today's investors lack experience of working through periods when inflation has been similarly intense. Indeed, your team was certainly not working in stock markets 40 years ago. But we view our fresh playbook as a potential advantage. The world was a very different place in the early 1980s: we think it would be extremely risky to assume that the kind of stocks that did well then will also outperform today. Indeed, a lot of the money being spent in 2022 is used to buy things that didn't even exist in 1982 – think Netflix subscriptions, iPhones and Fever-Tree tonic water.

At a stock-specific level, we believe that those companies that are better able to align their revenues and costs to inflation are likely to outperform. From a revenue perspective, pricing power comes from two things. First, providing a non-discretionary product or service: people may complain but they'll probably still buy these goods or services no matter what they cost. And, secondly, the ability to adjust pricing quickly. Very few companies have this agility, though small cap companies should prove nimbler than their larger cap counterparts. More established, larger companies tend to have more ingrained business models, making it harder for them to change the way they do business when inflation creeps up on them. On the costs side, we look for companies with low fixed cost bases (as evidenced with high gross margins), a focus on more short-term capital expenditure, and low levels of debt.

During the month, we bought more shares in **Treatt** (a supplier and manufacturer of natural extracts and ingredients, predominantly for beverages) and fashion retailer **JD Sports**. Both companies' share prices have been under pressure since the turn of the year, despite their strong balance sheets, pricing power and solid growth prospects. We also reduced our position in **ActiveOps**, a provider of Management Process Automation (MPA) software, which hasn't delivered in quite the way we would have liked. We try to act quickly when we change our minds about a stock.

Improving the quality of the fund

We think a bear market may best be described as one in which an earnings slowdown coincides with lower valuations. Broadly speaking, we have seen valuations reset, but not earnings. This means we're focusing particularly sharply on companies' earnings growth. We believe that when investors begin to recognise that some businesses are still growing their earnings, this will provide the catalyst for markets to start to stabilise and make gains from here.

Our fund's risk/reward dynamics have undoubtedly been amplified in 2022: we believe that there are fantastic opportunities out there for long-term investors.

Alexandra Jackson
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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