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Rathbone UK Opportunities Fund

Update, December 2019

2019 was, for most UK investors, dominated by Brexit – you can see the machinations reflected in the shape of returns over the year too. Yet despite intense focus on trade wars, Brexit of course, elections and plenty more besides, the first half of 2019 gave us the broadest equity market rally in over a decade. By reversing course to cut rates, the Federal Reserve managed to drive markets ahead. And for us in the UK, clearing the first 'no deal' hurdle at the end of March helped large-caps, financials, industrials and energy names to lead a rally. Normally, when large-caps do better than mid-caps our fund underperforms, but this time our domestic exposure actually helped us end the first half of the year slightly ahead of the IA UK All Companies sector average.

Toward the middle of the year, investors flocked to growth stocks and those that consistently provide strong, reliable earnings – qualities that we really try to zero in on for the bulk of the fund. In an uncertain environment, this is absolutely what we would expect to see: companies demonstrating stable revenue, returns, cash flow, management and strategy can continue to command higher multiples for extended periods of time.

The popularity of growth companies in that first-half rally meant their valuations (the multiple of earnings investors will pay to buy them) ballooned. We gently took some profits from a few of these sorts of companies, because we wanted to raise a little cash. Having seen a slowdown in macroeconomic data and global growth, we too felt a little cautious going into the second half. So we were unsurprised when the market wobbled over the summer. Volatility rose as those fairly binary-looking risks we mentioned earlier returned to investors' minds. As GDP growth around the globe slipped, suddenly everyone worried whether a hard Brexit or more tariffs between the US and China could be the catalyst for a global recession. We felt this was a bit overplayed, so stuck with our belief that the world was experiencing a short-lived fluctuation in growth, rather than the beginning of a sustained downturn.

This summer panic drove down bond yields all around the world as investors slashed their expectations of GDP growth and inflation and bought up safe haven government debt. The US 10-year bond yield dipped below 1.8% and even briefly dropped below that of US 2-year bonds. When yields are turned upside-down like this – 'inversion' in the parlance – it is often a signal that a recession is coming. This signal isn't always correct, however, and any recession could still be six months to two years away. It didn't take long for the mood music to change once again though. Bond yields rose sharply in September, causing a pretty sharp rotation into businesses that are highly sensitive to changes in economic growth and 'value' plays. This this was a headwind for our fund, which is unashamedly focused on buying high-quality 'growth' names.

All was forgiven in the final few months of the year, however. Sterling rallied sharply in the lead-up to the election, and then even more aggressively in the immediate aftermath of the Conservative victory, taking UK stocks with it. For the first time in years, investors were piling into UK equities. And it was mid-caps that took the lion's share: in the final quarter, FTSE 250 Index trackers took in more money than FTSE 100 Index trackers did over the entire year. The FTSE 250 has outperformed the FTSE 100 by about 10% since late summer.

And, as expected, it was the domestic names, those most punished since the 2016 referendum, which rallied hardest. You tend to find the greatest concentration of these names in the FTSE 250, and our overweight position here helped us to end the year up 25.1% versus 22.3% from our peer group, putting us at the top of the second quartile for the year. Our returns were much higher than our benchmark, the FTSE All-Share Index, which gained 19.2% in 2019.

The decisive electoral outcome reduces the likelihood of tail risks (low-probability yet high-impact events) that had restrained investors' optimism. The big tail risk worrying investors appeared to be the risk of a Jeremy Corbyn-led government, rather than a hard Brexit, which most companies we talked to have worked through. Of course, we still have to get through 12 months at least of tough negotiations, which will undoubtedly mean some nasty headlines. Sterling will remain sensitive to this.

Our strong 2019 performance wasn't just because we held more of the right parts of the stock market either. We've picked some good stocks too. Our big positions were, happily, some of our best performers: a couple of tech names, like design software developer **AVEVA** (+95%), and online security company **GB Group** (+86%), both of which we have talked about endlessly before. Alternative asset manager **Intermediate Capital** (+78%) had a phenomenal year too, as did student housing developer **Unite** (+61%). Other standouts, where we have smaller positions, include industrial business turnaround specialist **Melrose** (+50%) and video game publisher **Team17** (+92%). These are our British Bulldogs.

Our tech holdings weren't universally positive, however: **accesso Technology** (-67%) was our biggest faller and a real disappointment. It was a good lesson in expectations management. This company promised to conquer the world with those Q-bots that let you jump the queue at theme parks, when in fact a lot more investment was needed to claim the prize. We had hoped the company would be bought out, but since period end they have decided to continue alone. We don't have enough conviction in management ability to do this so have exited the position.

Another factor that dominated 2019 was the growing focus on liquidity. Monitoring this is very much part of the DNA of Rathbones, and so is deeply embedded in the investment process of our fund. We talk often about sizing positions relative to how easy they are to trade. Each small-cap and AIM stock is capped at 3% of the fund's total value, and in reality we keep them lower. The maximum for mid and large-cap positions is 5%. More crucially, though, is monitoring liquidity by assessing how long it would take us to sell all our shares. Latest analysis suggests we could trade 98.7% of the fund to cash within 10 days.

As we step into 2020, we're feeling pretty upbeat about the prospects for the UK, despite a few clouds hanging over the country. Retail sales were dire over Christmas, and a few companies have warned on profits early in the year. But is this just all rear-view-mirror stuff? It's probably more constructive to think about what the picture might be a year from now.

The UK sports a stable political environment for the first time in years, albeit trade policy uncertainty remains. While the Bank of England is worried about the slide in GDP growth and inflation and the impending Brexit, it has meant the chances of an interest rate cut have spiked. That could be a helpful support for an economy that is also promised greater public spending, particularly in some under-loved regions. Meanwhile, following the election, companies have shown they want to spend money, consumers are beginning to feel more confident after a year in the doldrums and the Chancellor is likely to loosen the purse strings meaningfully. Housing sentiment has already picked up significantly, the pile of private money waiting on the sidelines is only getting bigger and global asset allocators are still under-invested in UK equities. Plenty of domestic stocks were banished from portfolios. Many haven't recovered even now. I think this is behind a lot of the takeovers we've seen recently. I'm certain there will be many more.

We've had soggy but not negative GDP growth in the last few years, discretionary income has grown due to low inflation and high employment, and don't forget the UK is one of the best places to do business in the world. As long as the UK remains on a path of incrementally higher certainty, there should be concurrent falls in the risk premium, which in turn drives company multiples higher.

We need to be careful about jumping into any old 'bargain', however. Stock-picking has never been so important. Brexit has been blamed for mistakes committed by companies long ago that have now come home to roost. It's also far from true that political clarity on its own will slay the UK's structural demons. The reality is much more nuanced and we don't expect growth to roar back. It might not be enough to lift all boats, which is why we stick with our mantra: when growth is scarce, buy growth.

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Fund Manager

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