

Rathbone UK Opportunities Fund

Monthly update August 2022

With inflation in the US, Europe and the UK at multi-decade highs, central bank policy has been investors' prime focus for much of 2022. The messaging appears clear: the US Federal Reserve (Fed), Bank of England (BoE) and European Central Bank will pursue interest rate hikes to stop inflation getting entrenched. Markets were reminded of this forcefully by the Fed chair at his annual Jackson Hole speech, and so the summer rally fizzled out sharply.

We shouldn't expect central banks to come to markets' rescue any time soon, but we do retain a degree of scepticism over the degree and quantum of rate hikes in an ever-changing economic backdrop. At the extremes, investment banks such as Goldman Sachs and Citi are forecasting that inflation in the UK could peak at close to 20% (only by assuming that current gas prices don't fall back), whereas the BoE expects consumer price inflation will reach just over 13% by year-end. The next few quarters are undoubtedly going to be choppy for UK equities: we will continue to focus on our conviction in the underlying businesses of the stocks that we own.

Broadly speaking, the interim earnings season was positive for many of our holdings, which performed well relative to expectations. This is testament to the resilience of their operations, in particular their ability to demonstrate financially that they command the pricing power that they (and we) so often cite as critical.

The virtues of patience?

A bias towards action is one of the strongest forces in investing, yet we believe it's firmly at odds with the patience required to reap the benefits of long-term compounding. Consequently, we only made a couple of tweaks to the portfolio in August, most notably exiting our position in power solutions manufacturer

XP Power. While its interim numbers were adequate, we had concerns about its working capital cycle going into the second half of 2022 and an intellectual property dispute in a US court that is looming over the business. We like XP's end-market and positioning (it benefits directly from strong semiconductor capex spending), so it's the sort of company that's unlikely to leave our 'watch list' permanently.

Merger and acquisition activity is warming up again despite fears that higher interest rates will put off private equity-type buyers. Sterling weakness is once again highlighting some great UK businesses on sale. Long-term cornerstone of our fund's tech weighting, industrial software developer **AVEVA** announced in late August that it's being pursued by its majority shareholder Schneider Electric. There is no certainty of a deal just yet and the shares are still down a third from a year ago. UK plc looks vulnerable to many more opportunistic take-outs at bargain prices.

Stress-testing resilience to higher rates and energy costs

After nearly 15 years of near-zero interest rates, investor attention has naturally drifted away from companies' capital structures and the role of debt. However, a key part of our process involves ensuring that our holdings have the balance sheet strength to withstand higher rates. Thankfully, a significant proportion of our holdings are net cash (they have more cash than total liabilities) and, in many cases, debt-free. This means that going into 2023, and beyond, we have confidence in the ability of our companies to service their debt obligations and not find themselves subject to the whims of their creditors if their earnings falter.

The world is a complex adaptive system and we happily admit that we can't forecast unforeseeable variables. Nevertheless, we endeavour to pick quality companies at reasonable valuations which can withstand this unknowable future, while leaving as few stones unturned as possible. This holistic, bottom-up approach to quality incorporates a variety of quantitative to qualitative factors. These range from how a company accounts for share-based payments through to management's experience in riding out previous storms, which can only be truly assessed through regular interaction and face-to-face meetings.

Moving into the last few months of the year, a key theme for us will be questioning which inflationary pressures are keeling over and which are here to stay. In the UK, energy costs are front of mind for consumers and businesses alike, so we've been testing how well our holdings are hedged against substantial increases in energy prices going into the winter. We await with great interest new Prime Minister Liz Truss's plan for capping fuel bills. It will have a profound impact on both consumers and businesses over the winter – and it could provide markets with some near-term stability.



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.