

Rathbone Multi-Asset Dynamic Growth Portfolio

Monthly update August 2021

Equity markets have risen pretty consistently since spring 2020, making valuations of COVID-19 friendly stocks look pretty lively.

In fact, we have had to come up with a new ratings system: 'lively', 'spicy' and 'eye-watering'. Two US software and computing hardware holdings in our fund, simulations company **Ansys** and computer chip optimiser **Cadence Design Systems** are trading at multiples of around 50 times forecast 2021 earnings. They have definitely gone from 'quite expensive' to 'spicy', whizzing right past the 'lively' category. And if you think it's just the US, think again. Dutch business **ASML**, another of our computer-chip positions, is also on 50 times 2021 earnings.

Now, we believe that high-PE stocks will sell off substantially if interest rates rise, so these eye-watering multiples make us a bit nervous. However, they are expensive because they are quality businesses, just the sort of businesses we want to own. And timing the market using PE multiples is extraordinarily difficult, if not impossible. The values of these stocks could go yet higher. We discuss this conundrum in [episode three of our podcast **The Sharpe End**](#).

Hedging our bets

We don't want to sell these companies that boast reliable earnings growth and replace them with lower-quality or lower-growth names. We are long-term investors. We aren't buying highly indebted or unprofitable businesses valued on a price-to-sales basis. That tends to end badly when sentiment shifts.

To square this circle, we've followed our trademark strategy. That is, we've hedged our bets. We've been slowly but steadily reducing our exposure to technology and other highly valued stocks over the past 12 months. In August we trimmed Dutch manufacturer of industrial computer chip printers **ASML** and US diabetes monitoring company **Dexcom**. We still hold meaningful positions mind, as we reckon they have strong prospects for increasing their sales and implementing smarter cost cutting over coming years. But we are trying to prepare for the beginning of the (very long) end of Spinal Tap monetary easing ("turn it up to 11"). To do this, we've been buying quality companies that should benefit if the pandemic reopening really does take flight. Some of these businesses have had a more trying 2020, but they aren't airlines, restaurants and hotels. Instead, they are medical device businesses that should have lots of pent-up demand once hospitals are freed up from COVID-19 and well-capitalised events and ticketing companies, that sort of thing. We've catchily dubbed these companies 'lower-beta COVID reopening' stocks.

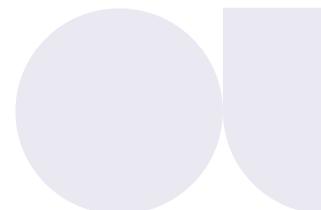
Along with this twist of our stock holdings we've been increasing the amount of cash we hold, so that we can add to our preferred companies – and potentially other asset classes, like high yield bonds – on any 'tantrums'. When real yields are as low as they are, cash seems the only safe option, followed by put option protection on your stocks, which are essentially insurance policies that put a floor under the value of your equities. In our case, we have made use of both in the past year. However, the VIX volatility index has been relatively high recently, increasing the premium you pay for this sort of portfolio insurance. Because of these reasons, we've been adding to cash and some bespoke structured products in recent months.

We also own a basket of sovereign bonds issued by several different governments. These bonds are mostly, but not all, short duration. This means they tend to have shorter lives before they mature and/or pay higher coupons, which makes their values less sensitive to changes in prevailing yields/interest rates.

Buying into reopening

We added two more companies this month: **Paccar** and **Squarespace**.

American lorry maker Paccar, which David met when on a [research trip to the US right before lockdown](#), makes all the vehicles you would expect: smaller models for city delivery, medium-sized ones for interregional haulage and the ginormous sort that will only really fit in America. It owns several different brands, including DAF (Leyland), Kenworth and Peterbilt. Half of its sales are in the US, another quarter are in Europe and a bit more than 10% in Asia. What attracted us to Paccar is that its trucks are known for their reliability and value, and Paccar is known for its no-frills focus on retaining and increasing that edge. Its management are exceptionally proud of the ugliness of its company headquarters, for example. Helps keep the rent down! Fewer breakdowns mean trucks have more time on the road making profits for hauliers. That reliability comes in handy for fleet managers too: when it's time to sell Paccar trucks on they tend to command a stronger price, reducing the total cost of ownership for truckers. That profitability boost for its customers encourages them to expand and buy more trucks. This all flows through to shareholder returns: Paccar's return on equity has averaged almost 20% over the past five years. Meanwhile, since the turn of the millennium Paccar has increased its US market share from 20% to 30%.



Squarespace is a New York-based software company with a West Coast feel. It builds websites that can be easily personalised with drag-and-drop modular features. They look good but are simple and easy for businesses to manage, whether they are small enterprises or large firms. It offers integration with digital payment companies, like PayPal and Stripe, analytics and automated advice on search engine optimisation. It has also started selling domains as well. Squarespace is particularly popular among small professional services companies, like accounting, legal and consulting practices, although it caters to thousands of retailers as well. It sports about 3.6 million subscriptions, with customers all over the world. We have often argued that the digitisation of business still has a very long road ahead of it, particularly among smaller companies. Also, increasing entrepreneurship should add another boost to companies like Squarespace.

Stacking sandbags

As another bit of defence against a sustained uptick in inflation, we continued to add to **US Treasury Inflation-Protected Securities 0.25% 2025** bonds (TIPS), whose coupons and principal are linked to US CPI. The average rate of inflation required over the life of the bonds to make these bonds more profitable than conventional US Treasuries - which is known as the "breakeven rate" - has fallen back slightly in recent months.

Now, onto those structured products we mentioned. Because bond yields are so low, it makes stocks, bonds and property all expensive. This means it's harder to reduce the correlation of portfolio returns - to ensure that everything we hold isn't going up or down together - which is a key measure of our risk. To boost our diversification over the past year or so, we have bought several different structured products, which are contract-based investments with banks. That means that if certain events happen or market measures hit certain targets we are paid a certain return, while if the opposite happens we lose the return and sometimes some of our capital. It depends on the product.

The most recent is the **Societe Generale VRR Index Structured Product**, which makes money if the volatility of US Treasury yields increases. So if yields rise rapidly because of an inflation scare or if they slump because of GDP growth concerns we make a return. Any increase in the size or frequency of moves in US treasury yields is good for this investment. However, if yields just amble along with little movement, we will lose money. And we would actually prefer the latter: if yields shoot up or down stocks are likely to be falling because of the fears driving the move. Whereas benign yields should be great for our stocks. Long story short, we view this product as an insurance policy for wobbly markets.

Don't get the wrong idea - we're not incredibly concerned about the future. On the contrary! We're quietly optimistic that the world will continue to grow steadily, taking markets with them. But asset prices have had a stellar run and people are casting round for worries, so we feel it's a good time to lock in some profits and make sure we're prepared for the unexpected. Always best to have the dykes ready before the flood.



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