Rathbone Dynamic Growth Portfolio

Quarterly investment update, October to end December 2020

Rathbones

Look forward

Hot topics – 'Top-down' (market and macroeconomic)

Viral evolution. A proliferation of vaccines has been met with a proliferation of mutations in COVID-19. After slow wind-ups, most developed nations are steadily beginning to inoculate more and more of their people. However, the discovery of

two particularly noxious COVID variants – one spawned in South Africa and another right here in the south of England – dampen the success somewhat. Most scientists say existing vaccines should work for the UK strain, but the South African one may have changed in a way that makes it harder for the vaccine-induced antibodies to fight. Jabs can be tweaked, if required, to better fight new mutations, but that takes time and some people are already dubious about the safety of quickly developed new vaccines as it is. This concern about the vaccines is both a shame and understandable. Humans are conservative creatures and there is a chance that developers and regulators missed some problems in their haste. Yet the power of these new vaccines, especially the breakthrough mRNA type, is an incredible advance in our ability to fight viruses. So, with mutating viruses and gargantuan production and complicated roll-outs of vaccines all across the world, we feel there are quite a number of unknowns floating around that could pop up to shock investors. And markets, in the main, haven't left much margin for error in prices.

Global Britain. Now the deal is done, Brexit is out of the way. Except for the bureaucrats, though. They will be wrangling about the details and add-ons for decades. But, once the new environment has bedded in, the conversation will move on. This is welcome. The UK's protracted divorce with the European Union became all-consuming, preventing our nation from focusing on much else. Brexit certainly seemed like the only thing that global investors were focusing on – British markets have carried a substantial discount to other markets ever since the vote to leave. UK stocks – particularly small and mid-cap – have already done extremely well in the final months of 2020 and into 2021. We believe that this should continue once overseas money begins to return to our isles en masse. There's definitely room for optimism, so we will be carefully watching what the government does next: Does it experiment with free ports and reduced regulation or does it bind itself up in protectionism? We're not changing our stance on the UK just yet. We're also surprised that sterling didn't bounce back more on news of the deal. Because of this, we have kept our currency hedges in place.

These are agreements with an investment bank to fix the sterling value of a good portion of our overseas assets, protecting us from losses that would result from sharply higher sterling. They also mean we forego any benefit from a fall in the pound.

Green new deal. Big plans for investing in more sustainable energy and infrastructure, from the UK and Europe through to the US and China, are very welcome. These projects have the potential to cut global pollution and refine energy

usage, helping us face climate change and maybe even save many of us from hours stuck in traffic. Yet there is also the potential for investors to get burned in the hype. The hubbub of a goldrush already surrounds these industries, with some hucksters setting up their stalls. There will be some fantastic opportunities to invest in this once-in-a-lifetime shift, but there will also be a lot fool's gold peddled. And that's before you think about most governments' track records on infrastructure projects: they tend to overpay for assets (because they use other people's money) and they tend to build the wrong things (because what looks good today is more valuable politically than what works best a decade hence). Whenever investing in these areas, we will be watching carefully for the chance of policy mistakes and misuse of capital. Where possible, we will also be cleaving close to that old adage: it's better to sell pickaxes than go prospecting for gold yourself. We believe it's usually best to invest in the technologies and equipment spurring this green drive, rather than punting on individual projects (or bundles of them).

Portfolio activity

Key purchases/additions	Key sales/trims
JP Morgan Emerging Markets FX Momentum (new purchase)	Sampo (sale)
Trex (new purchase)	Dürr (sale)
Jack Henry (new purchase)	Discover Financial Services (trim)
US Treasury 5.25% 2028 bonds (new purchase)	iShares FTSE 100 ETF (trim)
Kion (addition)	JP Morgan Japan Fund (trim)

Source: Rathbones

In October we bought a **JP Morgan Emerging Markets FX Momentum** structured product. This contract gives us exposure to a 'momentum' index of emerging market currencies. It uses price trend data to try to anticipate whether the basket of currencies will rise or fall against the dollar. This should enable us to generate positive returns in benign markets, and historically it has provided some protection in times of crisis as emerging market currencies typically sell off against the dollar, and the index model has picked up on this trend and moved to a long dollar position.

In late October/early November we added US government bond exposure via the **US Treasury 5.25% 2028 bonds** as prices fell amid rising inflation expectations that we believe are overplayed. With the chance of volatility looming next year – given the lingering virus, Brexit uncertainty and the potential for investor disappointment with company reporting in the first half of next year – we felt it was prudent to top up our safe-haven assets.

Just before Christmas, we bought US composite decking supplier **Trex**. Composite decking uses over 90% recycled materials and is an attractive alternative to wood. Penetration in its main US market is still relatively low, at about 20%. It also has the potential to expand its smaller overseas business as well. We have been positive on the US housing cycle for a while and think spending on these sorts of DIY products is likely to continue increasing for some time. Trex offers a clear opportunity to improve resource use. It beats wooden decking hands down: the amount of greenhouse gas and air pollutants is roughly halved compared with treated wood products, and the amount of acidification and ecological toxicity is slashed by about 90%. Trex lasts much longer too.

Another addition was **Jack Henry**, which helps American finance companies with technology and payment systems. Focusing exclusively on the US market, it has burrowed out a niche supplying high-quality-tech to smaller, regional banks, rather than the multi-national first tier banks. Its strategy is to help these companies grow by improving the service they offer customers through whizzier apps and service. Many of these smaller banks are still in the process of digitising, which means there's a lot to keep Jack Henry busy.

In late October, we sold our investment in Finnish financial conglomerate **Sampo** because we didn't like its purchase of UK-listed car insurer Hastings. We are less enthused about general insurance as a market and motor insurance in particular. This acquisition diluted Sampo's life insurance and banking businesses, so we exited.

Another sale was German warehouse automation company **Dürr**. We have recently built a position in **Kion**, which we felt is a better way to invest in warehouse automation and the boom in ecommerce because it accounts for virtually all of its sales. Dürr has other divisions that dilute this exposure, including a large automotive automation arm and a furniture-making tools business.

Spotlight

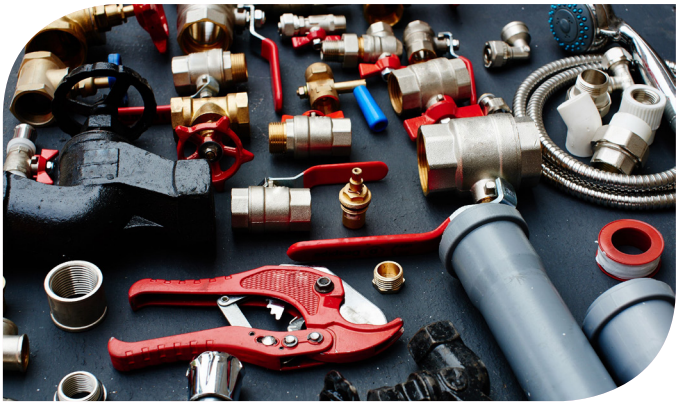
In this quarter, the spotlight is on our **Ferguson** and **Aptiv**.

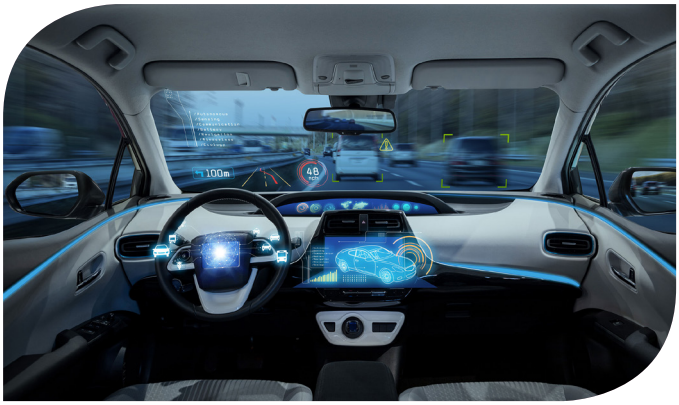
Ferguson

- The world's leading specialist distributor of plumbing and heating products
- Despite being listed in the UK, the majority of the revenues and profits come from the US
- Their end markets remain fragmented but they are the number one or two player in most of them
- The service level and technical expertise Ferguson provide are their key advantages, and a significant way they can combat the threat of disruptors, such as Amazon, in their markets
- They recently sold their UK business, Wolseley, and returned money to shareholders via a special dividend – this will enable the company to focus on the US where management believe they have the best opportunities for growth

Aptiv

- A global auto parts technology company with exposure to the key themes of vehicle electrification and connectivity, increasing infotainment, autonomous driving and active safety technology like sensors and automatic controls
- Their products are used in both commercial and consumer vehicles with increasing technology content being a key growth area in the autos space
- 25 of the world's largest auto manufacturers are customers, so it matters less to Aptiv which car company wins in the race for electric vehicles, autonomous driving, and other technological advances as they supply many of the key players
- Their long-standing presence and key customers in China help to broaden the growth opportunities
- Ongoing additional regulations support many key business areas for Aptiv, whether that be around quicker moves to electric vehicles, or the increasing safety standards requiring more safety software and sensors in cars





Fund performance

Top performers (%)		
Holding	**Performance**	**Contribution**
Discover Financial Services	+49.25	+0.41
Legal and General	+41.33	+0.42
Royal Dutch Shell	+35.85	+0.25
Aptiv	+34.36	+0.29
Schlumberger	+33.04	+0.02

Bottom performers (%)		
Holding	**Performance**	**Contribution**
Amgen	-13.61	-0.11
DCC	-13.14	-0.10
Christian Hansen	-11.94	-0.07
Dexcom	-11.74	-0.04
Lockheed Martin	-11.58	-0.11

Note: Top and bottom performers are taken from the list of all holdings of 0.25% and above of the portfolio.
Performance and contribution data shown above is based on unhedged GBP capital returns.
Performance (table above only): Gross of charges.

Source: Rathbones

The hedging we have of a large portion of our US dollars was a meaningful help to performance during the quarter. Over the period sterling experienced strength but also combined with broad US dollar weakness too. The rate of exchange moved from around 1.29 at the end of the third quarter of 2020 to around 1.37 at the end of the year. This is exactly the kind of move our hedging is designed to help protect against and it proved its worth during the quarter.

The rotation towards more cyclical areas of the market we saw during the quarter resulted in some of the companies and sectors which had performed very strongly throughout the earlier parts of the year faltering. Money flowed out of a number of those top performing areas as investors sought exposure that was more sensitive to an economic recovery. US small caps and more recovery-oriented stocks rallied significantly as the cyclical recovery began to take hold.

In Q4 2020, we saw a significant rally in the Russell 2000 index in which we have exposure via an exchange traded fund (ETF) as vaccines were announced and then rollout of vaccination programs began across the US. As you would expect given this environment supported the more cyclical names in the portfolio, broadly all of them had an excellent quarter. In addition to the **Russell 2000 ETF**, names such as **Discover Financial Services**, **Legal and General** and **Aptiv**, along with our exposure to certain banks and the oil majors, all saw a significant rally as market sentiment shifted and investors began to see the light at the end of the tunnel.

Asset allocation change and strategy

There were no significant asset allocation changes during the quarter.

Asset allocation split	30.09.20	31.12.20	% Change	
Liquidity assets/lower volatility	8.28%	11.51%	+3.23%	▲
Equity-type risk (economically sensitive assets)	86.90%	83.12%	-3.78%	▼
Diversifiers	4.82%	5.37%	+0.55%	▲
	100.00%	100.00%		

Asset class split	30.09.20	31.12.20	% Change	
Equities	75.89%	70.37%	-5.52%	▼
Index-linked bonds	1.38%	0.96%	-0.42%	▼
Conventional government bonds	4.30%	3.49%	-0.81%	▼
Corporate bonds	5.05%	6.73%	+1.68%	▲
Emerging market debt	4.48%	4.75%	+0.27%	▲
Private equity	1.48%	1.27%	-0.21%	▼
Alternative investment strategies	0.14%	1.52%	+1.38%	▲
Property	0.00%	0.00%	0.00%	◀▶
Commodities	3.22%	2.84%	-0.38%	▼
Cash	4.06%	8.07%	+4.01%	▲
	100.00%	100.00%		

Asset allocation ranges

Liquidity	Equity-type risk	Diversifiers
0% to 30%	50% to 90%	0% to 30%

Investment outlook

The array of vaccines is definitely great for the prospects of 2021. Imagine how grim things would be if they didn't exist...

Yet we're trying not to get carried away. There's a long, bumpy path ahead and we have to stay alert to how our businesses are faring. And ensuring that they are adapting to the post-pandemic world that will arrive, one day. It will take a good few months to roll out the vaccines around the world, so inoculation and the change it should bring won't come on suddenly. When we start to emerge from this strange period, it seems ever more likely that it will be gradual, and perhaps in stages. It's been a long, dark year, but we are optimistic about the future.

One thing we aren't optimistic about is the potential for a sustained rise in inflation. With most of the world still battling the virus, GDP won't return to pre-pandemic levels until 2022/23. When inflation does return, we believe it will spike because of the "base effect" – a statistical quirk of recovery from extremely low levels – and then remain much as it has for years and years: muted.

There's just too much debt and too many unemployed workers for this to be any different, in our view. There are also massive changes in the global economy that make it harder for inflation to drive higher. If you think about the most profitable – the most successful – companies of today, they increasingly have little need of capital investment and physical materials. Compared with the past, at least. Most of the profitable growth is in intellectual property, ideas and software, not in tonnes of copper or hoppers of cement. We think that many of these companies are intrinsically deflationary, because they operate to offer more value for less money and to drive efficiency gains for households and businesses. As an example, think of how much you can do with the mobile in your pocket compared with 10 years ago. We doubt mobile prices have kept pace.

GDP growth seems unlikely to roar back in this environment, which is why we focus our investments on those businesses that should be able to increase their profits independently of stronger GDP growth.

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Rathbones
Look forward

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 your original investment.

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