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intermediaries only

# Ditch the models

Time for a  
new approach

Rathbones  
Look forward

David Coombs, manager of the Rathbone Multi-Asset Portfolio funds alongside Will McIntosh-Whyte, shares his seven key investment themes for 2019.

- Prefer equities over bonds, with a focus on growth companies
- Continue to build safe haven assets, including S&P 500 put options, gold, cash and diversifiers
- Gradually add to government bonds as real yields rise
- Maintain exposure to the US, but watch for opportunities in the East

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.



# Ditch the models

**Something has been creeping into our minds over the past few years: in everything from technology, politics and risk to the dynamics of interest rates, the models of yesterday appear to be breaking down. And that accelerated in 2018. We think it's time to throw out some outmoded ways of thinking and ensure that flexibility and open-mindedness protects you from the left-field. While our aims are the same, the structure of our portfolios today are very different to how they were three years ago. Rather than equities, bonds and property, we're now classifying assets as equities and safe havens.**

**There's a lot going on in the world. And, despite what you may read, not all of it is bad!**

Breakthroughs in all sorts of technologies continue to tumble one over the other; so far this millennium rates of crime and war around the world are lower than they have been in hundreds of years – or perhaps ever; and the global economy continues to defy the critics and perma-bears. There are risks out there, there are always risks out there. Life is erratic, the future is uncertain. If you try to think through all the permutations of every possible scenario, you'll wake up in a straightjacket.

We are keeping tabs on several areas that we feel are most important for the global economy: the strength of the American consumer, the *steady* deceleration of Chinese growth and the pace of global monetary tightening. But most of our time is spent ensuring that the companies

in which we invest are the best in their field, that they are being managed effectively and that they have the best opportunities to grow. Finally, but not least, we are constantly assessing whether the price of these assets is right, and whether we should buy more or take profits. As it goes, we've found this shopping list tends to lead us to US companies.

Brexit casts a cloud over the UK and will do for years to come. It has divided the nation and almost definitely slashed the amount businesses have invested here. Yet the UK has muddled through so far. Wages are rising, albeit slowly, retail sales were ok despite some high-profile high street failures and business surveys remain in expansionary territory. We don't think the UK is doomed either way, but we see better investments elsewhere.

As central banks around the world tighten monetary policy, stock prices will be hampered. That's just the way valuations work: as the rate you get for taking zero risk goes up, the value for risky cash flows goes down. While this will likely cause another bumpy year for stock markets, it does come with benefits. Government bond yields are returning to levels where they should offer better protection for portfolios. And for rates to rise, that's usually because countries are growing and deflation is out of the picture. To us, that should be a good environment for well-run businesses with few debts to prosper. That's why we believe a more concentrated portfolio focused on these sorts of companies makes more sense than holding the broad indices, which we think could struggle in 2019.

**David Coombs**  
Head of Multi-Asset Investments



## 1. Life hacking

I live in the countryside, far away from the cash-strapped, relatively short arm of the law. Sometimes, when I'd read too much of the *MailOnline* and had a stressful time of it, I used to lie awake at night worrying about robbers. Nowadays, I worry about hackers. Roaming the house like Hamlet's dad, I become fixated by the blinking lights on the router. Are they normal? Am I vulnerable? What happens if someone is ordering commercial loads of avocados (horrible) to my smart fridge? I'm too old to go bankrupt and too young to see the poetry in it.

Most people are fixated on the geopolitical ramifications of hackers in a digitised world. How are Chinese or Russian or American – or British, for that matter – agents using the internet to attack other states and spread propaganda? We, however, are more interested in how increased cyber-risks will affect consumers and the businesses that serve them. This is the great macro risk of the coming decade, in my opinion. We ponder how to analyse this risk and how to invest in it. Things like cyber insurance have been talked about quite a bit, but that's an ambulance at the bottom of the cliff rather than a fence at the top. There are other, weightier changes that will have to come soon.

Data breaches are becoming more common every day. For many companies, the embarrassment is compounded by the fact that for far too long they weren't even aware they'd been hacked. And this isn't necessarily your local hardware store, many of these businesses are *technology* companies. They should be on this stuff, but many really aren't. That's why we've been making sure we're investing in companies that are taking this risk seriously and taking action to stay on top of it. We think customer outrage will drive change: it's illuminating that when hackers break into banks' systems, they often leave the cash alone and go for the more valuable customer information. In this way, they remain undetected for longer and can sell the information without leaving a breadcrumb trail of electronic transfers.

Companies cannot continue using the woefully outdated systems they usually sport. Better systems that offer greater protection, both to a business's operations and the customer details they hold, are imperative. There should be plenty of opportunities to gain through companies that offer these services, such as Amazon, Adobe and the artist formerly known as Google (Alphabet).

## 2. 5G: third time lucky?

Few sectors are more hated than telcos at the moment. It's one of those fascinating paradoxes: you can't go 30 seconds without seeing a mobile phone, yet mobile carriers have been dismal investments.

Perhaps the problem was that everyone got carried away with the unbridled potential for bundled internet and phone services with a side of streamed television. Unfortunately, technological advances and the scramble for market share sent prices for data spiralling lower. American prices are still much higher than in virtually all other countries – helped no doubt by perilously low competition – but even they have fallen a long way from extortionate over the past few years. And as the global price of data slumped, these companies made punchy investments in whizzy new technology. Unfortunately for essentially monopoly-sized telcos, upgrading your whole network doesn't come cheap – especially when the pace of progress makes your investments obsolete in less than a decade.

Not only that, UK telcos fell over themselves to bid stonking amounts for 3G spectrum in the early 2000s. How long does it take to recoup £22.5 billion simply to use the airwaves? The 4G auction of 2013 attracted just a tenth of that number. At least the telcos learned their lesson! But here's the thing: 2018 was the 5G auction in the UK, the spectrum went for just £1.4 billion. This generation is touted as a truly revolutionary step, one that will lead to the rapid expansion of the internet of things. It's not just self-driving cars and self-stocking fridges that can run on this technology either. It could create massive changes in how we use the internet. For instance, some say 5G will make home broadband irrelevant – we'll run everything from our phones instead. This new world will be years in the making, but it could have profound impacts on our lives and investments.

If the telcos can pick this new spectrum up relatively cheaply, it could prove to be much easier for them to make money in the future.

### 3. China does capitalism better than capitalists

I've been to see Baidu and the whole thing could be American. There's a real entrepreneurial spirit in China that can be seen from youngsters working furiously to better themselves to the massive businesses like Tencent and Alibaba that have risen like shooting stars above the modernised Chinese economy. About 60% of Chinese people live in urban areas today, only 24 years ago that was the proportion of Chinese living in the countryside. Hundreds of millions of Chinese now live in some of the world's largest metropolises, many of which didn't exist a generation ago.

The expansion in China's economy and wealth has been breathtaking. It hasn't been all roses, of course. The nation's human rights record is atrocious, labour protections are limited and were reluctantly extended only because of mutinous workers. Consumer product scandals have been rife, with dangerous gadgets and poisonous food. But it's exactly this lack of restraint that's allowed the economy to leapfrog from 10<sup>th</sup> to the second-largest market in the space of three short decades.

China has come to an interesting crossroads now. It is no longer an underdeveloped nation hustling its way to affluence. Yes, much of the country is tremendously poor and lagging behind technologically, but as a nation China has arrived as a major global power. This is true economically, militarily and culturally. It has tried to continue snubbing internationally-recognised intellectual property rules and trade laws that are generally agreed at the top table of geopolitics. This will become much more difficult as time goes on. You're seeing it now with President Donald Trump's trade vendetta.

China doesn't need to rely on corporate skulduggery or questionable practices to succeed. In fact, these old habits are now probably hindering the nation.



## 4. The middle is toast

More than anything else, one thing has been at the top of our mind lately: if you're not the cheapest or the best, you're toast.

This really hit home to me on my trip to the US in May 2018. I visited numerous companies that were investing heavily in their bid to stay one step ahead of Amazon. Or if not Amazon, then the disruption it overwhelmingly represents. Back in the 1980s, chief executives would spook each other with stories of corporate raiders that would swing aboard comfy conglomerates, cut them up and sell off everything – even the corporate jet. Nowadays chief executives are stuck in more of a Terminator kind of nightmare. Amazon has been merciless in its advance on many industries, finding ways to cut costs and improve customer satisfaction. It's not just Amazon though; Alphabet has decimated traditional media, companies like Netflix and Hulu offer much cheaper TV than cable providers and ride-hailing/sharing apps are hurting taxi and rental firms.

Many incumbent businesses took way too long to adapt to the new world and were punished for it. We invest in several companies that are doing the punishing, but we also own businesses that appear able to see off flash new rivals. As I said before, this tends to boil down to being indispensable to customers, the cheapest in the business or both. Typically, we find the best companies aren't aiming to be a bargain basement, but instead offer a premium product. Like chemicals company Ecolab: it sells cleaning agent for substantially more than rivals, but its efficiency helps customers save money overall compared with lesser brands. Or US Bancorp, a mid-tier lender that realised most people – Millennials included – want to come to talk to a human when it comes to massive decisions like mortgages and life assurance. It found that it should invest in its branches and aim to provide a suite of services for these people. There are a myriad of other examples of companies figuring out what makes themselves useful, but you get the idea.

Of course, having a good product or service is only part of a successful business. You have to be able to convince customers of it too.





## 5. More political meddling

Price caps on utility bills and railway fares are becoming ever more popular with British voters. Even nationalisation is on the agenda. Interventionism used to be crankery, but now it's squarely mainstream.

Part of the reason for this is that many people feel they've had a raw deal over the past decade. Pay has gone virtually nowhere, yet monopoly services rise inexorably in price each year. Some of these increases are warranted, some aren't; some of the public anger is warranted, some not. The UK rail network – and most of the franchises that run trains along it – is badly run, expensive and terrible at customer service. But state-run rail wasn't much better! As for utilities, energy costs have increased dramatically and that's been exacerbated by a large devaluation of sterling, too. In the main, these companies make reasonable profits, but regulators ensure their margins are pretty thin. They have to pass on higher costs because otherwise they'll go out of business.

The long and short of it is, politics seems to be having a greater effect on business than it used to. People are angrier and policies are getting more extreme. You can no longer rely on laissez-faire governments. Apathy is no longer ok – for customers or regulators. Any industry that makes its pricing opaque (car insurance) or has a whiff of hurting the

vulnerable (power companies and gambling companies) is likely to be targeted. Politicians are becoming more inclined to tinker with the efficient market model to show they are listening to the masses and we think the tentacles could creep farther than you think. Unfortunately, history tells us that intervention tends to save up trouble for down the road. And it's not just happening in the UK. Donald Trump often calls out 'wrongdoing' companies on Twitter. He's especially partial to pointing out high drug prices, which in many ways is America's answer to British railways. You get a worse service than other countries but at an extortionate cost.

All over the world there's increasing support for protectionism, which is virtually the same thing as interventionism. The US is facing off against China and its allies over trade, which has reverberated around the world. While we think nations will be better off coming to terms over trade rather than continuing tit-for-tat tariff battles, it could be some time before they agree. To protect ourselves against this market ruckus, as well as any tariff-induced consumer price rises, we are holding a good slug of commodities, from gold and pork bellies to steel, grains and coffee.





## 6. Shaping up for a backlash

Over the past couple of decades, everyone got fatter and died much later than their parents. That reached its peak in the last few years: super-fast internet meant you could work from home and get everything you ever needed delivered to your door. You could catch cabs everywhere like a Manhattan heiress and modern medicine ensured your bad decisions didn't catch up with you for years longer than you deserved. The wonders of technology.

Lately, something has changed, however. In many advanced nations life expectancies have started falling again. This has led to some interesting backlashes. Suddenly no-one is celebrating how advances in food technology, such as genetic modification and preservatives, have made food cheaper and cut down on waste. People have rebelled by craving local, organic and less uniformly shaped fruit and vegetables.

At the same time, people are striving for a very uniform shape for themselves: slim and toned. The number of gym-goers has skyrocketed, especially among the cash-strapped younger generations. And all the while people are augmenting their ultra-fresh diet with eyebrow-raisingly artificial powdered supplements. In the hunt for health, we think companies like Abbott Laboratories should prosper. Not only does it own a leading diabetes monitoring test (unfortunately, demand is soaring worldwide), but it also produces scores of nutritional supplements, from baby formula to vitamins.

Similarly, I've found myself pondering whether a similar backlash is coming in social media. Younger generations baffle me, but – as I happen to have fathered a 30-something and a teenager – I try to stay abreast of what they are up to and how they think. As we all know, this batch of kids (and young adults) was raised surrounded by a ubiquitous internet. Virtually all of them took to it like ducks to water. For the selfie generation, if it's not uploaded it didn't happen. But here's an intriguing thought: what happens if they abandon social media – or, at least, desert the social media giants of today? Increasingly, social media has become poisoned, mired in vitriolic political arguments, fake news and creepy social experiments playing with people's moods. Facebook is now the domain of middle-aged parents documenting Abba tribute shows down the local and sharing Brexit memes. Even Snapchat, a more privacy-conscious option for users, has started to flag this year.

What if Generation Z goes analogue?



## 7. A 90s argument

Many companies today peddle the idea that people in emerging markets are dying to buy Western consumer brands. They are scrimping and hoarding cash so they can get themselves some Air Jordans or to taste Froot Loops, just once.

We feel this is a very dated argument. And an arrogant one, imagining people in developing countries aspire only to our most humdrum everyday. We think most people in emerging markets think about shopping the same way we think about shopping. They care about value, and like us in the West, they see little reason to buy a branded detergent at three times the price of a local product that does the same job with a smaller marketing budget. Twenty years ago, local consumer products were ropery, inconsistent and scandal-ridden. Now, in many cases, these factories are on a level playing field with those that churn out the Western brands. In some industries, they may even be the *same* factories.

And as emerging middle classes grow, the importance of local tastes is starting to rise. Some Western consumer companies have been guilty of running a global culture strategy from headquarters in

London or New York when they should have been hiring local managers who know what their countrymen and women really want. Everything from the scent preference of cleaning products to the taste of toothpaste and how your marketing draws customers in can be completely different depending on the nation.

The new age argument for emerging markets is luxury brands. The number of millionaires being created in the developing world is phenomenal. And they are looking for something that simply cannot be delivered by local usurpers: signals of their status. They want fine French wine, fine Swiss watches and fast Italian cars. They want top of the line cosmetics, bona fide jewellery and haute couture (or at least limited-run dresses). That's why we own premium perfumery and make-up company Estée Lauder and LVMH, a holding company for a range of ultra-high-end luxuries that spans many industries.

We believe consumer brands are too slow to realise that they aren't luxuries and too far removed from emerging markets to avoid getting outflanked by more adaptable local rivals. But as middle classes and the number of millionaires swell in developing markets, we think the demand for true luxuries should rise noticeably. As long as they can keep control of their brand, that is.



# Get in touch

For more information, contact our intermediaries team on **020 7399 0000** or visit **rathbones.com**

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