Rathbone Dynamic Growth Portfolio

Quarterly investment update, July to end September 2021

Rathbones
Look forward

Gaslighting. The price of natural gas has risen rapidly this year all over Europe, driven by a cooler summer ratchetting up demand alongside the reopening of many nations after lockdowns. The European carbon credit price (the cost of emitting a tonne of carbon dioxide) has soared more than 80% since the beginning of the year, a sign of much-increased demand from industry and/or increased power generation by carbon-heavy producers, like coal plants. The energy crunch is most acute here in the UK, however, where the gas price is four times what it was at the beginning of the year. At one point in September it was 85% higher than the last record high posted in 2008. We think this is a bit of a reality check on our progress towards cleaner energy. Everyone agrees with the need to change – and quickly – but perhaps more thought needs to go into ensuring our network is set up for the new world. Because if the strategy isn't right it risks times like we're experiencing, where prices balloon, hitting people in the pocket and potentially turning them off green energy altogether. About half of the UK's electricity is generated with gas, and that only accounts for 30% of the gas we use. Fully 40% is used to heat homes and fire gas cookers, with the rest going to industry. Along with petrol, the single most crucial element of UK energy is natural gas. Yet the UK has one of the lowest gas storage capacities in Europe, with enough to cover just four to five winter days of demand. In 2017, a 30-year-old Centrica-run storage facility boasting 70% of the nation's tanks was shuttered because the company and the government didn't see the benefit in paying for the costly upkeep and essential upgrades of the site. Meanwhile, the best days are behind the North Sea gas fields, making the UK more reliant on imported gas. We have done extremely well to boost our renewable generation and dramatically reduce our carbon emissions. But there's still a long way to go. As maligned as oil and gas are, virtually everything in our society relies on them. Whether for comfort, production, packaging, transportation, or all four. This needs to change if we are to avoid dramatically altering our planet. Yet today, despite all our efforts to change, if oil and gas disappear, you're going to know about it.

Inflated importance. As economies try to get back into their rhythm, dogged by interminable waves of COVID-19, markets for everything from labour and energy to bread and computer chips have been upended. This has sent inflation bouncing higher in most of the world as businesses struggle to attract staff and buy the essentials. Currently inflation is higher in the US, at a 13-year record of 5.4%, yet it's the UK that concerns us more. The headline rate was 3.2% in August, but September and October have been chock-full of shortages: fuel, gas, staff, groceries and other imported goods. These are global issues, but they have hit the UK harder because of poor energy storage and bad labour market policies. All this puts the Bank of England (BofE) in a difficult position: its policymakers have about as much idea of the path of inflation over the coming year or two as any of us in these strange times. It's tough to tell. British inflation is almost definitely going higher in coming months. But this sort of inflation – 'cost-push', driven by higher supply costs – isn't the sort that can be solved by higher interest rates. Raising rates can only reduce households' and businesses' demand for goods and services by increasing the cost of borrowing and boosting the incentive to save rather than spend. Raising rates can't get the fuel to the pumps quicker, make it rain for the soybean crops in Brazil, grease the export of raw materials from COVID-cagey Australia or open ports in China. If the BofE acts too quickly, it could simply make things worse. It may even spark stagflation – putting the economy into reverse while persistent inflation eats away at people's spending power.

(N)Evergrande. China has battled a dangerously inflated property boom for many years now. Developers borrowed heavily from investors all around the world, using the cheap debt to finance countless apartment blocks and houses thrown up all over China. Demand for these homes, both as abodes and investments, was huge. However, many companies overstretched themselves, repaying maturing debt with ever more debt as they chased sales growth. This has finally come to a head with Evergrande, China's largest real estate developer defaulting on debt and essentially becoming the world's largest zombie company after China tightened up leverage rules. The government is trying to stop runaway price inflation in homes and encourage developers to become more financially responsible. It seems to have had the desired effect on property prices, but it may also destroy developers rather than bring them to heel. Concerns about Evergrande and its aftermath have hit the Hong Kong stock market the hardest. The satellite market – which used to be the largest in China and is typically used by overseas investors – came off worse following the government's recent crackdowns on technology and education businesses as well. Investors are worried that China may allow Evergrande to fail in the messiest possible fashion as a warning to the others. If so, this could set off a wildfire of fear, fire sales and plummeting prosperity that would dramatically slow Chinese GDP growth. That would have a knock-on effect for the whole world. We think China is unlikely to allow this own goal to happen. We expect the government to wind down Evergrande over the coming years, parcelling parts off to state-owned banks, perhaps creating a bad bank for the most toxic assets and letting bondholders take a bath.

Portfolio activity

Key purchases/additions	Key sales/trims
Societe Generale US rates volatility note (new purchase)	JP Morgan Japan Investment Trust (sale)
Shimano (new purchase)	Dexcom (trim)
Paccar (new purchase)	ASML (trim)
Caterpillar (new purchase)	iShares MSCI Far East ex-Japan ETF (trim)
Squarespace (new purchase)	

Source: Rathbones

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 US rates volatility note**, 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.

We continued a general shift towards more inflation-sensitive, 'quality cyclical' businesses during the quarter. One of them was Japanese manufacturer **Shimano**, which makes gears, brakes, cranks and other components, along with returns on equity in the mid-teens. It has a reputation for quality among cyclists and is heavily embedded in the production of most bike manufacturers (it supplies between two-thirds and three-quarters of bike gears and brakes globally). That has translated to compound earnings growth of almost 20% over the past three years. With more of us hanging round the neighbourhood in the flexi-working age and lots of government money getting funnelled into cycleways, this should lend a strong global tailwind to cycle manufacturers and their suppliers.

Another more cyclical addition was American lorry maker **Paccar**, which 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.

We also bought **Caterpillar**, the big yellow truck and dozer company. This business's fortunes are closely tied with global economic growth because its customers are raw materials producers, farmers and construction firms. These industries tend to run hot and cold depending on the economic cycle, yet Caterpillar is in no way a boom or bust company. It is renowned as a quality brand and it is run by cautious managers who are careful not to oversupply the market or degrade the quality of its machines. It focuses on selling to quality operators who are more likely to still be around in 10 years to swap in new machines, rather than ramping up production to sell as much as possible. This is important to ensure that the company doesn't overstretch itself and walk into an economic funk with more machines and production lines than it can sustain.

As another bit of defence against a sustained uptick in inflation, we continued to add to **US Treasury Inflation-Protected Securities 0.25% 2025** and **0.125% 2024** 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.

A 'growthier' addition to our equity portfolio was **Squarespace**, 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.

Finally, we took profits from some of our more high-flying stocks, including diabetes monitoring business **Dexcom** and computer chip printer manufacturer **ASML**.

Spotlight

In this quarter, the spotlight is on our holdings **Adobe** and **Christian Hansen**.

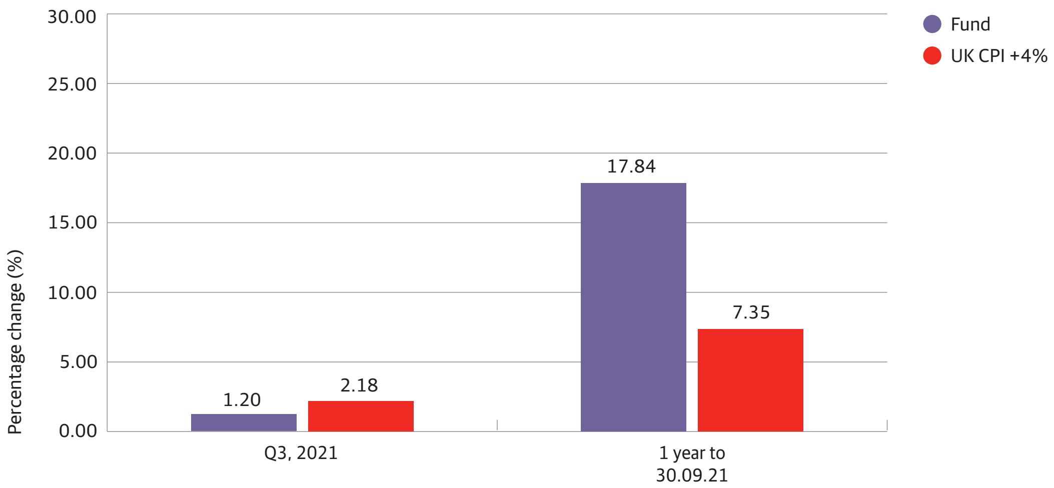
Adobe

- A US software company that creates digital media, design and publication tools for professionals and hobbyists alike
- Outside of the pros most will know Adobe for the PDF which has become a mainstay of the digital document world
- Adobe's expansion into areas like digital marketing software, cloud collaboration and document digitisation provide further drivers of growth in the future
- Like many software companies, Adobe moved from licensing to subscriptions, which has provided attractive levels of cashflow and line of sight to future revenues
- As more publishing and design has moved to digital Adobe has been at the forefront of this transition, providing people with the vital tools required for modern designers and marketeers – in the digital marketing and design world it's pretty hard to do your job without them these days

Christian Hansen

- A global bioscience company who are one of the leaders in developing natural solutions for the food, nutritional, pharmaceutical and agriculture industries
- The company has a long history of innovation which continues to this day, along with highly scalable production facilities which all provide barriers to entry for competitors wishing to enter the space
- Christian Hansen have been working with microbes for over 145 years so have significant expertise in finding new and useful strains and can then produce them at scale to help their customers
- With health and wellbeing such a significant focus, some of the work Christian Hansen do attempts to effectively help the food and agriculture industry achieve better crop yields and reduce the need for additives, along with providing probiotic supplements for a healthier digestive system
- Finally, there continues to be a significant but vital focus around the world on food waste – Christian Hansen produces solutions to improve freshness, safety, and the life of food products thereby making strides to support the need to reduce food waste

Fund performance



Performance (based on 'S-class' shares).
Net of expenses and tax. Net income reinvested.

Data source: FE fundinfo

Discrete annual performance					
Year to:	**End Sep 2017**	**End Sep 2018**	**End Sep 2019**	**End Sep 2020**	**End Sep 2021**
Fund	–	–	–	–	+17.84%
UK CPI +4%	+6.98%	+6.71%	+5.84%	+4.21%	+7.35%

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.

Top performers (%)		
Holding	**Performance**	**Contribution**
Dexcom	+31.30	+0.25
CTS Eventim	+23.58	+0.10
Rentokil Initial	+18.32	+0.15
Costco	+16.57	+0.14
Thermo Fisher Scientific	+16.40	+0.15

Bottom performers (%)		
Holding	**Performance**	**Contribution**
Tencent	-18.77	-0.12
Smith & Nephew	-16.61	-0.17
China AMC China Opportunity Fund	-15.68	-0.25
Squarespace	-11.17	-0.04
Rio Tinto	-10.62	-0.12

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.

Source: Rathbones

The quarter began on a strong footing for risk assets with markets continuing their ascent and the S&P 500 making new all-time highs again. Bond yields had dipped fairly sharply at the back end of Q2 and that continued in Q3. This was to be short lived though as yields moved significantly higher through September, particularly in the UK with the 10-year now at highs for the year. It would seem those fears around inflation aren't going away as investors and central banks wrestle with the data to figure out whether this inflation is transitory or more likely to hang around. Against that backdrop it was a positive quarter across the portfolio with equities being the main contributor to performance. During the quarter we saw US names like **Dexcom**, **Thermo Fisher Scientific**, and **Edwards Lifesciences** all provide valuable contributions after solid earnings. In Europe we also saw **Eurofins Scientific** report an excellent set of results and rally meaningfully afterwards, along with **ASML** continuing to push higher over the quarter but give back some of that performance at the end of September. We saw meaningful contributions from our **Commodity ETF** exposure as commodity prices moved higher still. Our oil exposure via the oil majors, **Shell**, **BP**, and **Total Energies** were all positive contributors and benefitted as the price of oil pushed on towards, and in the case of Brent crude beyond, $80 a barrel.

Fund performance (continued)

We saw some pressure on our China exposure in the wake of some of the actions the CCP took against the education sector and some of the technology space in the country. As we have discussed before, we remain comfortable holding the exposure we have at present, but this pressure manifest in negative contributions from **Tencent**, **AIA**, and the Chinese equity fund we own, **China AMC China Opportunity Fund**. We have also seen continued pressure on **Smith & Nephew** who have been hit by issues around health services getting back on their feet fully in the elective surgeries, which the company is reliant upon within their hip and knee replacement business. The US had shown progress in this area but sadly where a number of states began to see a surge in COVID hospitalisations we saw state governments and hospitals revert back to postponing many non-urgent elective procedures. This is one reason why the fortunes of Smith & Nephew and Edwards Lifesciences has been so different during the year - hip and knee replacements can perhaps be postponed more easily without dire consequences, whereas that is not the case with the heart valve replacement surgeries which Edwards rely upon. Finally, as expected the **put options** were a negative contributor over the quarter as equity markets pushed higher overall.

Asset allocation ranges

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

Asset allocation change and strategy

There were no significant asset allocation changes during the quarter.

Asset allocation split	30.06.21	30.09.21	% Change		12 month change	
Liquidity assets	16.07%	12.95%	-3.12%	▼	4.67%	▲
Equity-type risk	77.95%	78.61%	0.66%	▲	-8.29%	▼
Diversifiers	5.98%	8.44%	2.46%	▲	3.62%	▲
	100.00%	100.00%				

Asset class split	30.06.21	30.09.21	% Change		12 month change	
Equities	72.25%	72.61%	0.36%	▲	-3.28%	▼
Index-linked bonds	0.54%	1.38%	0.84%	▲	0.00%	◀▶
Conventional government bonds	2.25%	1.95%	-0.30%	▼	-2.35%	▼
Corporate bonds	3.79%	3.94%	0.15%	▲	-1.11%	▼
Emerging market debt	3.65%	3.57%	-0.08%	▼	-0.91%	▼
Private equity	1.10%	1.02%	-0.08%	▼	-0.46%	▼
Alternative investment strategies	1.65%	4.05%	2.40%	▲	3.91%	▲
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	1.49%	1.86%	0.37%	▲	-1.36%	▼
Cash	13.28%	9.62%	-3.66%	▼	5.56%	▲
	100.00%	100.00%				

For more information on our liquidity, equity-type risk and diversifiers (LED) risk framework, please consult the our investor brochure.

Investment outlook

As 2021 has progressed, risks have risen almost in line with stock markets.

In response to this, we've felt it prudent to take profits from some of our better-performing stocks, particularly those in the technology space that benefited considerably from the shift to remote working and increasingly digital lives. We've been reinvesting that money into two sorts of assets: more cyclical companies that should do well if the economic recovery continues to accelerate, taking inflation with it; and defensive assets that should protect us if inflation gets out of control, interest rates go on a tear or stock markets simply go into reverse.

Don't get the wrong idea — we're not incredibly concerned about the future. On the contrary! We believe the world will mostly likely continue to grow steadily, taking markets with them over the coming years. But asset prices have had a stellar run and people are casting round for worries, so it's no time to be a hero. Best to lock in some profits and make sure we're prepared for the unexpected. That's why we've been piling up the sandbags in our portfolio. We hope we won't have to use them, but it's always best to be prepared.

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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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