Rathbone Greenbank 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. There is no doubt of 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, many parts of our society still rely 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)	–
UK Treasury 1/8% Index-Linked 2031 (new purchase)	–
Orange 8.5% Senior 2031 (new purchase)	–
Japanese Government 0.1% 2022 (new purchase)	–
JP Morgan Emerging Markets FX Momentum (addition)	–

Source: Rathbones

As the portfolios launched this year, and we are seeing consistent inflows, there have been no key sales/trims during the quarter

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 since the fund's launch, 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.

In July and August, we bought **UK Treasury 1/8% Index-Linked 2031** bonds to protect ourselves from further increases in inflation. Unlike 'conventional' gilts, where coupon payments and capital returned at maturity are fixed, 'linkers', as they are called, have coupons and principal that increase in line with RPI inflation. Following the end of the quarter, inflation expectations in the UK had soared to the point where linkers looked very expensive, so we took some profits from these bonds.

In August, we bought **Orange 8.5% Senior 2031** dollar bonds at an attractive credit spread to increase our exposure to the dollar.

We added to the **JP Morgan Emerging Markets FX Momentum** structured product during the quarter. This contract with an investment bank gives us exposure to a 'momentum' index of emerging market currencies. It uses price trend data 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.

We also bought **Japanese Government 0.1% 2022** and **0.1% 2023** bonds during the period. While they yield less than nothing, they give us the protection of yen exposure, a currency that usually appreciates when worries rise and stock markets (and sterling) sell off.

Spotlight

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

Trex

- The world's first and largest producer of composite outdoor decking, made from timber and recycled plastic, for both residential and commercial use
- Their unique protective shell technology creates a superior product which is resistant to fading, staining, scratching and mould – helping to maintain their competitive strength and market share
- Trex uses what would normally go to waste, for example recycled plastic film, bags and wraps and reclaimed wood, to create durable decking made from 95% recycled and reclaimed materials
- As one of the largest buyers of recycled polyethylene film in North America, their recycling programme has 32,000 collection stations which help divert plastic from landfills
- The growing popularity of outdoor living spaces and consumer trends towards choosing more sustainable products should provide Trex significant growth opportunities in a still relatively lowly penetrated market

Adobe

- A US software company that creates digital media, design and publication tools for professionals and hobbyists alike
- Adobe's innovations in cloud-based software delivery, paperless workflows and virtual collaboration all help to reduce physical waste and cut emissions from transportation and delivery
- Like many software companies, Adobe moved from licensing to subscriptions, which has provided attractive levels of cashflow and line of sight to future revenues
- Adobe Digital Academy offers career switchers with scholarships, apprenticeships, and mentorships at an Adobe office to give them the education and experience they need to launch successful careers in design, data science and software engineering
- 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

Fund performance

Top performers (%)		
Holding	**Performance**	**Contribution**
Dexcom	+31.21	+0.30
Shimano	+27.11	+0.27
Sartorius	+21.73	+0.26
Thermo Fisher Scientific	+16.44	+0.20
Eurofins Scientific	+16.39	+0.18

Bottom performers (%)		
Holding	**Performance**	**Contribution**
GN Store Nord	-18.23	-0.20
Smith & Nephew	-16.62	-0.23
Smith (AO)	-12.43	-0.17
Vodafone	-6.61	-0.08
Clorox	-5.20	-0.07

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, performance for the portfolio has been fairly positive over the quarter, mainly driven by the months of July and August. Equities were the leading contributor with our US exposure and European exposure adding the most. A few names to highlight which were significant parts of this strong performance were **Dexcom**, **Thermo Fisher** and **Cadence Design Systems** in the US, as well as **Sartorius** and **Alfen** in Europe. **Edwards Lifesciences** made significant gains after reporting stronger than expected Q2 results in late July. This was driven mainly by the growth of their heart valves as the economic recovery enabled important replacement surgeries to re-commence soon after the pandemic and at high levels. This segment continues to deliver meaningful upside for the company, and management has also innovated around this concept in order to take advantage of the long-term growth opportunities. **ASML** also had strong performance and reported impressive gross margins earlier this quarter. They have benefitted from the chip shortage which has meant customers are eager to upgrade software to increase capacity as soon as they can. As ASML has a near monopoly in the machines needed to produce chips, this gives them particularly strong pricing power, helping their margins and results. The chip shortage also highlights the importance of ASML's innovative photolithography machines as our reliance on semiconductors grows.

UK equities were more of a drag including **Smith & Nephew**. They have primarily struggled due to uncertainties around non-urgent surgeries caused by the COVID-19 pandemic, and this led them to miss Q2 revenue expectations. However, as much of Europe and US continue to emerge out of the worst of the pandemic crisis, elective procedures should resume strongly, boosting their performance. The company has also maintained its research and development spend and launched innovative products including a new handheld orthopaedic robotic-assisted surgical system for knee surgeries which gives us continued confidence in this business. 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

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	14.31%	16.19%	1.88%	–
Equity-type risk	81.14%	77.82%	-3.32%	–
Diversifiers	4.55%	5.99%	1.44%	–
	100.00%	100.00%		

Asset class split	30.06.21	30.09.21	% Change	12 month change
Equities	76.58%	73.97%	-2.61%	–
Index-linked bonds	0.69%	1.24%	0.55%	–
Government bonds	4.32%	4.80%	0.48%	–
Corporate bonds	4.56%	3.85%	-0.71%	–
Emerging market debt	0.00%	0.00%	0.00%	–
Private equity	0.00%	0.00%	0.00%	–
Alternative investment strategies	4.55%	5.99%	1.44%	–
Property	0.00%	0.00%	0.00%	–
Commodities	0.00%	0.00%	0.00%	–
Cash	9.30%	10.15%	0.85%	–
	100.00%	100.00%		

Sustainable category split	30.06.21	30.09.21	% Change
Decent work	14.52%	13.86%	-0.66%
Resource efficiency	11.40%	10.76%	-0.64%
Habitats and ecosystems	0.00%	0.00%	0.00%
Inclusive economies	1.43%	1.30%	-0.13%
Energy and climate	15.80%	16.09%	0.29%
Health and wellbeing	17.41%	15.91%	-1.50%
Resilient institutions	5.01%	6.04%	1.03%
Innovation and infrastructure	20.58%	19.90%	-0.68%
Diversifiers	4.55%	5.99%	1.44%
Cash	9.30%	10.15%	0.85%
	100.00%	100.00%	

The 'resilient institutions' category includes government bonds.

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 let the size of some of our better-performing stocks shrink as a proportion of our fund, particularly those in the technology space that benefited considerably from the shift to remote working and increasingly digital lives. We've then been adding to 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 make sure we're prepared for the unexpected.

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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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