Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone UK Opportunities Fund

Quarterly update March 2022

Markets held up well in March, offering a glimmer of recovery after a punishing quarter for 'growth' stocks.

Some investors are puzzled by this resilience in March, given there was little let-up in the concerns that have driven markets in 2022: higher inflation, higher interest rates, and clogged supply chains. As always, stock market moves are a function of where you start from. Markets very quickly front-loaded a lot of negatives in February as the war in Ukraine broke out. And while there's no end in sight to the conflict, there's been no further major market-moving deterioration in the outlook on that front. But, clearly, the longer the war continues, the greater chance of oil and gas sanctions and the harder it will be to claw back economic growth in Europe.

Investors have been contending with interest rate rises from the US Federal Reserve and Bank of England to combat the rapid increases in the cost of living. The war has exacerbated inflationary worries, while at the same time hastening concerns that we could be approaching a marked slowdown in economic growth.

	3 months	6 months	1 year	3 years	5 years
Rathbone UK Opportunities Fund	-15.9%	-13.1%	-0.4%	26.6%	25.4%
IA UK All Companies Sector	-4.9%	-2.9%	5.4%	17.5%	24.1%

	31 Mar 21-31 Mar 22	31 Mar 20-31 Mar 21	31 Mar 19-31 Mar 20	31 Mar 18-31 Mar 19	31 Mar 17-31 Mar 18
Rathbone UK Opportunities Fund	-0.4%	45.9%	-12.9%	-6.7%	6.2%
IA UK All Companies Sector	5.4%	38.0%	-19.2%	2.9%	2.7%

Source: FE Analytics; data to 31 March, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future returns.

The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

Anticipated but still regretted, our underperformance this quarter was largely due to the much-discussed rotation out of historic winners and into 'value' cyclicals. As an example, investors sold their tech positions and bought energy companies instead. For a fund like ours, that dynamic is a big headwind — our biggest fallers during the period were some of the rockstars of previous years (software firm **Kainos**, specialist publisher **Future**, luxury mixers brand **Fever-tree Drinks** and sportswear retailer **JD Sports**). Another development that hurt us was the reversal in the usual outperformance of UK mid-caps over large-caps, thanks, in the main, to the FTSE 100 Index's heavy weighting to energy and mining companies which became temporarily more attractive as oil and commodity prices shot up. Our fund doesn't own any oil or mining companies — they don't meet our quality hurdles — but we do have exposure to renewable energy. This sector looks even more attractive given the seismic shifts in European energy strategies following Russia's invasion. Similarly, hastily planned investment in oil and gas facilities to replace links with Russia have boosted oil services companies' share prices. Also, changes in Continental military budgets have buoyed defence companies as well. The FTSE 100 also has a chunky healthcare weighting, a classic defensive place to hide out when uncertainty rules.

To demonstrate what a strange and tricky market we're in, the FTSE 100 is up 2.9% year-to-date, but only 29 stocks in the index have actually made gains. Small and mid-cap underperformance (the FTSE 250 is down 9.5% and the AIM 14.2%), on the other hand, has been as broad as the outperformance of large caps has been narrow.

We also observe a classic allocation dynamic. When investors start warming up to a market they've long shunned, like the UK, we usually see the first inflows coming into large-cap, passive indices. It's only when the trend takes hold that flows start moving on a stock-specific basis and into smaller-cap indices. We aren't surprised to see global investors nibbling away at UK assets once more. UK stocks are more insulated from Russia than their eurozone counterparts and enjoy significantly more appealing valuations than US stocks. In our view, this looks like a pretty attractive combination.

Our experience and recent conversations with management teams persuade us to position ourselves more defensively to protect against slowing GDP growth. But we also believe that inflation is close to peaking and should soon fall sharply. For our portfolio, this means we won't be chasing cyclical, inflation-beneficiary type companies — we think this trade has largely run its course. Instead, we will be adding to our highest-quality names. We're convinced that resilient and reliable growth companies that take in a lot of cash and boast 'clean' accounts are a great form of defence.

Meanwhile, we don't have lots of exposure to the UK consumer, as this is an area that looks vulnerable in the face of tax rises and rising energy bills. So no pubs, restaurants or leisure facilities and no retailers of expensive 'nice-to have' gear like electronics or furniture. One bright spot, however, could be spending on home renovations, which is still very strong, supported by post-COVID lifestyle changes. For instance, kitchen manufacturer **Howden Joinery** has raised its earnings forecasts by 20% for this year. And **JD Sports'** average customer is still living at home, so isn't paying their own energy bills. We're also adding to our companies that benefit from the capital expenditure of businesses, whose investment intentions are extremely high. Construction and heavy machinery equipment rental company **Ashtead** says that it's rarely seen such a positive construction environment in the US, and IT solutions provider **Bytes Technology** is benefiting from very strong demand for software upgrades.

We still have around 5% of the portfolio in cash thanks to inflows and a lack of the usual IPO pipeline, so expect news on a new holding or two next time.

Alexandra Jackson
Fund Manager

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. 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 what you originally invested.

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