Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Greenbank Global Sustainability Fund

Quarterly update March 2022

As inflation rose ever higher in the first months of 2022, it became clearer that central banks felt the need to hike interest rates substantially in response. This had a severe effect on stock markets, sending many share prices tumbling and lighting a fire under others. Your fund had more than a few of those businesses that dropped sharply so performance was weak over the first quarter.

We're really sorry about this. Unfortunately, there were few places to hide. The types of companies that have done well over the past three months are those that we either can't own or don't want to own.

The Bank of England (BoE) was the first major central bank to react to rising prices by increasing its benchmark interest rate to 0.25% in mid-December. It has since hiked by a further 0.50% in back-to-back meetings, taking the bank's benchmark rate to 0.75%. We think another one or two 25-basis-point hikes are yet to come this year. Some investors expect four or more; however, we think that would be overkill. In recent meetings the BoE has seemingly agreed with that opinion by highlighting that their economic models forecast a rise in unemployment next year if it were to increase rates that rapidly. The BoE also noted that it would lead to years of below-target core inflation (which strips out energy and food, both highly volatile and seasonally affected).

	3 months	6 months	1 year	3 years	Since launch (16 July 18)
Rathbone Greenbank Global Sustainability Fund	-13.2%	-8.5%	2.5%	51.7%	47.5%
IA Global Sector	-5.0%	-0.5%	8.4%	43.2%	42.9%
FTSE World Index	-2.0%	4.8%	14.9%	51.2%	54.0%

	31 Mar 21-31 Mar 22	31 Mar 20-31 Mar 21	31 Mar 19-31 Mar 20
Rathbone Greenbank Global Sustainability Fund	2.5%	44.6%	2.4%
IA Global Sector	8.4%	40.6%	-6.0%
FTSE World Index	14.9%	39.9%	-6.0%

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

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

Risks today, opportunities tomorrow

For your investment, prevailing interest rates in the US are more important. That's because America is the dominant economy, its currency is the default for international commerce and its government bonds are considered the gold standard of safe-haven investment. When investors start to value any investment they tend to begin with the expected return on government bonds, i.e. the bond yield, and then they demand more return on top of that for the risks they are taking on. The yield of those US Treasury bonds has jumped from 1.51% to 2.35% by the end of the quarter. Since month-end they have leapt even higher to almost 3.0%. This has been driven by a booming US economy, higher inflation and the consequent rate increases from the US Federal Reserve, which are expected to take its benchmark interest rate to 2.75% by the end of the year. That's a large step up from today's 0.50%.

As interest rates and prevailing bond yields quickly increased, it meant the value of profits due far out in the future dropped. This disproportionately affects 'growth' companies because they are investing in themselves in pursuit of greater profitability on much larger revenues once they get big enough to dominate their markets. In effect, these businesses are foregoing profits today on the hope of delivering much greater returns further down the road.

Added to the rapid rise in the cost of money, the harsh atmosphere led many investors to focus like a laser on the short term: any company that disappointed even slightly on its sales growth or reported higher-than-expected costs was sold aggressively. There have been some breath-taking drops in share prices because of these knee-jerk reactions. Some will no doubt be warranted, but for others we're not so sure. We are looking for strong businesses that are helping make the world better while delivering you a good return over many years.

Right now, there are economic forces at work making it harder and more expensive to do business. But we think this is a passing phase, driven by the sudden and traumatic shock of the pandemic and the equally jarring reopenings (with some repeats for good measure). The greatest features of market economics are the flexibility and automatic incentives to solve problems and meet society's needs. When something is scarce and valued, its price rises and encourages people to make more of it or find a better alternative.

I believe that, in time, markets will help sort out the recent disruptions caused by snarled up supply chains and higher energy prices. That's why we're focusing on finding those businesses with strong cash flow, low debt levels and a clear source of increasing demand for what they produce over five, 10 years and beyond. If you're debt-free and have lots more cash coming in than going out, you have many more options to deal with any unexpected hiccups. The same goes for companies. They should have the flexibility to adapt to tough times so that they can take advantage of the longer-term opportunities.

Crisis in Europe

The quick rises in energy prices, inflation and interest rates were of course compounded by Russia's invasion of Ukraine. War is always awful and this one is no exception. The stories from the embattled nation are harrowing and the devastation foisted on the Ukrainian people is heartbreaking.

The war has sparked some discussion in the market about whether arms companies deserve a place in sustainable funds — because they also "arm the good guys". We categorically disagree. The right — and indeed the responsibility — of nations to defend their people is a reality. And that requires investment in weaponry. However, it should not be done by our investors. George Orwell once noted that for pacificists to have the luxury of their convictions it requires other people to commit violence on their behalf. That pacifists can object to war only because others will pick up a gun to protect them. This is patently true. But it isn't an indictment of pacificism, it's not a hypocrisy. And Orwell didn't mean it that way either. It's simply one of the myriad complicated realities that make up our societies and our world. People with guns protect our borders, but pacifists offer something as well. An ideal and conscience that drags society towards a more peaceable and equitable world, a counterpoint to militarism and the will to power that often stems from it.

Instead of buying weapons manufacturers, we are investing in carbon-lite businesses and companies whose whole business model is about dragging the world away from the fossil fuel addiction that binds Western nations to petrostates with poor human rights records. If anything, the current crisis should make it harder for countries to ignore the urgent need to shift to cleaner energy. And if that shift weakens the power of rogue states, all the better.

Some of the businesses we own offer solutions to the current energy crisis. A few focus on building cleantech infrastructure all over the world, including **Hannon Armstrong Sustainable Infrastructure**, windfarm developer and operator **EDP Renovaveis**, power cell producer **Ballard Power Systems** and smartgrid operator **Alfen**. Then there's US building insulation business **Owens Corning**, which we bought during the quarter. It's the world's largest manufacturer of fibreglass insulation, which goes in hundreds of thousands of homes, offices and other buildings. Better construction techniques are crucial for improving heat retention. More efficient buildings can dramatically reduce energy consumption — this is the other side of the cleantech revolution. It's not enough to simply make our power carbon-free, we have to use much less of it too. Owens Corning's Pink Next Gen Fiberglas insulation is made with almost 75% recycled glass, the highest proportion in the industry. In just one year it saves 12 times the energy it takes to produce it.

Good companies going cheap

We used the Q1 weakness to add to many holdings that we believe were oversold.

One of these was **Halma**, which provides safety, environmental and medical technology to a range of industries and customers. It has a strong market share in its niche segments, including water analysis and treatment, blood pressure diagnostics and fire and gas detection equipment. This helps its businesses charge high prices and achieve attractive returns on capital. It is very well managed – we have been impressed with how its executives have managed and passed on costs to its customers.

Another was American pure-play packaging business **Ranpak**, which supplies sustainable paper and cardboard boxes and wrapping for industrial supply chains as well as e-commerce orders. Ranpak has an attractive 'razor/razorblade' model that should support the prices it can charge for paper packaging. Essentially, Ranpak sells quality packaging machines to its customers at a keen price and then makes money on their refills of paper and cardboard (the 'razorblades'). Paper currently accounts for less than 20% of the global packaging market, but is much more sustainable than other materials like plastics. We believe this bodes well for Ranpak's growth over the coming years.

We also added to Canadian e-commerce platform **Shopify**. The share price has fallen about 75% from its peak in late 2021. There is concern in some quarters about the heft of its much larger rival Amazon; however, we think Shopify is a more appealing option for merchants. Shopify allows its business customers to retain control over their own customer data and shopping trends – rather than using the information to undermine them. This data is an invaluable source of information to businesses, helping them grow faster and boost the profits of both themselves and Shopify. The true potential of Shopify is continually underestimated, in our opinion. This business is very popular among small and mid-sized businesses, offering them a full white-labelled digital sales system, from website design and hosting to payment, shipping and after-sales care. Shoppers' desire for the boutique and the unique is good news for small businesses. And it is also a strong dynamic for companies like Shopify that give them a platform to sell to the world. There are literally millions of small merchants and artisans out there, and each one of them could boost their business tremendously by using quality e-commerce tools.

Adding from the watchlist

The market turmoil also meant that companies we have admired for some time suddenly became much cheaper. We took advantage and bought a few new names.

Royal DSM makes nutritional additives for people, livestock, poultry, marine farming and pets. These are enzymes as well as natural preservatives and taste and smell modifiers. We know the bioscience and specialty ingredients sector well and really like its prospects. It's amazing how much difference such small additives can make. For instance, you may have already heard of DSM's Bovaer cattle feed additive that reduces methane emissions by 80%. There are so many other fantastic products that have received less publicity, but which help the world hit its climate goals. DSM is about to spin off its industrial-focused resins and chemicals business, which will make the company focused purely on the food additives business that we are most interested in.

We swapped in diabetes monitoring business **Dexcom** for medical devices and nutrition business **Abbott Laboratories**. Dexcom is a great business, in our view. Its share price has fallen back a long way in recent months, so we could add it to our portfolio at a more appealing price. We sold Abbott because it had flagged a potential contamination of baby powder at one of its factories in Michigan. It voluntarily recalled several products after it received three complaints of babies becoming ill after drinking the formula. Abbott routinely tests its facilities for bugs. During a recent check, it found harmful bacteria in "non-product contact areas" of its factory. Abbott's management seemed too relaxed about this potential contamination of its products for our liking – especially given that they are for children. Since we sold, the Federal Food & Drug Administration released inspection reports that showed a pattern of food safety problems at the Michigan plant, so our gut feeling to sell seems well founded.

Another sale was workplace hygiene, food safety and water quality monitoring and purification business **Ecolab**. We've owned it since launching the fund back in 2018. We think this is a great business, but unfortunately its share price performance has continually lagged. Frustratingly, investors have unerringly focused on the negative side of its business throughout the pandemic. So when we were all in lockdown, the spotlight was on its shuttered hospitality customers, while its all-weather water monitoring and hospital hygiene divisions stayed in the shadows. And then, when markets reopened, the spotlight swung to the lessened hygiene business while the recovery in hospitality revenues were ignored. This seemed overegged to us, yet it has become clear that Ecolab struggles to deliver the sales and profit growth that shareholders are looking for. Because of this, we felt our money would be best placed elsewhere.

An American tilt

Over the quarter, we've slightly increased the proportion of our American investments at the expense of our European holdings. This wasn't a conscious decision to tilt toward to the US, but more the outcome of our individual decisions about the businesses that we want to own. On the whole, it seems that the US economy is simply running at a better clip than that of the Continent, and so offers better opportunities. Also, greater risks hang over Europe right now. There is the fallout from the war in Ukraine, but also many smaller nations in Europe will be squeezed by the drastic increase in sovereign borrowing costs. These issues have obviously influenced our thinking while analysing companies.

Our fund doesn't chase themes. The investments we make are determined by the strength of individual companies and their prospects. Yet you can trace the most pressing challenges facing our world through how our portfolio shapes up. Many of the companies we hold tend to be in the vanguard of the IT revolution, making it cheaper, easier and faster for people to complete tasks, whether at home or in the office. Similarly, we have a lot of manufacturers striving to make better products with less waste or which make crucial resources like water and soil go further. We also invest in a lot of businesses that provide for older people — particularly healthcare companies — and businesses that help alleviate the demand on our overloaded planetary resources. These are the areas where we see potential over the coming five years and beyond.

David Harrison
Fund Manager

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Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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