Rathbones
Look forward

Rathbone SICAV Multi-Asset Total Return Portfolio

Monthly update May 2022

Bizarrely, May was actually relatively flat for most stock markets. There was a lot of volatility in between the beginning and the end though. At one point, several major developed market equities were down about 5% and emerging markets were down 8%.

Markets rallied into the end of May; however, in early June they abruptly sold off once more. We are now officially in a bear market (when stocks fall more than 20%). In bond markets, the yield of a benchmark 10-year US Treasury mirrored stock markets: it ended May just nine basis points below where it began, yet there was 40bps of difference between its monthly high and low. That's the fixed income equivalent of a London bus. In the first half of June, the yield has soared 56bps; so that's the equivalent of a double-decker.

We switched from the **UK Treasury 4¼% 2032** and **7/8% 2029** bonds to the **Australian Government 1% 2031** while fixing the exchange rate of the Australian dollar to protect ourselves from currency fluctuations. We did this because the Aussie treasury offered a much better yield for a similarly safe government bond, even when taking into account the cost of hedging the currency.

We continued a trade started in April where we sold **US Treasury Inflation-Protected Securities (TIPS) 2024** and bought the **US Treasury 1.875% 2032** instead. Prices of TIPS are assuming a huge amount of inflation, so we were taking profits and reinvesting in more attractively valued bonds.

The reason for the fickle and erratic markets is likely no surprise: inflation. By late May, investors and talking heads had convinced themselves that American inflation had peaked and was coming down. This hope buoyed stocks and bonds. Then, in early June the resilience crumbled and stocks and bond prices dropped in unison, compounded by US inflation hitting a new multi-decade high of 8.6%.

Everyone wants to know how long high inflation will persist and nobody has a clue. Well, there are some clues, but they are noisy and difficult to use for short-term predictions. And so, so many parts of the market are focused on the short term these days. Algorithmic trading – where computers trade countless times using signals measured in seconds or days – often seem to overwhelm those people who are trying to take the long view. We believe this gives flesh and blood traders an advantage in times of dislocation; big swings in markets offer more prices at which you can buy or sell. But it truly is very tough to hold your nerve when you're not a machine!

We did a heck of a lot of trading in May – and into June – rebalancing our portfolios and adding quite a few stocks that were suddenly much cheaper than we've ever seen them. The largest top-ups to our existing holdings included electric vehicles systems developer **Aptiv**, American digital-focused consultancy **Accenture**, internet search giant **Alphabet**, creative industries software developer **Adobe** and investment bank **Morgan Stanley**. The largest trims to our positions were oil services business **Schlumberger**, oil major **Shell**, and the **Legal & General All Commodities** and **Invesco LGIM Commodity Composite** ETFs.

We never expected the late-May bounce to be the end of the depressed period for markets. We think volatile markets will be the norm for some time yet. We have the confidence to buy stocks because we are buying companies with little debt, strong profits generated predominantly in hard cash and reliable growth over the next five to 10 years. Put simply, we are buying businesses that we believe are likely to survive and even thrive regardless of whether economic troubles drag on for three months or three years. Meanwhile, over the past year or so we have built up positions in defensive assets that should mitigate shorter-term swings in stock markets. These have done us well so far.

Volatility is opportunity

We took advantage of large falls in the price of corporate bonds to buy quite a lot of high yield and investment grade bonds. The high yield markets were very gummed up in April, yet liquidity returned in May allowing us to pick up some bonds at attractive prices. These included the **Co-operative Group 6.25% 2026**, **Marks & Spencer 4.75% 2025**, **Travis Perkins 3.75% Senior 2026** and **Thames Water (Kemble) Finance 4.625% 2026**.

We don't necessarily intend to hold these bonds until they mature, instead we will hold them until their prices return to more reasonable levels. There is a chance of more shorter-term falls – and we may even be completely wrong and their values may never recover – but we feel these risks are more than compensated by their low prices. Essentially, we are being paid to take on the volatility of these assets, which we are comfortable doing as part of a balanced portfolio.

We used market weakness to buy computer graphics processor designer **Nvidia**, which makes some of the best components in the industry, with a particular stranglehold on computer gamers. This business replaces our holding of games developer Activision-Blizzard, which is being bought by **Microsoft**, which we own. Gaming has grown massively in the last couple of decades and we believe this will continue. The stock had fallen more than 35% so far this year, giving us an attractive entry point to what is, in our view, a high-quality and market-leading business.

Spreading diversifiers

We frequently use stock market options and structured products to build protection into our portfolio. Options are tradable contracts with investment banks that give us the right to 'buy' (calls) or 'sell' (puts) a certain value of an index which has the effect of limiting our exposure to market fluctuations. Structured products work in a similar way, except they are more like contracts that pay out gains in set situations and lose money in others.

When stock market volatility is high, the value of these sorts of assets increases, making it more expensive to buy more of them. Because of the recent elevated volatility, we thought a replacement of our recently matured vanilla **S&P 500 Put Option** was too pricey. We still wanted the protection, however, and we felt a 'put spread' was a cost-effective option. Stay with us here, it's not too painful. We have bought a put option that kicks in when markets fall 5% below where we bought it and we have sold a put option that kicks in if markets fall 25%. By selling an option, we get paid a premium which offsets some of the cost of the put option that we bought, but we are effectively insuring someone else's investment in the S&P. This arrangement means that we are protected from another 25% fall in the S&P 500, however we are exposed to any falls beyond that. Given how far markets have already fallen, we felt this was a reasonable risk to take.

Another diversifying trade using options was buying the **Societe Generale Commodity Curve Delta 3 Structured Product**. Typically, the value of a contract for future delivery of commodities is lower than the spot price because they tend to be bulky and costly to store. In the lingo, this default situation is called 'contango'. However, due to the upheaval in commodity markets and supply shortages lots of buyers are using futures to lock in what they need further down the line, pushing up the price of futures relative to spot prices. This 'backwardation' difference today is higher than at any point since 2007 in all sorts of commodities from metals and energy through to livestock and grains; we believe it will return to its contango equilibrium in time. Our structured product makes money if this occurs.

Meanwhile, it's holiday season so you may have noticed that the pound has been exceptionally weak recently. Against the dollar, sterling has slumped more than 10% year to date. Against the euro it's fallen 3.5%. In recent years the pound has traded as a 'risk-on' currency — some, perhaps unfairly, characterise this as the UK is trading like an emerging market. This means that when investors are confident and willing to invest in riskier assets, the pound's exchange rate rises. Yet, when everyone is scared and markets are falling, the pound falls too. This has myriad effects, but the main ones are that it makes UK-based costs, like labour, cheaper, and overseas costs, like oil, gas and imported food, more expensive. It also means that domestic UK earnings (in sterling) are less attractive and foreign exchange earnings from investments abroad more valuable.

The furore over sky-high energy bills — which are set to soar yet further in the autumn — led UK Chancellor Rishi Sunak to announce a £400 government support payment for every home in the UK. The poorest 8 million households will also get £650 to help with the cost-of-living crisis, split between July and October. The £15 billion programme will be partially paid for by a 25% windfall tax on the profits of UK-based oil and gas companies, which is expected to reap £5bn this year for the Exchequer. The tax will be removed once oil prices return to normal levels or by the end of 2025.

Put bluntly, this is 'helicopter money' — cash thrown out the window into the hands of the people below. That has pros and cons. It's great because, unlike quantitative easing, more cash gets into the hands of the poorest who are most likely to need it and spend it, boosting the economy. The drawback is that it increases the amount of money being spent in a time of supply constraints. You may remember Milton Friedman, who pioneered the big glasses economist style before it was cool, talking about inflation being the effect of too much money chasing too few goods. This UK money-drop policy may exacerbate the UK's inflation problem in the medium term even as it helps out struggling families.

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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.

This fund is actively managed. This is a marketing communication. Please refer to the prospectus of the UCITS and the KIID before making any final investment decisions.

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