

# Rathbone Defensive Growth Portfolio

Quarterly investment update, January to end March 2022



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## Hot topics – ‘Top-down’ (market and macroeconomic)

**Rising rates.** The first quarter of 2022 really was grim: fears of recession, war, rapid inflation, an energy crisis, a cost-of-living crisis and a stock market correction. This assortment of risks sent bond yields aboard a rocket ship. The 10-year UK government bond yield soared from 0.97% to 1.61% over the quarter, and then pushed above 1.80% in early April. The rise of the US 10-year was even more dramatic: from 1.51% at the dawn of 2022, it finished



three months later at 2.35%. At time of writing, it had surpassed 2.80%. Investors expect central banks to deliver a whole bunch of interest rate increases and reverse their quantitative easing schemes, perhaps more tightening than is indeed possible. Meanwhile, the values put on company profits (price-earnings multiples) have retreated – to an average of 19x in the case of American stocks – roughly where they were before the pandemic upended markets back in 2020. Put plainly, investors want much higher returns for lending money or putting up equity because of the foggy future. Even as company profits are actually growing at a fair clip. Investors are finding it extremely difficult to weigh up shorter-term risks with longer-term opportunities. This is leading to some pretty bizarre moves in share prices. Some stocks reporting earnings have dropped 10% in the morning only to finish the day 10% higher than where they started. That's barmy. But, mad as it is, it creates plenty of opportunities for us to trim winners and pick up bargains as we rebalance carefully and often to keep our portfolios prepared for rough waters ahead.

**Upended energy.** The war in Ukraine puts the spectre of a worldwide energy crisis front and centre. The news flowing from the embattled nation is awful to see, yet two months on Ukraine's defiant stand continues to frustrate Russia, which commands vastly more troops, supplies and equipment. Russia's attempts to pound Ukraine into submission have failed and instead sparked renewed discussion of wider sanctions among European Union (EU) members, specifically on Russia's copious oil and gas exports (which the US has already implemented). The price of energy has skyrocketed because of the uncertainty created by one of the largest producers invading its neighbour. If the flow of Russian oil and gas to Europe is halted, the effect on both Russia and the EU would be catastrophic. Many European nations would struggle to keep the lights on as energy costs rocket, while Russia would be stripped of a crucial flow of foreign cash. The whole mess has taught Europe an important lesson about energy strategy and security. But it will take more than a few years to put right. In the meantime, soaring prices for gas, petrol and electricity are squeezing households and businesses



from Seattle to Singapore and virtually everywhere in between. This led the World Bank to cut its forecast for 2022 global growth to 3.2% from 4.1%. Households and businesses have broadly come out of the pandemic flush with cash and a hankering to spend. But a sustained increase in costs with no end in sight will rein that optimism in. Recent surveys suggest that may already be happening, but it's really too early to tell how long the squeeze will last. By summertime we should have a better idea of the path of inflation and how people are feeling about life.

**Virus fatigue.** The latest wave of COVID-19 in the UK has broken and numbers of daily infections are falling once again (although daily reported deaths are still climbing). But given that there was less than three months between this viral resurgence and the last one, you have to wonder whether to pencil in another variant and another wave for the summer holiday. COVID-19 has lingered much, much longer than any of us expected. The US seems to be a month or two behind Europe, going off daily case numbers, yet it's right in lockstep on its fatigue for the



situation. After years of caution, testing and procedures, people are beyond tired of the virus and its effect on their lives. You will have seen the change as the months have slid into years: many of those initially most worried about their health have faded into a mixture of resigned acceptance and grim determination to do whatever it is they want to do. This of course makes it easier for the virus to spread, especially as every other month it makes itself more infectious. It seems unlikely that governments will implement any more lockdowns – with some exceptions, the most important being China – to combat any future spikes in the virus unless COVID-19 becomes markedly deadlier. However, the sheer number of people getting ill and falling out of the workforce for days at a time must surely drag on economic activity, particularly when many companies are struggling to find staff. Of course, the flipside of this devil-may-care attitude is a positive: people want to enjoy themselves, and if you've been out anywhere lately you have probably noticed that places are noticeably busier than the recent past. That's good for businesses and the people they employ. Let's hope COVID-19 doesn't have any more tricks up its sleeve.

## Portfolio activity

Key purchases/additions	Key sales/trims
Charles Schwab (new purchase)	Clorox (sale)
Home Depot (new purchase)	BP (sale)
US Treasury 1.5% 2030 (addition)	Coca Cola (trim)
Société Générale VRR Index Structured Product (addition)	Northern Trust (trim)
iShares Physical Gold ETF (addition)	CME (trim)

Source: Rathbones

In January we added to the **Société Générale VRR Index Structured Product**, which makes money if the volatility of US Treasury yields rises. Any increase in the size or frequency of moves in US treasury yields (both up and down) is good for this investment. However, if yields just amble along with little movement, we will lose money.

We added to our **iShares Physical Gold ETF** in mid-February because of the increasing geopolitical tension. We are mindful, however, that gold is virtually the only reserve asset now available to Russia after its central bank was sanctioned, as the 2,300-tonne hoard (worth roughly \$160 billion or £122 billion) is stored in Russian vaults. It's unclear whether Russia will add to its gold using cash from oil and gas consignments or sell it off to make payments. Either could affect the gold price. Meanwhile, we completely sold oil major **BP** the day Russia invaded because of its 20% stake in Russian oil-exploration-to-pump business Rosneft.

We added to a range of sovereign bonds as yields rose over the quarter. These included the **US Treasury 1.5% 2030**, **Japanese Government 0.1% 2023**, **Australian Government 1% 2031** and **UK Treasury 4.25% 2032**.

We used the first-quarter market correction to add to our stocks across the board. We also used the turmoil to buy some new companies. One of them was **Home Depot**. This business is the place to go for DIY warriors, with good-value tools and materials, and well-skilled and knowledgeable staff who can give advice on getting the job done. But it is also one of the most popular suppliers for small and medium-sized trades businesses. Its professional sales relationships are thriving because of Home Depot's investment in its supply chain, delivery service and staff.

Another addition was American stockbroker, ETF provider and wealth manager **Charles Schwab**. The company is growing well, driven by its compelling zero-fee approach to execution-only accounts. Charles Schwab makes most of its revenue from the interest earned on cash in client accounts, so it is actually an interest-rate beneficiary in disguise. It also makes commission on more complicated orders, and fees on guided investments and advice.

Finally, we sold bleach and home goods producer **Clorox**. The business's profit margin has fallen back in recent results, lending weight to concerns that it will have to absorb rising input costs rather than passing them on to customers or offsetting them with lower expenses.

## Spotlight

In this quarter, the spotlight is on **WEC Energy** and **Global Agribusiness ETF**.



### WEC Energy (Wisconsin Energy)

- US based multi-utility company providing energy to predominantly Wisconsin, with some assets in Illinois and Minnesota
- The company is consistently considered one of reliable electricity company in the US and a market leader, critical in places where weather can be severe (-20 degrees Celsius is not uncommon)
- Favourable regulatory and political regime compared to UK or European equivalents – reduced threat of nationalisation!
- They are well diversified by energy source between coal, natural gas and carbon free, with plans to further reduce coal as they replace the older less efficient coal plants
- The company is able to generate the inflation-proofed revenue expansion expected of a utility, but it also benefits from local economic growth too, potentially giving it a growth booster

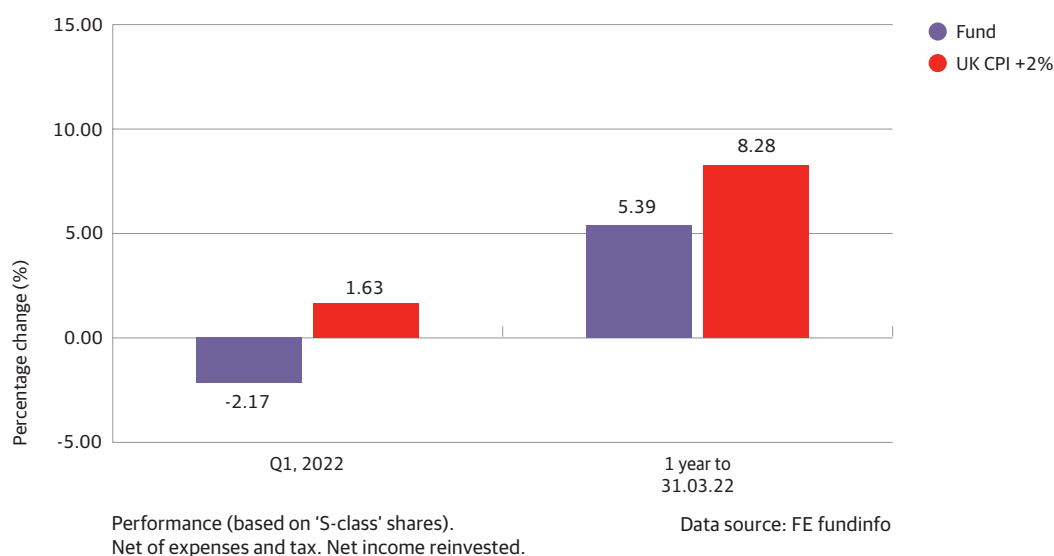
### Global Agribusiness ETF

- We added exposure in the fund to a global Agribusiness ETF (exchange-traded fund) as we believe that food security, efficiency of production, and environmental impacts of production will be high on the agenda for governments in the coming decades
- The agribusiness ETF we own has broad exposure to most of the key players who are at the forefront of many of the developments in the agriculture industry required to support those areas of medium and long-term focus for governments
- We believe that many of the businesses who are leaders in driving the necessary change in the agriculture industry stand to benefit meaningfully from the tailwind of spend and focus in this space
- Examples of key holdings in the ETF include:
  - **Nutrien** the world's largest provider of crop inputs and services which helps growers increase food production in a sustainable manner
  - **Deere** who are known for their green and yellow agricultural equipment but are now also focused on more advanced technology and data services to enable farmers to be more precise and productive and will less intensive use of soil and water
  - **Corteva** who develop and supply products to support in producing optimum yields for farmers and others which protect crops from weeds, insects, pests, and disease both above and below ground including seed-applied technologies





## Fund performance



Discrete annual performance					
Year to:	End Mar 2018	End Mar 2019	End Mar 2020	End Mar 2021	End Mar 2022
Fund	—	—	—	—	+5.39%
UK CPI +2%	+4.80%	+3.85%	+3.72%	+2.46%	+8.28%

Price performance based upon single price (mid). 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 (%)			Bottom performers (%)		
Holding	Performance	Contribution	Holding	Performance	Contribution
Rio Tinto	+31.24	+0.19	Shopify	-48.85	-0.36
Legal and General All Commodities ETF	+30.68	+0.27	Kion	-38.41	-0.29
Lockheed Martin	+28.52	+0.18	Fever-Tree Drinks	-32.89	-0.14
Invesco Markets Commodity Composite ETF	+26.48	+0.28	Nidec	-29.42	-0.18
Jack Henry & Associates	+21.70	+0.12	Aptiv	-24.71	-0.19

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

As you would expect in a period which saw most commodities rally significantly in price, our exposure to this area was a key positive contributor. Our holdings in **Shell**, **Schlumberger**, **Total**, and **BP** in the equity space all rallied to differing degrees but contributed meaningfully. Schlumberger in particular was very strong, perhaps buoyed further by the expectation of more drilling and exploration required to close any supply gap should sanctions on Russia spread further into the energy sector. During the quarter we had discussed the possibility of the Biden administration pressing US oil producers to start drilling again and we saw some evidence of that at the end of the quarter with Mr Biden suggesting measures such as levies on US oil producers who were not making use of their drilling licences on public lands. This could also be having a positive impact on Schlumberger.

The **commodity basket ETFs** were also material contributors to portfolio returns given the large moves across the broad commodity complex. The position we had built in **US TIPS** (US index-linked government bonds) over the last 18 months provided notable support to the portfolios as US breakevens moved materially higher through the quarter, albeit did come back slightly towards the very end of the quarter.

## Fund performance (continued)

In October last year, we added a **Nasdaq put option** to the funds to help protect us from a crash in equity markets, but specifically an equity market fall more focused on the growthier names which tend to be more prevalent in the Nasdaq index. This put option helped to protect the portfolios during some of the worst of the market falls, both the January rotation which hit the Nasdaq hardest, and then latterly when a period of broad risk off sentiment took hold after the Russian invasion of Ukraine. Importantly though, those puts gave us the confidence to add into some of the highest quality names in the portfolio towards market lows. The addition of the **US rates volatility notes** in 2021 also helped in the first quarter of the year as rates volatility was indeed higher. We took advantage of a drop in the price in January to add a little more into these notes to provide us more protection from increasing volatility in the US rates space. These notes both provided a helpful positive performance contribution for the quarter and between them were a key part of mitigating some of the equity drawdowns.

Given the falls in equity markets it is of course no surprise that equities were the largest performance detractor. Our US equity exposure was the largest detractor with some specific companies being larger contributors to that such as **Shopify**, who were weaker at the start of the year given the market rotation, but after announcing much higher capex to build out more of their own fulfilment than had been expected the shares fell further. Europe detracted less from performance given the smaller overall weight in the portfolio, but again there were some specific companies who were hit harder. One example is **Kion**, who as a European industrial name stand to be potentially impacted by any energy issues in Europe as a result of the situation with Russia, but they also saw a fall in their share price as a read across from peer Jungheinrich who issued a profit warning at the end of March due to challenges from raw material costs pressuring margins and supply chain issues dragging on growth. In fixed income, conventional bonds were a drag on performance as yields rose but given our short duration positioning since the middle of 2020 this rise in yields did not prove to be a meaningful detractor to performance.

## Asset allocation ranges

Liquidity	Equity-type risk	Diversifiers
5% to 45%	30% to 70%	0% to 45%

## Asset allocation change and strategy

There were no significant asset allocation changes during the quarter.

Asset allocation split	31.12.21	31.03.22	% Change		12 month change	
Liquid assets	34.27%	31.61%	-2.66%	▼	-2.31%	▼
Equity-type risk	52.08%	52.38%	0.30%	▲	-3.46%	▼
Diversifiers	13.65%	16.01%	2.36%	▲	5.77%	▲
	100.00%	100.00%				
Asset class split	31.12.21	31.03.22	% Change		12 month change	
Equities	48.85%	49.51%	0.66%	▲	2.63%	▲
Index-linked bonds	5.72%	5.62%	-0.10%	▼	2.99%	▲
Conventional government bonds	12.47%	14.15%	1.68%	▲	1.75%	▲
Corporate bonds	5.59%	7.42%	1.83%	▲	-4.16%	▼
Emerging market debt	0.89%	0.72%	-0.17%	▼	-2.17%	▼
Private equity	0.39%	0.39%	0.00%	◀▶	-0.03%	▼
Alternative investment strategies	5.07%	5.04%	-0.03%	▼	1.55%	▲
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	3.16%	5.67%	2.51%	▲	2.35%	▲
Cash	17.86%	11.48%	-6.38%	▼	-4.91%	▼
	100.00%	100.00%				

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

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## Investment outlook

The pall of uncertainty hanging over the future leads us to focus on ensuring our portfolios are ready for whatever jumps out of the gloom. This year is looking like it will be a tough one for households, businesses and some governments. Because of this, we are focusing our investments on 'quality' companies – those that have little debt, make a lot of cash and have products and services that are hard for their clients to pass up.

Strong cash flow really is so important for companies, especially when economies start to slow. Put bluntly, cash equals flexibility. It gives managers options: the ability to invest in promising ventures or take out struggling rivals for a song, to pay down debt or take on more at reasonable rates. These businesses have the best chance of coming through difficult situations unscathed – and sometimes even stronger.

While we're prepared for short-term pain, we still note that there's a chance of things turning out better than people expect right now. Prices in bond and stock markets suggest people are anticipating a royal flush of bad stuff. Yet the Citi Economic Surprise Index, which measures actual economic news against expectations, has risen sharply this year showing that so far, the reality hasn't lived up to the nightmares. When the news is jammed full of war and inflation and pandemics it can lead you to think the world is going to the Inferno in a shopping trolley. But these things have plagued us before and, sadly, will again. People can be terrible, yet only a fool would bet against human ingenuity in the long run. To paraphrase the immortal Jeff Goldblum, humanity finds a way.

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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.**