Rathbone Strategic Growth Portfolio

Quarterly investment update, July to end September 2023

Rathbones
Look forward

Professional Adviser PA AWARDS 2022 WINNER Best Multi-Asset Fund: Risk Managed

Professional Adviser PA AWARDS 2022 WINNER Multi-Asset Group of the Year

Hot topics – 'Top-down' (market and macroeconomic)

Rates rise. The American benchmark 10-year government bond yield soared over the summer. From 3.84% at 30 June it ended September at 4.58%. And since quarter-end it has surged further to 4.80%. The UK 10-year government bond yield had already popped higher in the spring, but it has whipped higher in late September and early October as well. It now trades above 4.60%. These are big moves for government borrowing markets, which are the bedrock for all longer-term interest rates in the economy. When a household or company wants a loan, a bank will take the long-term bond yield and then add a percentage on top to account for the risk of default and to make a profit.

This means bond market moves are very consequential for economies. So what has caused such a wild ride in markets that should be relatively stable and calm? Inflation, particularly in the US, has eased and economic growth forecasts haven't changed all that much in the past few months. A spike in the oil price above $90 a barrel may have fuelled concerns that inflation may come back for one last scare. Yet we're more of the opinion that a higher oil price should actually cool wider inflation because it's a tax on people and businesses. When you spend more on getting from A to B, there's less left over for buying other stuff, so overall demand should cool, alleviating inflation. Signs of economic weakness are increasing around the world and inflation is generally falling, so it seems to us that the reason for the sharp uptick in bond yields is heightened uncertainty about the future. Bonds have a strange effect on many investors: when their prices fall and yields rise, many are put off and are discouraged from buying. But we believe that's exactly the time to buy them. Unlike stocks, they offer a fixed return over their life. When you buy a government bond, you know what you're getting right up front; only default or hyperinflation can take it away from you. And if one of those happens, your bonds are the least of your worries. With yields much higher than they have been in decades, UK and US government bonds offer great long-term value, in our view, so we have been increasing our holdings of them.

Hero to zero. Tackling climate change will be the enduring task of our generation – and likely the next couple as well. Cleaning up how we power our societies and minimising the effects of rising global temperatures is as important as it is difficult and expensive. Unfortunately, climate policy can often stray into fantasy land. It's understandable when you have such a huge issue relying on decades-long milestones, cross-border agreements, assumptions about technologies that haven't been developed yet and large behavioural adjustments by billions of people. Sometimes you can get ahead of yourself and sometimes your assumptions are found to be unrealistic. Perhaps that's where the UK government has found itself, and why it's starting to unwind many policies it had planned in order to achieve net-zero by 2050. These include scrapping energy efficiency requirements for residential landlords, delaying the ban on the sale of combustion-engine cars by five years to 2035 and extending the phase-out of gas boilers by nine years, again to 2035. The government is adamant that its row-back won't affect the UK's legally binding commitment to reduce the nation's net emissions to zero in 27 years. Scientists and the government's independent advisory body, the Climate Change Committee, disagree. Bluntly, this comes down to politics, and who's going to pay for the transition to clean energy. Being happy to pay extra for everyday expenses is a luxury most people cannot afford. And helping them afford it tends to mean taxing the wealthy more to help subsidise those less well off. People struggling to pay the bills don't deal well with diktat and upheaval, and governments don't like approaching elections with promises to increase taxes. With a cost-of-living crisis bubbling away, inflation stubbornly high and an election in the offing, an unpopular government thinks Britons simply cannot cope with what they are being asked to bear. Whether they could or not is sort of irrelevant, unfortunately, as it's another one of those assumptions – we won't know till it's tried. Rather than focusing on setting customer-focused goals like banning

cars or types of heating, we would prefer the government was bold and ramped up support for supply of the technologies it wants people to adopt. To help make them better and cheaper so customers *want* to change, rather than allowing them to gripe that they are being forced to give up what they have. The UK government's investment in the energy transition and the infrastructure it requires has been miserly over recent years, while the US, Europe and China have ramped up spending markedly. Here's a question: if roughly a third of British cars used electricity in seven years' time, would we have the grid capacity to power them, let alone with renewable electricity? UK renewable projects face tough planning hurdles as well as the longest wait in Europe to connect to a national grid. The same electricity capacity concern goes for replacing gas boilers with electric boilers and heat pumps. The UK desperately needs a plan to achieve its net-zero targets. It needs to be bold and imminent, but also credible.

Miracle drug. Everybody loves a panacea. The idea that intractable troubles can be banished with a simple salve is alluring. There's always a wonder drug getting people excited, but more often than not it comes with mixed blessings. Generally, the ones that get the most attention are those for pain relief and losing weight, perhaps because they tend to have the widest general appeal. In the 1990s Oxycontin was marketed as the perfect painkiller, yet it turned out to be a gateway to opioid addiction. There have been more than a few dodgy diet pills over the years: the earliest legal ones were speed – methamphetamine – which isn't exactly clean living! Lots of people are duped by snake oil pills touted by fraudsters on the internet where the best case is it's only a harmless placebo. So in that context, the newly approved diet drugs developed by Danish firm Novo Nordisk and American pharma Eli Lilly are remarkable tools for battling obesity and diabetes. Yet their long-term effects simply won't be known for years to come. Whether they will need to be taken forever to keep weight off. Whether that's even possible because of the drugs' impacts on the body. Whether, as is often the case with medication, people are merely swapping one ailment for another. Despite this, customers and investors are getting very, very excited by the latest vintage of diet drugs. Novo and Elli's share prices have both rocketed more than 65% in the past year at the expense of companies with existing treatments. Diabetes monitoring companies, like our holding Dexcom, which fell 30% over the quarter, have borne the brunt. Meanwhile, big-bank stock analysts have started to extrapolate the implications deeper into markets. Airline profits are set to soar because lighter people mean less fuel burn. Restaurateurs' takings will slump because people won't be eating out as much. Presumably sales of nausea pills will pop as well, given the side-effects, but we haven't seen any news on that. All this seems like bunkum to us. It will be years before the effects of these new treatments on people, lifestyles and markets can be discerned, yet we wager that they will be much less ground-breaking than all the hype suggests.

Portfolio activity

Key purchases/additions	Key sales/trims
UK Treasury 1.125% 2039 (purchase)	UK Treasury 0.875% 2033 (sale)
Citi FTSE/S&P Autocall 2028 (purchase)	Trex (sale)
US Treasury 3.5% 2033 (purchase)	Diageo (sale)
McDonald's (purchase)	Rio Tinto (trim)
Soc Gen Commodity Curve (addition)	Amazon (trim)

Source: Rathbones

As bond yields continued to rise over the quarter, we swapped our relatively shorter-dated UK government bonds for those that mature much further in the future. This meant we sold the **UK Treasury 0.875% 2033**, bought the **1.125% 2039** and added to our position in the **3.75% 2052**. We also bought **US Treasury 3.375% 2033** bonds. The further into the future a bond matures and repays its capital, the more sensitive its price will be to changes in prevailing interest rates. That's because, if market rates fall, the value of earning more interest than anyone can secure today is factored into the price of the bond – and if you have that rate locked in for many years to come that's more valuable than if it's only for a few years. Similarly, if rates in the market rise, your bond is earning less interest than you can get if you invested today, so the value of your bond will fall – and it will fall much more if you're locked into that poor rate for many years. With yields at multi-decade highs, we felt it made sense to increase our interest rate sensitivity (or 'duration' in the lexicon).

Another effect of higher interest rates is that it makes structured products cheaper. These investments are contracts with investment banks that pay specific returns when triggered by certain scenarios. We bought the **Citi FTSE 100/S&P 500 11.02% Autocall** which pays an 11.02% coupon and gives us our capital back if, in a year's time, both the US and UK stock markets are above the level at which we bought in. If one or both are in the red, the autocall doesn't pay out but rolls the coupon payment into the next year. This continues until both indices finish a year above their trigger levels or the contract reaches its final maturity in 2028. If in five years' time both indices haven't fallen more than 20%, then we are paid 55.1% (11.02% for each year) and our capital is returned. However, if one or both indices has fallen more than 25% then we suffer capital losses in line with the market. If the worst-performing index has dropped between 20% and 25% we get our capital back only. This sounds complicated, but the point of the investment is that it locks in a high annualised return if markets don't fall precipitously and stay there. In return, we give up any stock market returns above our 11.02% payoff. We believe this is a good way to make returns while reducing risk.

Earlier this year I (fund manager Will McIntosh-Whyte) took a trip to the US to research companies and kick the tyres on how the economy was faring. While there I met **McDonald's**, a business that impressed me with its strategy and potential. The fast-food giant has had huge success over almost 70 years with franchising its business (selling the right to operate restaurants to independent operators). It still runs about 2,700 centrally, but 35,000 are franchised and there has been a clear move over the last few years to increase this number further – and its profit margins with it. McDonald's has dominated the world through supreme efficiency, a laser focus on costs and cashflow, and the golden arches themselves: a brand instantly recognisable anywhere in the world. The company is currently rolling out its 'Accelerating the Arches' strategy, focusing on its core: burgers, chicken and coffee (it's the second-biggest seller of coffee in the US); and doubling down on the 4Ds: drive-through (this remains the biggest channel in the US), development of sites, delivery, and digital. We think it still has plenty of potential to grow, so we bought shares when its valuation fell back in the quarter.

In late August the volatility of the US stock market dropped to quite a low level. Put options, which work like portfolio insurance in that you pay a premium upfront and receive protection if markets drop, become cheaper to buy when volatility is low and more expensive when it's high. The reason for this is that if volatility is high – if prices are yo-yoing all over the place – there's more chance that the option will be used, so it's more attractive. However, volatility isn't stagnant, so it's often best to buy insurance when the sun is shining, which is why we added to our put option exposure.

We added broadly to equities on weakness, particularly medtech firms such as medical device maker **Boston Scientific**, heart valve manufacturer **Edwards Lifesciences** and diabetes monitoring specialist **Dexcom**.

We sold alcoholic drinks conglomerate **Diageo** in the quarter because we felt smaller, more artisanal brands were better able to challenge its premium labels. We also trimmed cloud computing giant and everything store **Amazon** and sold American recycled decking supplier **Trex** because we felt its valuation had become unattractive.

Spotlight

In this quarter, the spotlight is on our **Aptiv** and **Linde** holdings.

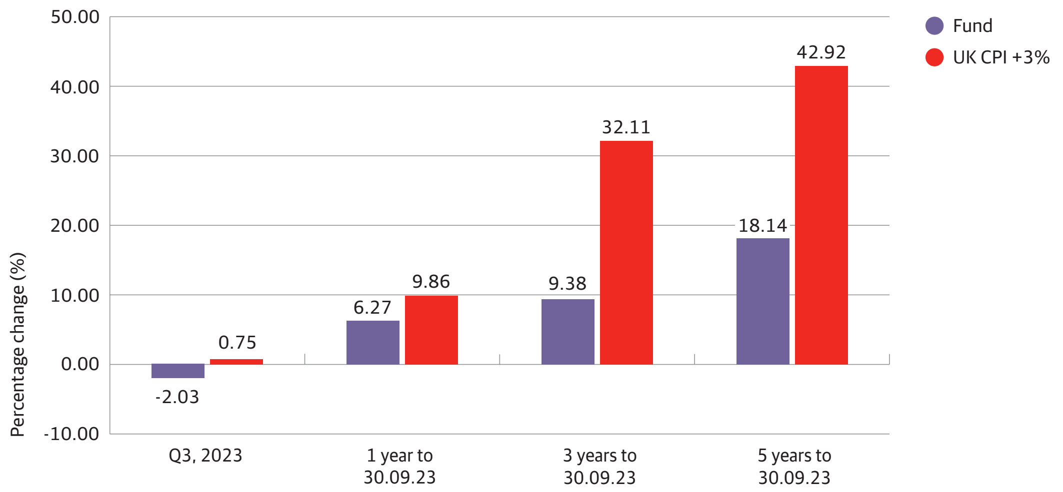
Aptiv

- A global auto parts technology company with exposure to the key themes of vehicle electrification and connectivity, increasing infotainment, autonomous driving and active safety technology like sensors and automatic controls
- Their products are used in both commercial and consumer vehicles with increasing technology content being a key growth area in the autos space – examples include their Advanced Driver Assist Systems (ADAS) which utilises AI and machine learning to further improve the reliability and performance of sensors to enhance both safety and driver experience
- 25 of the world's largest auto manufacturers are customers, so it matters less to Aptiv which car company wins in the race for electric vehicles, autonomous driving, and other technological advances as they supply many of the key players
- Their long-standing presence and key customers in China help to broaden the growth opportunities
- Ongoing additional regulations support many key business areas for Aptiv, whether that be around swifter adoption of electric vehicles, or the increasing safety standards requiring more advanced equipment in cars

Linde

- Largest industrial gases company in world created by the merger of Linde and Praxair in 2018
- Linde has a very diverse business model in providing industrial gases and engineering services for a global customer base in multiple sectors, including healthcare, food and beverage, and electronics
- Innovative solutions for their customers that are vital to their operations, such as a CO_2 based solution for paper mills helps improve pulp washing efficiency, helping increase capacity without shelling out on new equipment, or ultra-high purity oxygen to keep a room 'clean' for electronics manufacturing
- The end markets Linde provides to are either very robust or have large fixed-fee components, such as a rental on gas cylinders, which are needed in order to be able to restart manufacturing quickly – this provides Linde's own business model with resilience
- Globally, a lot of focus is on how hydrogen could help in decarbonising numerous sectors and Linde are playing a very promising, active role in the hydrogen market along the entire value chain from generation and liquefaction to solutions for transport and storage – it also took a minority stake in ITM Power last year which reinforces a strategic move into green hydrogen

Fund performance



Performance (based on 'S-class' shares).
Net of expenses and tax. Net income reinvested.

Data source: FE fundinfo

Discrete annual performance					
Year to:	**End Sep 2019**	**End Sep 2020**	**End Sep 2021**	**End Sep 2022**	**End Sep 2023**
Fund	+5.54%	+2.34%	+14.81%	-10.35%	+6.27%
UK CPI +3%	+4.83%	+3.20%	+6.32%	+13.11%	+9.86%

Price performance based upon bid to bid prior to 21 January 2019 and single price (mid) thereafter. 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.

Our benchmarks are calculated on the rate of change of the CPI index, over different time periods (e.g. if we were calculating year to date figures in January 2021, we would look at the percentage change from December 2020 to the end of January 2021). So we take CPI to the current value, and add on 3%, prorated over a year (roughly 0.25% per month). If the CPI Index benchmark were to fall, more than the amount pro-rata, the benchmark year-to-date will be negative, even though inflation as reported by the media (calculated specifically as a 12M rate of change), remains positive.

Top performers (%)		
Holding	**Performance**	**Contribution**
Schlumberger	+24.07%	+0.09%
Total SE	+21.25%	+0.11%
Soc Gen US Rates Volatility Trend Note	+18.57%	+0.18%
iShares S&P 500 Energy ETF	+17.04%	+0.05%
Caterpillar	+16.12%	+0.08%

Bottom performers (%)		
Holding	**Performance**	**Contribution**
Tomra	-25.67%	-0.15%
Dexcom	-24.07%	-0.24%
Edwards Lifesciences	-23.34%	-0.28%
Estée Lauder	-22.93%	-0.25%
Discover Financial Services	-20.87%	-0.24%

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

It was a tough quarter for all types of investments as government bond yields rose and stock markets wobbled. Because of this, our equities ticked slightly lower overall. The big losers were medtech businesses **Edwards Lifesciences** and **Dexcom**, which were hit by concerns about how recent developments in weight-loss drugs might impact their businesses. China-focused cosmetics firm **Estée Lauder** was another poor performer as the outlook for growth in the Middle Kingdom deteriorated further. These disappointing performances were partially offset by oil majors **Total** and **Shell**, which were buoyed by a sharp rise in the price of crude, and by strong results from **Alphabet**.

After almost a year of sterling strength against the dollar, the pound reversed course last quarter, falling almost 4%. When the pound falls versus overseas currencies, it boosts the returns you make from foreign assets, as the investments are worth more in sterling when you convert them back. We 'hedge' a portion of our dollar exposure in order to ensure we are not over-exposed to this currency risk, however the portfolio still received a useful tailwind from this US dollar strength.

Asset allocation ranges

Liquidity	Equity-type risk	Diversifiers
5% to 40%	40% to 80%	0% to 40%

Asset allocation change and strategy

We significantly increased our exposure to fixed income over the quarter, reducing our equities and cash.

Asset allocation split	30.06.23	30.09.23	% Change		12 month change	
Liquid assets	23.62%	23.93%	0.31%	▲	7.12%	▲
Equity-type risk	67.48%	66.44%	-1.04%	▼	-2.75%	▼
Diversifiers	8.90%	9.63%	0.73%	▲	-4.37%	▼
	100.00%	100.00%				

Asset class split	30.06.23	30.09.23	% Change		12 month change	
Equities	63.93%	61.91%	-2.02%	▼	-4.18%	▼
Index-linked bonds	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Conventional government bonds	13.72%	16.71%	2.99%	▲	1.64%	▲
Corporate bonds	4.35%	6.97%	2.62%	▲	5.17%	▲
Emerging market debt	0.83%	0.76%	-0.07%	▼	-0.21%	▼
Private equity	0.28%	0.27%	-0.01%	▼	-0.06%	▼
Alternative investment strategies	6.96%	7.82%	0.86%	▲	-0.45%	▼
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Infrastructure	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	1.94%	1.81%	-0.13%	▼	-0.49%	▼
Cash	7.99%	3.75%	-4.24%	▼	-1.42%	▼
	100.00%	100.00%				

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

Investment outlook

While we're pretty cautious about what the future will bring, we're holding much less cash than we have over the past decade. A return to normal interest rates (and yes, this is normal – the last 15 years were not!) has created opportunities in all sorts of places, and our portfolio has changed because of it.

We now hold less equities, less cash, and more bonds in our portfolio. Today, we have more government bonds than ever before – and for the first time none of them are inflation-linked. We also own a sizeable chunk of structured products and have started investing in infrastructure for the first time (barring an investment in US oil pipelines several years back).

This is exciting. Proper multi-asset portfolios are back on the table! Zero-interest-rate policy pushed the prices of all types of assets higher and higher, squeezing our options. To retain diversification and avoid areas that we believed were too expensive, we tended to have a 'barbell' approach. Like a weightlifter with equal weights on the ends of their bar, we had big positions in equities on the one hand, and big cash piles and 'diversifiers' on the other. Essentially, there was no alternative to equities, and you needed something to moderate their ups and downs, even though the returns on offer from bonds and other income-heavy areas were miserly to non-existent. This is no longer the case. Now that interest rates are much higher, we can buy government bonds that offer yields and portfolio protection. We can find corporate bonds that pay large incomes to compensate for the risks they present. And we can scoop up out-of-favour investments with generous margins of safety.

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If there are any of the commentaries you require further clarification on, then please contact your advisers or RUTM at the contact details contained on the RUTM website.

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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