

TRANSCRIPT: EPISODE 18

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[INTRODUCTION]

Sam Slator (SS): I'm Sam Slator from FundCalibre and you're listening to Investing on the Go. I'm here today with David Coombs, the manager of Rathbones Strategic Growth Portfolio. Hi David.

David Coombs (DC): Hi.

[INTERVIEW]

[0:11]

SS: So you've managed this fund for about 10 years now, what have been the highs and low points of the past decade for you and what have you learned along the way?

DC: High points, low points is difficult. The way we run the fund is it's meant to produce consistent returns so we never shoot the lights out, we never kind of go through the floor. Everything's been a 10 year bull market since the financial crisis of '08, if it hasn't been taper tantrums, yield curve inversions, there's been lots of market blips over that period that have been challenging to get through.

The highlights have been to see the fund get through half a billion [pounds] towards the last two or three years, it's been a long slog, a lot of presentations in hotels around the country trying to get people interested in this type of strategy. And finally we seem to be in the sweet spot where multi-asset and targeted return and risk are much more in vogue than they probably were ten years ago.

[1:05]

SS: So you've mentioned target returns and risk, so this is a new type of fund where you actually think about risk first and then the returns that you can get from it. Is that correct?

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DC: Not exactly. This fund has two targets that are equally weighted: the risk and the return. So if I hit the risk but not the return, that's not acceptable. If I hit the return but take too much risk, that's also not acceptable. They are weighted 50/50 in terms of how I look at the fund and probably equally importantly how I'm remunerated.

[1:34]

SS: You split the portfolio into three buckets: liquidity, equity risk and diversifiers.

DC: Yes.

SS: Can you explain what you mean by each of those please?

DC: Yeah, when we're targeting risk, for example, we're looking at relative volatility but really we're talking about drawdown because that's what clients really get nervous about. It's when you have stress market conditions and your investments are going down. So what we're trying to do is manage the downside. We think managing liquidity risk is a key part of that, if not the most key part of that, so the liquidity bucket contains asset classes that we know we can sell during those distressed market periods.

We don't look at average daily market liquidity, we look at liquidity during stressed events. The L-bucket is only investments we have high conviction confidence we can sell them during those market stressed events but also they will probably produce a positive return, ie they're negativity correlated. What's in there? Mostly sovereign bonds but AA rated credits and above as well and cash, of course.

SS: Okay and the equity risk is that shares in companies?

DC: It's everything I just described I guess, it's clearly equities that's fairly obvious but it's also credit, high yield, emerging market debt, corporate bonds below single A rated. Again any investments which we think may be illiquid, may have a high correlation to equities during those market stressed events. Because a lot of multi-asset funds will have lots of diversification in terms of asset class and sectors and they don't really stress test their portfolios, they just look at long-term correlations. We don't do that. We look at correlations and liquidity and downside risk during a say 20/30/40% collapse in equity markets.

[3:23]

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SS: Okay thank you. In that equity risk sector at the moment you've got what looks like an eclectic mix of shares and holdings at the moment, at least at first glance. You've got likes of Estée Lauder, the makeup company, LVMH which is Louis Vuitton and Moët Champagne, ASML that's not even a chip maker for phones or computers it provides the bits for those phones and things, so is there a theme I can't see or how do you go about picking those particular holdings?

DC: We're not thematic investors particularly, I don't sit there and go I must have an investment in makeup theme for example - we own Ulta beauty as well - just to take that forwards. I think what's really important is we have 40 or 50 companies in the portfolio and they're all weighted accordingly, there's no top 10. It's strategic growth, they will typically be between 0.7 and 1% of the portfolio, that's part of our risk discipline, that's the first thing to say.

Secondly, what would they have in common. They would have a management team that we feel has the culture that's appropriate, ie they're willing to be challenged. We don't want CEOs who are a huge personality that aren't going to be challenged by their management teams because that's where you tend to have risk and poor allocation of capital. The culture and organisation, how they empower their senior managers is really important. So there'll be a strong management culture within all the companies we invest in. But probably the most important thing they have in common is that they put the customer at their priority of stakeholders.

[4:53]

Now a lot of people talk about stakeholders in terms of shareholders, in terms of employees, we think the most important stakeholder is actually the customer because if you don't get that right your employees will struggle, the shareholders will struggle and management will struggle. It's really important that all those companies focus on the customer and what the customer wants.

For example Estée Lauder as you used the example, they are looking at reducing plastic use and moving toward glass because they are seeing a huge shift in consumer behaviour, okay. That's a company that clearly is up to the minute in terms of what their consumer wants and desires and is moving accordingly, even if that's going to cost them money to do so. They're taking a long term approach. Customer focus, customer service, absolutely vital whether it's a business to business or it's a direct to consumer business.

[5:42]

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SS: Thank you. Just going back briefly to the liquidity bucket, you hold some things in there called Treasuries 0% T-Bills that actually - we're talking in June at the moment - they expire next month, so they're quite short term. What are they exactly?

DC: So they're short term government borrowing, like gilts if you like but they're less than one year typically to maturity. They're a way of us investing cash for a better return than cash when we're feeling that the world is a bit risky and we want to hold more liquidity.

In Strategic Growth and some of our other funds we have very high level of liquidity at the moment which reflects the risk of trade wars, political interventions and some of the other macro factors and Brexit that everyone's aware of. So we're running high levels of liquidity, we don't just want to hold cash. So by holding Treasury bills, which are government bonds effectively, we're not taking any bank risk or credit risk and we're maximising our risk return on cash if you like.

SS: So when they do expire would you simply go and get another one that expires in another three months?

DC: Yes, correct. Or maybe depending on where rates are they may be slightly longer and sometimes we might buy a two year gilt instead. It will really depend on the value of where the best rate is for maturity based on our views. So we will have UK sovereign bonds from say one month right up to two years as part of that kind of alternative cash position when we want to have high levels of liquidity, such as now.

[7:11]

SS: Okay thank you. And in the diversified bucket there's just a small amount at the moment, just 5%, perhaps you could explain why that is and what you've got in it. I see there's something called an S&P 500 put, could you perhaps explain that one?

DC: So the 5% really reflects just the nominal value of the investments, how much money we have invested there, but actually what the S&P put does, at the moment our position covers 20% of the equity risk. So it's actual coverage of the portfolio is higher than 5% so it's slightly misleading. One of the big advantages of scale and as the fund's got bigger it's allowed us to enter into more sophisticated ways of managing risk and put options are a way.

So an S&P 500 put effectively, if you buy say a put at S&P 2,500, if the S&P falls below 2,500 we can still sell at 2,500. So we isolate the losses below 2,500. What are the advantages? You have again an absolute number that you have 100% confidence that risk beyond that you're not exposed to. So

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you're not hoping like hedge funds that they'll be uncorrelated, this is a guaranteed negative correlation to equity risk. It's a bit more expensive than other forms of insurance but the way to look at it, the way for investors to look at it, we're buying insurance for the portfolio and like all insurance, like house insurance, you hope to lose money on it.

SS: Yes.

DC: Because if your house insurance investment pays off, you haven't got a house it's just burnt down or flooded and it's the same with S&P puts, they work exactly the same way. They isolate you from that risk. If we covered 100% of the portfolio with those put options we would have no US equity risk at all.

Now we don't do that, we just depending again how we feel, last year we were 50% and at the moment we're 20%.

[9:03]

SS: Going back last year when we met you were one of the few people who was still very positive about the US.

DC: Yes.

SS: The market had risen quite a lot at that point, it was looking little bit expensive but you I think you said you thought it was probably going to be the best asset class in terms of returns, definitely over the next 10 years but perhaps over even the next 1, 2, or 3 years as well. Is that still your view?

DC: 100% yes. I would dispute whether it's expensive actually. I think if you compare the US market on a sectoral basis, technology is 1% of the UK market, it's nearly 20% of the US market. Often people aren't comparing like for like. And also if I compare the valuation of US banks versus European banks were talking about completely different types of institutions with different qualities of management and history.

I think looking purely at valuation and a PE-level between markets is fraught with danger and it's not something we look at to be honest. I would argue the US equity market, I'm not arguing it's cheap, I'm arguing it's good value in terms of the transparency of the future earnings and yes I'm still a buyer, I still have a bias towards it, I have no doubt that will be the case in six months time as well.

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SS: Brilliant, thank you.

DC: You're welcome.

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