TRANSCRIPT: EPISODE 175
24 February 2022 (pre-recorded 22 February 2022)

Below is a transcript of the episode, modified for your reading pleasure. Please check the corresponding audio before quoting in print, as it may contain small errors. Please remember we've been discussing individual companies to bring investing to life for you. It's not a recommendation to buy or sell. The fund may or may not still hold these companies at your time of listening. For more information on the people and ideas in the episode, see the links at the bottom of the post.

[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast. In this episode we're staying close to home in the UK market with Alexandra Jackson, manager of Rathbone UK Opportunities fund, who tells us why she believes the dominance of growth strategies has come to an end and what changes she's made to her portfolio to find more balance.

Sam Slator (SS): I'm Sam Slator and today I've been joined by Alexandra Jackson, manager of Rathbone UK Opportunities fund. Hi Alexandra, thanks for coming.

Alexandra Jackson (AJ): Hi, Sam. Great to be here.

[INTERVIEW]

[0:29]

SS: So, quality growth companies, like the ones that you invest in, have had a pretty tough start to the year. And you've said you think that the dominance of growth strategies has come to an end, how do you see this playing out?

AJ: Yeah, you're absolutely right. Markets have been really tough the last couple of months for quality growth investors. After many years of outperformance, these types of names, they're the ones finding themselves suddenly out of favour compared to the more cyclical value-type names. And this rotation's been really aggressive, but it's also from what we can see been very indiscriminate. Yes, those, you know, the very speculative end of the market, those loss-making

largely US-listed tech names, they've been hit the hardest, but even our selection of very profitable UK-listed tech names, they're down on average 20% so far this year. These are companies with huge structural drivers at their backs. They make double digit margins, in many cases they make over 30% margins. They're growing their top line, they're generating cash. They find more useful things to do with their cash than just return it to shareholders. All these things are really positive for the long term, but we are wary that these periods of extended draw down, you know, it's painful for clients, it needs to be managed. It needs to be talked about.

And especially I think because we've been hearing this slightly one way quality growth story for many years now, global markets have really leaned into this with only the kind of odd period of rebalance. Then we had COVID, that further extended the dominance of quality growth stocks, interest rates were held down, technology, you know, really became our everything during lockdown. Now though, we've got a fairly sustainable looking reopening (hopefully!), a very forceful rate hike cycle in the US and the UK. So it's not hard to see why that one way street of growth outperformance might be coming to an end.

We certainly don't think growth is over - those qualities that we just talked about, particularly in the tech sector, they're very attractive. They're very appealing over the long term, but like so much in life, I think maybe a bit more balance is needed now. And you know, a more balanced market, it's a healthy sign, it’s also particularly beneficial to UK investors because the FTSE is naturally a more cyclical, more value-led index.

[2:43]

SS: And so have you been adding to any of your names that have sold off in recent months if you think it’s been indiscriminate in this way?

AJ: Yeah, we have, but in quite a small way, so far. For example, you know, that tech exposure, that indiscriminate area that we talked about, as a whole our exposure there has been coming down since the summer in favour of more reopeners and a few more financials. Reflecting this view that we needed a bit more balance. Since the start of the year, since the sell-off, we have been adding back to some of those names that became very, very oversold - only in quite a small way and very selectively. So, names like GB Group, they are engaged in cybersecurity, Keywords, the outsource video game developers. These are quite good examples I think of those

really profitable companies that found themselves with the wrong factor for the market at the moment. But we strongly believe that these kind of businesses will be multiple times their current size within an investable timeframe, but we are very overweight quality growth already.

So we don't necessarily need to add more exposure overall to this factor. It's more about making sure we are in the names that can provide earnings upgrades as the year progresses. And then on the other hand, we've been selling names where we think wage or other cost inflation could actually take the shine off numbers from here. You don't want that double whammy of being in the wrong factor and then seeing downgrades as well.

[4:01]

SS: So you alluded to it then about the financial names and reopening plays. You've been adding to some financials and travel companies. So these are what we would be thinking of at the moment perhaps as value sectors. Are you still kind of going for the quality growth companies within that value sector or are you going purely for that reopening trade?

AJ: No, that's absolutely right. It's quality within the reopeners or within financials. A lot of the financial sector is very, you know, can easily be labelled value, yes. The banks, they trade on very low price to book values. We're still avoiding those, that's hurt us year to date, definitely, but as quality investors, we, you know, we struggle to own names with such a low return on asset. Such big adjustments in the accounts, such a lack of sustainable growth, a punchy regulator. Right now, you know, the banks are enjoying this rising rate cycle with the expectation that this improves their margins and therefore their profits, but we have a slightly different view, that in fact, at this point in the cycle, you want to be more focused on credit quality. So we're seeing that credit spreads are actually picking up a little bit indicating the potential for rising levels of financial stress, which kind of makes sense when you think about how many strains there are on consumer incomes right now from, you know, increase mortgage rates, higher food and energy bills. So actually, we think the high street banks in the UK, they may actually have to give up their gains from interest rate rises because of these higher, bad debts that they're going to experience.

That wasn't really your question. I had a rant about the banks. We have been adding to our financials. Yes. Outside the banking sector.

Insurers are a really nice way to get a bit of leverage to rate hikes, but without some of that quite binary outlook, that we see in the banking sector, ie we'd still want to be invested in these names

even when the interest rate cycle is done. So we've been adding to life insurance company, Phoenix, that's a FTSE 100 name also to a slightly smaller business, a specialty insurance company called Beazley, that's done extremely well after a tough couple of years. They're benefiting again from that sort of two-pronged rising interest rates, but also very chunky growth in their premiums in areas like cybersecurities, particularly. So, Beazley will start to look very profitable in areas like that.

And I think actually this sector's quite under-owned by fund managers, partly because of concerns that climate change has not been properly priced into premiums that insurers charge. So, we see more floods, more fires, more other natural disasters, you know, they come increasing frequency. And so that means the insurers need to pay out more claims and probably higher claims as well. That's not great for shareholders, but Beazley have come out quite early saying that they don't know exactly how to price for climate change yet, but they do know that they need to increase premiums by some way to account for this. And I think actually this is a really sensible, quite an honest way of managing profitability while also being able to continue to insure these risks, which is the most important thing. And it compares to other insurers that we see who are still burying their heads in the sand, I think around climate change. So Beazley's really differentiating itself like that.

[7:13]

SS: And this fund can invest companies of all shapes and sizes and thinking more specifically about smaller companies, how do you manage the extra volatility that can come with them and the liquidity, how you are able to buy and sell a smaller company at times when there's not a lot of trading going on?

AJ: Yeah, it's such a big focus in the team. As you say, you know, 70% of the fund is in mid and small caps. We look at our liquidity on a day-by-day basis. The kind of official figure says that over 97% of the fund could be traded to cash within two days. But we look at this on a daily basis kind of on the desk, making sure we don't own too much of quite a thinly traded stock. And actually then having that multi cap mandate is crucial. We really want to have exposure to these exciting small, nichey, you know, the little gems, the game changing gems that we find quite low down the market cap scale, but because of the multi cap mandate, we can balance this out with some of those larger growth compounders so that we are never forced sellers. That's important to us. So, we've got about a quarter of the fund in the FTSE 100, we found a few really

interesting growth companies. They fit our process and they provide that easy level of liquidity. And then we also tend to size our positions with liquidity in mind as well.

[8:32]

SS: And what's exciting you most at the moment and what's worrying you in terms of the portfolio?

AJ: Yeah. Lots of, lots of things in both camps. I think this year is going to be super for some of the reopening stocks. Again, it's about finding quality within those reopening names. Not just taking the most kind of binary approach. We were reading some research this morning that shows that 45% of us haven't been into a pub or a restaurant since 2020 and 85% of us have not been overseas on holiday since then. So that pent up demand is huge. And the final removal of restrictions, the lower risk aversion that I think we're probably feeling now around going out, that's going to be very powerful, leisure and travel will be more of a priority for our spending than buying more cushions or teles.

Sam, you and I have talked about SSP many times over the years. They operate cafes and bars in airports and railway stations around the world. None in Russia or the Ukraine I should add. So I think they'll be really well placed to enjoy this kind of renewed demand and actually having that captive consumer base, - you know, you're sort of stuck in an airport - means that pricing is less sensitive, so they should be able to protect their profits despite inflation. Obviously, a new variant would be a problem for these reopening stocks, but actually for SSP, you know, they paid back their government loans, but even having done that, their balance sheet looks, looks pretty bombproof now. W H Smith sits in this bucket as well. It's no longer a high street, you know, stationary retailer. It's a global travel retailer as well, so similar dynamics to SSP.

But more generally we don't have much exposure to retail. We are quite nervous around that point around the consumer, having a lot of higher costs to try and absorb this year. And also that we have better things to do with that lower amount of discretionary spending money than just to buy more stuff, it's going to be services. So we've been scouring the portfolio for names where we are concerned where, you know, the pandemic led to a lot of demand being pulled forward and where potentially the market has then been a bit lazy in extrapolating that demand level as the new normal from here. So I think any slight slip in numbers for, you know, home furnishings

companies or consumer electronics, could be taken negatively. And then even on a very short-term view while we don't own those home furnishings or kind of consumer electronics names, even areas like pet products or gaming, they could be a bit vulnerable to the same dynamic, I think as well.

[11:02]

SS: Maybe finally, we could have a quick chat about M&A and IPOs, which was two very strong areas for the UK market in 2021. Do you think that's going to continue this year?

AJ: M&A, yes. IPOs probably less so for the time being at least. I think the IPO market is probably shut in the UK for now anyway. We, in the team, we've seen a handful of IPOs, potential IPOs, already this year, and none of them have actually succeeded in coming to market. You know, there were quite a few high profile disasters last year, mainly those kind of headline grabbing consumer brand names. And I think they've caused investors to rethink their appetite around IPOs. You never have so little information as you do on the day that a company IPOs. So it has to be a real 'must own' if you're going to buy stocks at IPO. And I think the traditional discount that fund managers tend to ask for, I think that has, probably needs to come back into the market as well.

M&A though, that looks much more promising. Once some of these, you know, geopolitical scary headlines abate, it's a similar story really to last year, I think private equity, still awash with cash. The UK is still trading at a 40% discount to other global developed markets. So, lots of bargain hunting can be done there. And then we also expect our companies to undertake their own M&A. So we've seen names like Halma, Kainos, Dechra, Cranswick, XP Power, for example, they've already been busy this year with quite small deals. But you know, it's a great sign that they're doing it. Lots of our holdings do have excess cash that we know they'd like to deploy. And now that they're able to do face to face due diligence, traveling overseas again, I would certainly expect activity to pick up and this can be a really nice driver for share prices

SS: As always, that was really interesting. Thanks very much.

AJ: Thanks Sam.

SW: The Rathbone UK Opportunities fund looks to combine structural winners with a strong core of high-quality compounders from small companies all the way through to the very largest in the UK. The fund's heavy mid-cap and quality growth bias means it is likely to deliver very different performance to the UK market. To learn more about the Rathbone UK Opportunities fund visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.

Please remember, we've been discussing individual companies to bring investing to life for you. It's not a recommendation to buy or sell. The fund may or may not still hold these companies at the time of listening. Elite Ratings are based on FundCalibre's research methodology and are the opinion of FundCalibre's research team only.