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investing ON THE go

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[INTRODUCTION]
Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Over the next two episodes we're focusing on the UK stock market and the opportunities for investors. But we start overseas with the impact of Silicon Valley Bank's failure and what it means for some of the UK's most creative companies and why valuations look good for UK firms.

Chris Salih (CS): I'm Chris, and today we're joined by Alexandra Jackson, manager of the Elite Rated Rathbone UK Opportunities fund. Alexandra, once again, thank you for joining us and spending some time with us today.

Alexandra Jackson (AJ): Hi, Chris. Thanks for having me.

[INTERVIEW]

CS: I know all things UK are on the radar, but maybe let's start with overseas and what's happening with Silicon Valley Bank in the US. [It's] obviously thousands of miles away, but the bank's been used by a lot of UK tech companies. Maybe just give us a brief overview of what's happened, how higher interest rates in a lower growth environment might impact some of the UK's most creative companies. And, you know, is it as worrying and the fear of contagion? We've had this before, should we be as worried this time?

AJ: <Affirmative>, I think it's a really good point. As you say, it is miles and miles away, but there is definitely some second-round impact that we need to think about in the UK. I don't think this is a systematic issue that we need to get extremely nervous about, because of the way that the Fed [Federal Reserve] has reacted and because of the signs that I've seen in bank lending since.

But, you know, Silicon Valley [Bank - SVB] had a very impressive Rolodex of relationships with those US tech firms, but also a lot of UK tech firms, as you say. And during that era of very low interest rates, those tech startups, they increasingly banked with Silicon Valley Bank. So, SVB was taking a big share of those deposits and those loans and they were attracting more loans - more deposits, sorry - than they could loan out. But those deposits weren't particularly sticky because they are effectively current accounts for very cash-hungry, loss-making startups. So, you've got short deposits on one side, and then the assets that they had on the other side of the balance sheet were very long duration bonds. So, this is basically an asset liability mismatch. This is banking 1-0-1.

And then the catalyst for things going wrong, of course, was when short [interest] rates started rising, and long rates didn't really move. So, SVB was very long duration, during one of the most violent yield curve inversions we've ever seen. So, you get huge losses and then a depositor base, which gradually and then very suddenly noticed that a) they could get a much better rate on their money somewhere else, and b) was able to pull their money, just with a very quick swipe on the app.

But what we've been looking at is, it wasn't the asset quality that was the problem, and it wasn't the quality of the loan book that was the problem; it was just a simple case of balance sheet mismanagement. And, in a funny way that's a bit reassuring because it, I think that demonstrates that it's idiosyncratic, rather than systemic credit issues. Which is the muscle memory that I think investors who were around in ‘07/’08 are feeling kicking in.

But the other positive signal was the speed and the surety with which the Fed acted to protect depositors, to prevent a run on the bank, and then to sell the bank to another, you know, [to] find it another home. But as you say, the second order impact is, this is what happens to earlier stage creative companies.

So, you know, higher interest rates, that's one thing; the availability of credit is the other important thing. And there's been a lot written about banks tightening their lending from here, which makes sense. But we haven't actually seen any sign of it happening yet. So, the numbers that we see - the data - has not suggested that it's happening. Actually, banks seem keen to continue lending to their quality credits, and I think that's quite important. They will be looking at all of the fundamentals within a business, to keep lending there.

So, I think we need to wait longer of course, to see how it pans out, but the signs so far are that quality credits will still be able to borrow money.

I spoke to the CEO of one of our portfolio holdings just after SVB - well, SVB UK - was taken over by HSBC. Molten Ventures [Molten Ventures VCT plc], the company we own, it's a UK-listed venture capital firm, and they have stakes in around 70 private, early-stage, consumer tech businesses. So, you know, right in the eye of the storm. And their view is that, you know, there will be more strain in this kind of startup part of the market, and that some business models really only worked because of the era of free money.

But the companies that they invested in their core portfolio, they are fully funded for 18 months, so they don't need any more cash in order to realise their growth forecasts. And actually, they're growing very rapidly as well, like really rapidly - kind of 60% plus a year some of these companies. So, they're not really the areas that you'd be worried about. But nonetheless, Molten have been asking their businesses to cut their costs where they can, to reduce that cash burn, so that they're double sure that they don't need extra cash, without harming the long-term growth, obviously. And actually, what he said was that the end of free money, it kind of raises the bar for success. So, weaker players will fall by the wayside and the strong will get stronger. He thinks that plays to his portfolio. I know that it definitely plays into our investment style, which focuses on high quality, category leaders, best in class.

CS: Well, let's push on that then, because obviously, I read a commentary from you, I think it was from January the first I think it was, basically you said 2023 would be a year we'd start to feel the chill from monetary policy. Is dispersion on the table? I mean, you said it's not the classic setup for equities. Is it a case [of] now is the time to spot some of the stronger from the weaker firms? And in that scenario, does the UK stand out from maybe some of its peers overseas?

AJ: Yeah, I think that's exactly right. You know, this should be a really good time for stock picking. And valuation will be the key. You know, when you get this very rapid tightening cycle, strange things happen like, you know, crypto frauds and bank runs and things like that. But more prosaic things happen as well. Like, companies have to spend more money paying their interest bill, obviously - funding might not be as plentiful; you know, we've had supply chain issues, labour shortages, all of those things, which mean companies potentially have to downgrade their revenue and profit expectations.

And when you get downgrades, valuation becomes essential because, for share prices to move forward, you need to be in areas that have already priced that in. And actually, the UK does score really well there. So, I think it's the cheapest developed market out there - the UK trades on around a 40% discount to global equities. Now, you know, we've been saying that the UK is cheap for a while. It is usually cheaper than the US, so we have to just kind of get used to the UK trading on a discount to the US. But the discount now is so wide, it's never been this wide. The S&P 500, for example, sits on 18x *[18 x earnings – for every one dollar of earnings, investors are willing to pay 18 times that in value]*.

CS: And it's a lot more than just the fact that the US is a growth-orientated economy - it's a lot more than just that, isn't it? It's the uncertainty of other things over the UK as well?

AJ: Yeah, exactly. But you know, the UK trading on kind of 10, 11, 12x, that's pricing in a good deal of those issues already and I think that's quite a nice starting point. It's a good, you know, you really need that margin of safety when downgrades are in the post, when you have that uncertainty.

CS: A lot of the stuff you read is almost chasing shadows. You're trying to figure out how far the market's going to fall before you perhaps jump in and take an opportunity - not [that] that's necessarily the way to invest - at the moment for you, do you look at the market and go, I might have to do this if we have a recession, and then what type of recession will it be, you know, soft landing or not? You know, how do you approach that, and does the environment lean itself to certain sectors, or is it purely company by company?

AJ: Yeah, for us, it's always company by company because, you know, we own 50 to 60 companies only. So, we don't need to own anything in any sector. We don't need to own any sector if we don't want to. For example, we don't own any banks at all. So, that's quite a nice place to start. So, it is always quite bottom-up.

I guess what we see is that when you have environments like this, and you don't get kind of downgrades across the market very often, that's quite a peculiar set of circumstances and they're quite rare. But what we've observed is that during those periods, the areas that outperform, it's actually very consistent and it is always quality. So, you know, what do people mean by quality? It's return metrics, so, return on invested capital, cash flow returns - you know, any of those kind of return metrics.

CS: Just to be clear for listeners as well, when you say quality, we're not talking about size here, that can be any type of company across the spectrum in terms of quality, can't it?

AJ: Absolutely. Small companies can be, you know, very high quality and, you know, can definitely be higher quality than some large companies for sure. It's around how high is the … it's [a] combination of margin and how quickly they turn their assets. It's also for us, there's a lot in there around the stability of revenues and profits. So, you don't necessarily want something that's up a huge amount one year and then down a huge amount. That's not what we mean by quality and reliability. So, it's that kind of recurring, reliable, those sorts of factors tend to outperform very, very consistently.

And the UK is quite mixed, I would say, on that front. You know, we've got a lot of energy companies, banks, they don't really fit a lot of those classic quality markers. So, you have to be quite selective. And actually, to your point, you have to be willing to go down the market cap scale a little bit because, actually, a lot of the quality compounders sit in the FTSE 250.

CS: Well, obviously, that brings us on nicely to the portfolio. Because obviously you've got a decent chunk invested in the FTSE 250 and also in AIM-listed companies. Maybe let's take each one in turn. I mean, are the clouds lifting for the FTSE 250, for these midcap companies? Are there still stresses? How do you view that? And then maybe let's talk a bit about AIM *[a sub-market of the London Stock Exchange that allows smaller companies to raise capital by listing on a public exchange with much greater regulatory flexibility compared to the main stock market]* as well.

AJ: Yeah, sure. So, I think a lot of the headwinds that really weighed on the FTSE 250 last year, I can see them lifting or maybe even reversing. So, weirdly, politics has been one of the strongest upside surprises in recent months, which I didn't imagine that I would be saying <laugh>. That's not what we're used to in the UK, that's for sure! Obviously, it's improved off a very low base in October, but the current government has actually achieved some things around the Windsor framework *[a proposed post-Brexit legal agreement designed to address the problem of the movement of goods between the European Single Market and the United Kingdom in the current Northern Ireland Protocol]*. We might even get a public sector wage settlement, drama free budget, … yes, these are things we should be able to expect but we haven't had them successively in recent times, so expectations have been so low, so even, you know, a vaguely competent government seems to be an upside surprise.

And then, you know, you've got gas prices, which are down below levels they were before Russia invaded Ukraine. So that's a really nice boon for consumers, and for businesses. It means hopefully that, you know, inflation has peaked and therefore interest rates are probably pretty close to peaking. And we've

seen sterling also, you know, reflect a lot of those headwinds dying away. And, sterling has bounced really nicely, so, and those are all really good predictors of midcap outperformance.

CS: Is there maybe an example of a midcap that you would like to highlight, that falls into the bucket for your portfolio?

AJ: Yeah, absolutely. Keyword Studios [plc] is a really interesting UK midcap. They are a video game outsourcing business. So, we really like the video game space, but I'm never sure exactly which game is going to do best and exactly which console, which area, which niche. So, it's a bit like buying a fashion brand, you know, you don't know exactly which are the most successful, so I would rather go one stage back and buy the outsourcers. So, Keywords does game design, game support, game translation, all of those things for almost all the AAA manufacturers. [It's] really interesting.

CS: And I was just going to ask in terms of AIM, is there anything you can do differently? Are you having to maybe meet management a bit more to really get under the bonnet, even perhaps more so in this environment? How does that perhaps work because of the liquidity, perhaps the issues that are attached to that part of the market?

AJ: Yeah, I think, for us, it's just raising the bar again in terms of the quality, the accounting focus, you know, we just have to be stricter, more and more strict all the time about, you know, finding those signposts in the accounts that suggest that all is not what it seems. And it's usually around the same things: it's cash, it's accruals, it's working capital. So, it is possible to spot, but I think it's not being done all the time. So, we just have to raise the bar.

We also raise the, you know, we've kind of raised the size limit a little bit in AIM, and that seems to help a bit. But what we have seen, you know, our AIM weighting has come down a lot in recent years, partly because a few things have been taken out, have been bid for, a couple of things we've sold, and then lots of companies are moving from AIM to the main list, which is an interesting little development. For years, having said, you know, there's nothing wrong with AIM, we're happy here, actually now people are saying, you know, we need to demonstrate that we have the most stringent corporate governance and accounting and all of those factors. And one way to demonstrate that is to move on to the main list.

CS: Okay. I'm going to hop across the Atlantic back to the US again. I mean, you've talked recently about UK companies that can benefit from US infrastructure spending. Maybe tell us a bit more about that?

AJ: Yeah, that's a really interesting theme running through the portfolio at the moment, and it's not just the Inflation Reduction Act, the IRA; it's more, it's also the CHIPS Act [*CHIPS and Science Act provides $52.7 billion for American semiconductor research, development, manufacturing, and workforce development*], the JOBS act *[Jumpstart Our Business Startups act]*, a lot of stimulus around infrastructure spending is percolating through the US economy. And it's actually, you know, it's being translated into actual dollars on the ground now, which is something I think people often worry about with infrastructure spend, that you actually never see the dollars, the companies never really benefit from it. Actually, it's

happening now. So, companies that we invest in, like Ashtead [Ashtead Group plc] and CRH [plc], which are both in the FTSE 100, and then Hill & Smith [plc] also, which is a FTSE 250 business, and they are variously involved in different parts of the infrastructure space.

So, CRH is aggregates and cement, so very [involved] at the very beginning of building roads and bridges and things like that. Hill & Smith, they galvanise steel. So, they would be more involved towards the end of building a bridge or something like that. And then Ashtead rents out the equipment that you need during that whole process. So, all three companies benefiting, you know, at slightly different points of that cycle, and talking very, very favourably about the outlook for spend there.

CS: Okay. I just wanted to round off with a bit of a rallying cry for UK equities. Obviously, it's [been] the best part of seven years since Brexit. Now there's been so much uncertainty for so long that, you know, if you'd invested seven years ago, you'd still be wondering, you know, what's going on? Maybe give us your view for UK investors and you know, why now might be an extremely good time to go into UK equities and, just give them a bit of reassurance for the market.

AJ: Mm-Hmm. <Affirmative>. Well, I think it's a mixture of that valuation point. So, you've got this, you know, you've got this great margin of safety, this great cushion, that means we can absorb some of these downgrades. I thought it was really interesting during February when the US market actually sold off because of all these concerns about a harder landing and recession and whatnot. You know, investors started worrying about that again, and during that time period actually, the UK market was up a little bit. So, you know, this is not huge numbers and they're not super long-term, but I think that's a good pointer for how this year could potentially play out. So, valuation is the first thing.

And then it's those, you know, those headwinds disappearing around, you know, politics, interest rates sterling weakness, you know, some of those things lifting. And you know, the stock market is not the same as the UK economy. So, if you can stay active and be quite selective in the names that you own, for me, if you can, you know, really focus in mid-caps - which is where the alpha comes from - you know, if you want to outperform in UK assets, you need to own FTSE 250 businesses, not just the FTSE 100. And if you can stay in quality, you know, to try and outrun some of those sorts of potholes that can [hinder] performance.

CS: Is there an element of …I mean, I know we don't want to use the old saying of past performance is not a guide to future performance, but, you know, if there is a recession, these type of companies in the mid and small cap space tend to be the ones that lead recoveries as well.

AJ: Yeah, they lead it out. Exactly. They've got some, you know, they've got interest rate sensitivity, they've got domestic sensitivity, all of those things. But hopefully with that extra quality filter so that you're not surprised.

CS: Okay, Alex, thank you once again for spending some time with us.

AJ: Thanks Chris.

SW: Rathbone UK Opportunities is a flexible fund targeting quality growth businesses. Alexandra looks to take advantage of cheap UK valuations, but avoids the ex-growth, large-cap dinosaurs. She combines structural winners with a strong core of high-quality compounders and the final portfolio consists of around 50 to 60 holdings, with a bias to medium-sized companies. 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.