

# Rathbone Global Opportunities Fund

Quarterly investment report, April 2010 to end June 2010



## Overview

During the second quarter to the end of June 2010, the Rathbone Global Opportunities Fund fell 6.5% against a benchmark decline of 10.7%. Only fund managers and actuaries revel in this sort of outperformance, but it does illustrate that efforts to reduce the risk profile of this long-only fund has had some success. As one analyst

recently put it, we seem to have entered the “punch drunk” stage of equity market returns – the rapid ascent of economic indicators, earnings upgrades and multiple expansions have likely peaked – now investors will only reward those companies that significantly outperform expectations. Negative share price reactions to real events and mirages tend to be amplified in this ‘shoot first ask questions later’ environment.

As I approach my tenth anniversary in fund management, I’ve had time to reflect on the key qualities in selecting investments. The one that crops up the most often is ‘adaptability’. Of course, this applies to the management teams of my companies, but actually this is a key quality in a fund manager. Balancing conviction with a willingness to eat your own words if necessary is essential, and it becomes increasingly difficult the longer you spend in the industry. The dismal performance of the fund in 2008 was a call to adapt the investment process, add more balance into the portfolio, and manage risk without straying from the mandate. This is an evolution that will continue over the rest of my career but has already borne fruit in the recent market correction. I have invested in companies with more predictable earnings growth (normally they lie within ‘defensive’ sectors). These companies are less sensitive to changes in economic growth, and the subsequent double-whammy hit of earnings downgrades and valuation compression. However, these companies also embrace the core strategy of the fund and have above-average

quality growth rates. These exciting fundamentals are not simply a magnification of economic growth but are borne of highly successful management, product innovation, disciplined pricing, operational leverage, rational competitive behaviour, and lower risk to future earnings streams.

The pharmaceutical sector is a defensive area that I have shunned for many years as the industry faces structural headwinds of deteriorating patent protection, pricing pressure and political interference. These arguments are well worn and probably discounted by market participants. A recent conversation with a biotech CEO confirmed a greater risk to the pharma business model – the clinical body that approves drugs in the United States, the Food and Drug Administration (FDA), is “dysfunctional”. There’s inadequate funding, skilled personnel and a significant fear of lawsuits. The era of the high margin blockbuster drug is fading – political and legal risk are now more important than clinical benefit, and with it goes the high margin growth.

**Past performance should not be seen as an indication of future performance.**

## Portfolio activity

However, there may be another way to penetrate this space. One of the top performers this quarter was *Virbac*, an animal health business for treating farm animals and household pets. The bulk of its spending is focused on developing and reformulating existing drugs rather than drug discovery. Product innovation comes from simpler treatments (sprays, drops and pills), fewer repeat dosages, and the ability to administer multiple drugs at once. The company is forecast to grow compound earnings by 16% between 2006 and 2011 – the rest of the pharmaceutical sector would be drooling over that...

What will be the most popular mobile phone, movie, video game, or portable music player this year? This is the question that many investors agonise over as they play the boom and bust nature of the consumer electronics industry. Our substantial investment in *Dolby Laboratories* allows us to benefit from the explosive growth of entertainment devices, without having to pick the winner because Dolby surround-sound technology is incorporated in almost all of them. This is a globally-recognised brand with a 40-year history in the industry; 50% operating margins, and an ever-increasing penetration into content creators and hardware manufacturers. I am a strong supporter of the business model and prospects, but the shares have recently gone parabolic, and I have used strength to trim the position.

These investments have been positive contributors to return this quarter but the fund has had to endure our fair share of pain. The holding in *Greenhill*, a boutique M&A advisory business, fell sharply as investors correctly anticipated a fall in deal-flow in the wake of the euro sovereign debt crisis. Greenhill transformed its business in 2008 by hiring several managing directors from distressed investment banks like Lehman, UBS and Merrill Lynch. This has increased its cost base and depressed earnings in the short term, but has also materially increased normalised earnings capability – potentially double the previous peak in strong market conditions.

## Outlook

Unfortunately, I cannot predict when the cycle will turn, and perhaps there are just too many bankers (not many would shed a tear for fewer) which could feed through to pricing pressure. For now, I feel more comfortable with this type of exposure to the financial sector. Whilst financial legislation is just around the corner, turning that into financial regulation will take years (the US Office of the Comptroller of the Currency will soon be a sexy post). Meanwhile, most banks will have difficulty quantifying the impact or determining where they will allocate capital that they are not forced to retain.

It will be more difficult to make money during the second half of this year. 2011 earnings estimates are being reined in; China will probably tighten in response to higher inflation; and US politicians will be reluctant to approve a new stimulus package ahead of the November elections (only Democrats would get the credit). Concerns of a double-dip recession will need to fade before investors' confidence is restored.

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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. **Past performance should not be seen as an indication of future performance.**

**Source performance data, Financial Express, bid to bid, net income re-invested.**

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