RATHBONES

RATHBONE MULTI-ASSET PORTFOLIOS

TOTAL RETURN FUND

Quarterly investment update
January to end March 2024

CONTENTS

HOT TOPICS

MARKETS HOT TOPICS (MACROECONOMIC)

SO NEAR, YET SO FAR

At the back end of last year, investors were confidently forecasting six or seven interest rate cuts from the US Federal Reserve (Fed) in 2024. They've since reined those bets in big time and currently think the Fed will deliver about three 0.25% cuts – if that – perhaps starting in the early summer.

That about-turn has driven big moves in government bond markets. Government bonds are the asset class most sensitive to rate expectations, so it's hardly surprising that their yields have risen, driving their prices down.

We think American rates will fall in time, but inflation and economic growth will need to moderate further first, and exactly when that will happen is anyone's guess. Ours, for what it's worth, is sometime in the second half of this year.

On this side of the Atlantic, however, we think there's a greater chance of rates falling faster and further. Given dire economic growth in the UK and a lot of Europe, the rates situation seems more favourable than in the US, where there's greater evidence that inflation mightn't yet be vanquished. The UK and EU seem more likely to cut sometime around the middle of the year.

WHO NEEDS RATE CUTS ANYWAY?

For much of 2023, investor confidence tracked central bank-speak slavishly. Stocks sold off in early autumn when investors expected the Fed to keep rates higher for longer in its ongoing fight against inflation and then surged towards year-end when the central bank seemed more confident about getting inflation down to its 2% target.

So why have stock markets hardly blinked this year as rate cut bets have been pared back so aggressively? It seems that as 2023's higher-rate-driven US bank failures fade from their collective memories, investors have got a lot more comfortable about higher-for-longer rates. Who needs cuts when America's economy keeps defying recession forecasts and is booming instead?

Providing company profits prove sustainable, stocks can probably keep rallying for a while longer. Stronger profitability would tend to imply a better economy and, therefore, less pressing need for those ever-elusive rate cuts. Stock market bulls also argue that gains are getting broader, and less alarmingly concentrated. In contrast to the first 10 months of 2023, when an unusually small number of stocks contributed to the gains of the entire US index and most underperformed, more global companies are participating in this year's rising markets.

Expectations for Fed interest rate cuts fall from six 0.25% cuts to three in just one quarter.

THE WORLD'S THIRD-LARGEST ECONOMY AND FIFTH-LARGEST STOCK MARKET ARE ONCE AGAIN BACK ON THE MENU.

CAN HOPE TRIUMPH OVER EXPERIENCE?

Since its stock market popped in 1990, Japan has had a long history of reliably disappointing investors. Every few years they're lured back by the promise of a new dawn, only to find little's changed, and so repeating the trauma. And yet, once again, the lure of Japan is calling.

The world's third-largest economy and fifth-largest stock market are once again back on the menu. The stock market has rallied handsomely, adding almost 50% since the start of 2023, and approaching levels not seen since the last Japanese market high in 1989 when Japan was all the rage, before the market burst spectacularly.

The Japanese economy has been plagued by low growth and deflation (falling prices), aided and abetted by terrible demographics. Often, the attraction of Japan was around valuation. Stocks trade cheap, with 30% of TOPIX stocks still trading below book value – this implies that investors believe almost a third of the index is likely to destroy capital in the future. However, we see several factors that should boost stock prices. One is the ratcheting up of the pressure on Japanese companies to do better for shareholder which is bringing genuine change. At the same time, Japan's economy is still relatively weak, but there have been some improvements. House prices have increased, and the country is finally experiencing positive inflation, helped by reasonable wage growth. International investors are returning to Japanese companies, reversing decades of outflows.

PORTFOLIO ACTIVITY

Key purchases/additions	Key sales/trims
UK Gilt 1.5% 07/31/2053 (purchase)	Vodafone (sale)
UK Gilt 1.75% 09/07/2037 (purchase)	Nvidia (trim)
US Treasury 3.375% 05/15/2033 (addition)	Assa Abloy (trim)
US Treasury 2.25% 05/15/2041 (purchase)	Estée Lauder (trim)
Credit Agricole TOPIX Callable Note 2029 (purchase)	Dexcom (trim)

Source: Rathbones

US inflation has been running a bit hotter than expected over the last few months, but we don't see much that suggests a nasty resurgence in inflation that might force the Fed to start hiking rates again. Because we think rates (and therefore bond yields) will drop at some point this year) we've been adding to our government bonds whose values are more sensitive to such moves. Specifically, we have been buying the relatively long-dated US Treasury 3.375% 2033 and 2.25% 2041, and UK Treasury 1.5% 2053, 3.75% 2052, 1.75% 2037 and 0.875% 2033. Even if we're wrong and rates don't fall, we think yields north of 4% in the UK and 4.2% in the US for the next 10 years or more were a prudent long-term investment that should also protect our portfolios if stock markets drop markedly.

Speaking of interest rate disappointments, we bought a new diversifier to protect against exactly this. The BNP Paribas 10-Year US Rates Swaption May 2024 covers half the value of our US bond portfolio and makes money if 10-year yields rise. Usually, a swaption gives you the option to swap your fixed rate interest payments for floating ones; however, rather than giving us a series of floating cashflows into the future, ours is set up to simply pay us a lump sum when it's exercised. If rates remain flat or fall, all we lose is the small premium payment we made to buy the swaption.

Because we think central banks are now done raising rates, we've been buying assets that seem well priced for a coming period of falling bond yields and borrowing costs. Part of this shift is picking up infrastructure companies whose prices have been battered by increasing bond yields. These companies own the roads, railways, mobile data facilities, electricity networks and hospitals that we simply can't do without, recession or not. Some of them literally keep the lights on. We've continued buying HICL Infrastructure and GCP Infrastructure at a discount.

We added another infrastructure investment company to our portfolio as well: International Public Partnerships. It part-owns the UK's largest gas distribution network, Cadent, and the Thames Super Sewer. It has stakes or fully owns many other projects, predominantly in the UK but also abroad.

While we don't allocate assets geographically, there are times when structural trends emerge that we'd like to gain exposure to. The 'three arrows' of former Japanese Prime Minister Shinzo Abe's reform agenda for corporate Japan, which began more than a decade ago, have started to bear fruit. Corporate governance changes have taken effect, further supported by changes implemented by the Tokyo Stock Exchange. This, alongside structural shifts in Japanese monetary policy and a more robust macroeconomic backdrop, have left Japan in a very different place to the last 30 years. This is reflected in the much stronger performance of Japanese equities over the last year or so. To gain exposure to this positive trend, we added a new structured product based on the TOPIX index which gives us the potential for some capped exposure to TOPIX gains plus conservative downside protection to any weakness.

In the last couple of years geopolitical stresses have escalated around the world, with the Russian invasion of Ukraine, tensions between the US and China, and the conflicts in the Middle East. Increasing belligerence between nations encourages investors to pay more attention to defence stocks as expectations for military spending rise. We've long owned aerospace and defence contractor Lockheed Martin to mitigate the risks of a more stressed geopolitical age, yet we increased our position this quarter.

We think there are a few additional tailwinds which could drive long-term returns in the years ahead. The doctrine and needs of militaries are changing rapidly because of technological advances and the new fronts they open up. New threats require new solutions, and while large defence contractors are mostly known for the big machines they have produced in the past, a much more meaningful part of their business is now focused on cybersecurity and digital warfare. A kicker to this need for military investment is the potential for Donald Trump to win a second term as US President and the war in Ukraine, which both seem likely to push European members of NATO to spend more on defence.

US-listed Lockheed Martin has a comprehensive suite of cyber capabilities, supported by elements of AI, machine learning, and automation to deal with the complexities of today's deployments. These technologies also have civil uses, beyond the military ones that drive their creation. For example, Lockheed Martin is using its AI capabilities and hardware to support firefighters dealing with wildfires by connecting land, air, and space-based sensor and monitoring, which help predict and mitigate the spread of wildfires.

We sold UK telco Vodafone in February because we felt we had better opportunities elsewhere. Despite announcing an €8 billion deal to sell its Italian division to Swisscom to narrow its geographic spread and focus on growth markets, more needs to be done to eke out that growth.

As global stock markets continued to rise in 2024, we trimmed some of our better-performing shares, including AI computer chip designer Nvidia (check out our colleague David Harrison's explainer on what all the fuss is about), multinational locksmith and access business Assa Abloy and fragrance and cosmetics maker Estée Lauder.

SPOTLIGHT

IN THIS QUARTER, THE SPOTLIGHT IS ON OUR TSMC AND MERCK HOLDINGS.

TSMC

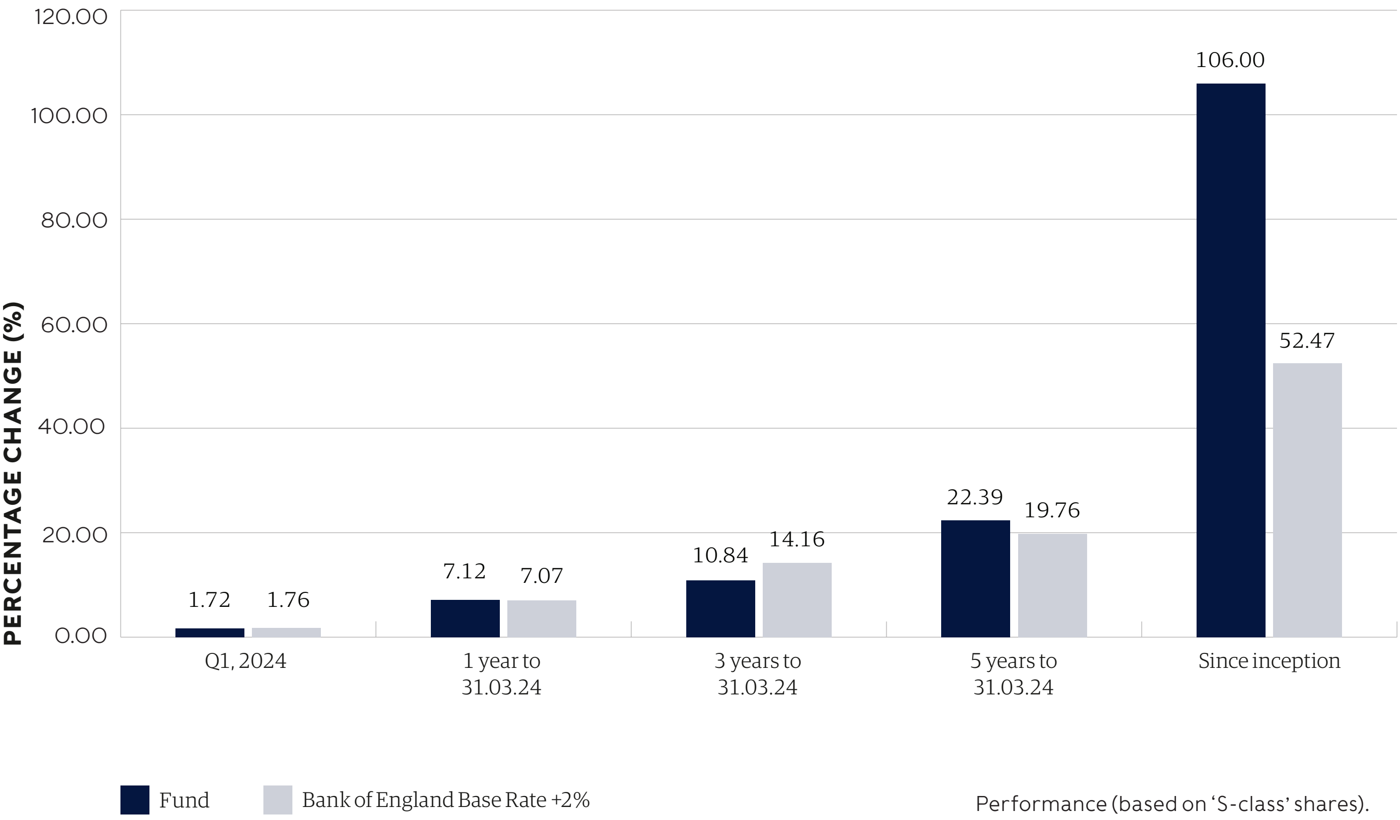
- TSMC is the world's largest semiconductor foundry, manufacturing chips for a variety of uses, including smartphones, computing, cars and data centres
- It has hundreds of customers across a diverse range of companies, technologies, and industries, all fundamental to the advancement of human progress
- Its advanced technology and capabilities provide TSMC with a strong competitive advantage and high barriers to entry as semiconductor production and design become increasingly complex
- Given its scale and strong technological expertise, TSMC is likely to benefit from favourable industry trends such as 5G, artificial intelligence (AI) expansion and rapid digitisation

MERCK

- Merck is a global health care company that offers health solutions through prescription medicines, vaccines, biologic therapies and animal health products. It operates through two main segments – pharmaceutical which is the vast majority, and it also has a small animal health segment
- It has a wide range of pharmaceutical products, including those for treating cancer, diabetes, and heart disease – its flagship drug is Keytruda a cancer immunotherapy drug
- This diversification helps mitigate risk, as the company is not overly reliant on any product or therapeutic area. Additionally, the company has a strong pipeline of new medicines to further drive future growth
- As a pharmaceutical business it should be less susceptible to rising costs from inflation compared to other sectors and should perform relative defensively if we enter a recessionary period

FUND PERFORMANCE

RATHBONE TOTAL RETURN FUND — QUARTER 1 2024



Performance (based on 'S-class' shares).
Net of expenses and tax.
Net income reinvested.
Data source: FE fundinfo

12-month rolling performance					
Year to:	**End Mar 2024**	**End Mar 2023**	**End Mar 2022**	**End Mar 2021**	**End Mar 2020**
Total Return	+7.12%	-2.08%	+5.67%	+12.32%	-1.69%
Bank of England Base Rate +2%	+7.07%	+4.33%	+2.19%	+2.10%	+2.75%
Annual calendar performance					
Calendar year	**2023**	**2022**	**2021**	**2020**	**2019**
Total Return	+7.11%	-4.67%	+7.00%	+5.06%	+9.16%
Bank of England Base Rate +2%	+6.73%	+3.47%	+2.11%	+2.23%	+2.76%

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.

Top performers (%)		
Holding	**Performance**	**Contribution**
Nvidia	+84.13	+0.36
ASML	+29.35	+0.16
Edwards Lifesciences	+26.47	+0.12
Kion Group	+23.85	+0.11
Merck & Co	+22.72	+0.11

Bottom performers (%)		
Holding	**Performance**	**Contribution**
AIA Group	-21.76%	-0.09
Adobe	-14.65%	-0.07
Nike	-12.30%	-0.06
Aptiv	-10.46%	-0.05
Apple	-10.00%	-0.05

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

Government bond yields rose in the first quarter, driving down their prices. Government bonds had rallied into year-end after the US Federal Reserve (Fed) seemed to imply that it could cut interest rates sooner than investors had been expecting. However, the strength of US economic data, combined with stickier inflation numbers, subsequently led the US central bank to adopt a more conservative tone and yields rose again. Higher bond yields proved a headwind to performance, reversing some of our gains from bonds (particularly US, Australian and longer-dated UK bonds) over the previous three months.

We used first quarter weakness to add further to our US and UK government bonds. We continue to believe they offer attractive return potential after accounting for inflation and should also offset any equity market weakness in the event of a material economic downturn.

AI chip designer Nvidia was the most significant contributor to performance as the stock continued its meteoric rise into 2024. In late February, it again reported very strong earnings as data centre demand for its chips continued to soar off the back of burgeoning artificial intelligence demand. Nvidia's quarterly revenues jumped 265% from a year earlier and the stock has rallied by more than 80% over the first three months of 2024.

Other chip-related stocks, such as ASML (which makes the machines that make chips) and Cadence Design Systems (whose software helps design and test chips) were also strong contributors.

Elsewhere in technology, cloud names such as Amazon, Alphabet and Microsoft had another good quarter and broadly backed this up with strong earnings and healthy outlooks. These businesses are also perceived as the leaders in the development of AI, helping to drive their share prices to at, or near, all-time highs.

Stock markets have continued to move higher as investors have grown more confident about the chances of a soft, or at least softer, economic landing. That's helped support industrials such as Kion (automated warehouse solutions), which rallied sharply. US consumer-related stocks, such as home improvement retailer Home Depot and discount retailer Costco were also stronger off the back of a sunnier outlook for the US economy.

A key detractor from our performance for the quarter was Hong Kong insurer AIA, whose share price fell by around 20%, dragged lower after its management warned about weaker profit margins on its China business.

ASSET ALLOCATION CHANGES

THERE WERE NO SIGNIFICANT CHANGES DURING THE QUARTER.

Asset allocation split	31.12.23	31.03.24	% Change	12 month change
Liquid assets (10%-50%)	42.9%	46.1%	3.2%	3.3%
Equity-type risk (20%-60%)	44.5%	41.4%	-3.1%	-1.9%
Diversifiers (0%-50%)	12.6%	12.5%	-0.1%	-1.5%

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

Asset class split	31.12.23	31.03.24	% Change	12 month change
Equities	34.5%	33.2%	-1.3%	0.3%
UK	5.8%	5.9%	0.1%	-0.2%
US	20.9%	19.9%	-1.1%	-1.2%
Europe	5.0%	4.4%	-0.7%	-0.1%
Japan	0.0%	0.6%	0.6%	0.6%
Asia ex-Japan	0.9%	0.9%	-0.1%	0.0%
Emerging Markets	0.0%	0.0%	0.0%	0.0%
Global	1.8%	1.7%	-0.2%	1.2%
Index-linked bonds	0.0%	0.0%	0.0%	0.0%
Conventional government bonds	23.5%	26.3%	2.8%	2.4%
Corporate bonds	18.0%	12.9%	-5.1%	-6.0%
Emerging market debt	0.0%	0.0%	0.0%	0.0%
Privite equity	0.3%	0.3%	0.0%	0.0%
Alternative investment strategies	8.9%	8.8%	-0.1%	-0.6%
Property	0.0%	0.0%	0.0%	0.0%
Infrastructure	0.5%	0.5%	0.0%	0.5%
Commodities	3.7%	3.7%	0.0%	-0.9%
Cash	10.7%	14.4%	3.8%	4.3%

INVESTMENT OUTLOOK

THE YEARS-LONG WAIT FOR AMERICAN RATE CUTS THAT REMAIN ALWAYS JUST OVER THE HORIZON REMIND US OF ASYMPTOTES: CONSTANTLY APPROACHING AND NEVER ARRIVING.

The last couple of months have done little to disabuse us of this notion. Businesses, households and investors are eagerly awaiting drops in benchmark rates, yet they keep floating on the horizon.

The big piece of the puzzle is inflation: will it continue to fall (we think it will), reassuring central banks that they can reduce borrowing costs without sparking another flare-up in prices? We have always suspected that the last mile of getting inflation back to 2% would be the hardest. And so it has been so far. To add another nuance to this point: all else equal, it's harder to get inflation lower when your economy is flying than when it's in the doldrums.

To avoid being burned by any shifts in expectations that arise as investors continually re-evaluate the likelihood of rate cuts and the strength of economies, we've continued trimming stocks whose valuations appear to have got a bit over-optimistic. We've used that money to add to equities and other assets that have fallen from favour. We don't want to sell outperforming businesses completely – lots of people want to buy them for a reason! – because over five years or more, we think they have the opportunity to grow well and become more valuable. Yet we try to minimise the short-term downdraughts that happen.

2% INFLATION

We have always suspected that the last mile of getting inflation back to normal would be the hardest.

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Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation.

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