LIONTRUST

THE SUSTAINABLE FUTURE PROCESS

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Liontrust SF Managed Fund: Q2 2022 review

Fund managers: Peter Michaelis and Simon Clements

The Fund returned -12.5% over the quarter, underperforming the -7.4% IA Mixed Investment 40-85% Shares sector average (which is the comparator benchmark)*†.

Prevailing conditions continue to offer considerable headwinds for our Sustainable Future investment approach, with central banks around the world still raising interest rates to curb inflation. As we have written before, for companies where the market expects growth for years to come, a large proportion of the valuation is attributed to cash flows in the future (known as long duration); conversely, for stocks with lower expectations, less value is ascribed to future growth and the bulk of the value is in near-term cash flows.

Companies with strong growth expectations, therefore, have higher sensitivity to interest rate changes than those with lower growth prospects, with the market discounting future earnings more heavily and bringing down their present valuation as a result. This shift has hit our funds hard given their growth bias and longer duration relative to the market. Performance figures above show this portfolio has fallen more than its benchmarks but, to reiterate, the MSCI index contains many currently outperforming 'value' companies in oil, tobacco and defence sectors, where we have never invested.

We have recently reviewed each of our holdings to ensure that, in this new higher interest rate and inflation world, our conviction remains strong, and, in almost all cases, it does. We have therefore not altered our portfolios significantly; this may sound as if we are not managing the assets actively but it has never been our approach to trade rapidly, only when necessary. Experience has also shown that indiscriminate sell-offs give us the chance to add to our highest-conviction companies at more attractive valuations, as well as starting positions in names we have long admired but, prior to now, were fairly valued. We continued to add to healthcare monitor provider Masimo over the quarter, for example, and this was among our better contributors.

There are several other businesses in the portfolio offering similar upside potential after recent derating and we are as positive on opportunities as we have been for several years. We trimmed some of our stronger performers over Q2, including Alphabet, Waste Connections, Visa and Palo Alto, freeing up capital to add to sold-down companies including Croda, Halma, Smurfit Kappa, Spotify, Charles Schwab, Intuitive Surgical, Adobe, ASML, IQVIA, Avanza and Keyence.

ASML, for example, sells the machines that make semiconductors and is the world's largest supplier of photolithography systems, the s**tandard method of printed circuit board (PCB) and microprocessor fabrication.** We believe the company's focus on next-generation EUV (extreme ultraviolet lithography) technology puts it in a dominant position and yet it has sold off over recent months as a long duration play, meaning we now see five-year upside of more than 60%.

Looking forward, we cannot say exactly when the qualities of the businesses we own will become evident in their share prices; what we can say is that we have used the same approach for more than 20 years and it has served our clients well. There have been weaker periods of performance as a consequence of value rallies – notably in 2003, 2009 and 2016 – but by sticking to our process, we have more than compensated for these over the last 21 years and are confident that backing sustainable businesses is the path to making good recent underperformance once again.

Asset allocation over the quarter was marginally negative, as our underweight cash and overweight credit positions were detractors, offsetting the positive impact of our underweight to government bonds. Bonds overall, but particularly government debt, are suffering from interest rates and yields continuing to climb as

central banks try to curb inflation. We left our overall position unchanged over Q2, retaining a neutral allocation to equities.

Against a challenging short-term backdrop, a handful of our holdings were still able to post positive returns and we highlight two UK names as underlining our long-term approach, with Trainline and Compass Group among the hardest hit in the portfolio during Covid lockdowns.

Trainline faced additional uncertainty as the UK government announced plans to create a new public sector body to oversee Britain's railways, with fears this could threaten its business model as an online platform for tickets and railcards. This ambiguity now appears to be receding and we feel Trainline is well placed to win the government's contract to white label the train ticket solution, as well as potentially benefiting from a major growth opportunity in Europe as that market is democratised and opens up to independent providers.

Compass Group, meanwhile, continues to recover from lockdowns, recently hitting the key milestone of revenue exceeding pre-Covid levels on a run rate basis. The catering business said it has seen a notable improvement in Business & Industry and Education sectors as employees return to the office and students to in-person learning, with this allowing the company to increase FY 2022 organic revenue guidance from 20-25% to around 30% and start a share buyback programme.

We added to both companies at depressed levels in the wake of lockdowns and the market is now recognising their improving prospects with higher share prices.

Elsewhere, consumer goods giant Unilever was also among the strongest contributors. After a drop in the company's shares since a September 2019 peak, news of activist investor Nelson Peltz taking a stake and joining the board was welcomed by the market. Peltz has a track record of driving change and his arrival comes as Unilever has faced criticism for its recent corporate direction, particularly a £50 billion bid for GlaxoSmithKline's consumer drugs business earlier this year.

Helios Towers, held under our *Connecting people* theme, also had a strong quarter, with the market reacting well to Q1 numbers – year on year revenue growth up 20% – announced by new CEO Tom Greenwood. He highlighted a solid contribution from new markets of Senegal, Madagascar and Malawi and the company also launched its new five-year sustainable business strategy. Helios has already achieved the five-year goals set at IPO in 2019 and its new target is to have 22,000 towers across sub-Saharan African by 2026.

In our global equity portfolio, American Tower was back among our best holdings, highlighting 5G ramping up in the US and Europe while 4G coverage initiatives continue to grow in earlier-stage markets. *Connecting people* remains one of our key sustainable themes and this company is well placed to capture the benefits of emerging technological trends.

PTC was one of the few tech-related business able to post strong returns against a difficult backdrop, a leading player in areas such as the Internet of Things and Augmented Reality. Across this range of software, the goal is to make its manufacturing customers more efficient, bringing digitalisation to the factory floor, and the company is therefore a good fit for our *Improving the resource efficiency of industrial and agricultural processes* theme. PTC delivered strong second-quarter results that exceeded expectations, allowing it to raise guidance for fiscal 2022 ARR, free cashflow, and revenue.

As would be expected during a period of rising energy prices – and a burgeoning cost of living crisis – several holdings linked to our *Improving the efficiency of energy use* and *Increasing electricity from renewable sources* themes also posted strong returns, including Greencoat UK Wind, Renewables Infrastructure Group, and SDCL Energy Efficiency Income Trust.

Among weaker performers, as has been the case since the value rotation began, are several other technology-focused businesses suffering from higher discount rates, including Molten Ventures, DocuSign, Splunk, Paypal and Spotify.

To reiterate our message on DocuSign**,** this US business saw a huge acceleration in terms of demand as it enables paperless contract signing and businesses needed its services to operate in a lockdown world. We are still only in the earliest stages of market penetration in terms of paperless signatures and DocuSign is the clear market

leader. It is now four times the size it was pre-pandemic and, yet, the share price is back to where it was before Covid after recent selling. We see the company as a beneficiary of the move towards a more circular economy and greater resource efficiency, saving billions of sheets of paper (and therefore trees) based on its position today and potentially increasing this massively as the market continues to grow.

Spotify's shares also remain weak but again, this is a company where we believe operational performance continues to be excellent, with user numbers increasing and signs of monetising this growing base. Despite generating positive cash flows, however, Spotify recently posted another year of accounting losses and, in this market, companies not seen as generating profits today are punished more than most. We remain confident this business can be profitable over our longer-term investment horizon.

PayPal's situation is different and we are continuing to review our thesis and position. This has been a major performer for the portfolio over recent years but, earlier in 2022, the company missed analyst expectations for growth and earnings, downgraded guidance for 2022, and, most concerningly, provided new information that calls into question the growth algorithm investors had modelled. Management explained the business operates on a Pareto Principle – the concept that around 30% of customers drive the majority of revenues and profits. This is not uncommon but it was the first time we had heard management mention this, having followed the company since 2017. This raises a number of questions, notably whether PayPal is much more mature than investors thought and should therefore trade on a lower multiple. A share price move of the magnitude seen necessitates a full review and we will take our time to analyse these points before acting.

We also struggle to understand why shares in Oxford BioMedica continue to be sold off. This company creates new treatments using gene therapies, hugely widening the scope in terms of helping people suffering from previously untreatable diseases; in addition, it manufactured millions of doses of the Oxford-AZ Covid vaccine and its share price rose rapidly as a result. Over the last six months, the shares have sold off dramatically but if you compare the business to how it looked in 2019, it is vastly different, with revenues doubling and moving from a handful of partners to more than a dozen major pharmaceutical names looking to buy its products. We see Oxford BioMedica's prospects as so much better and yet, after the sell-off, the shares are back to where they were three years ago.

In terms of other trading over the quarter, we added AstraZeneca under *Enabling innovation in healthcare*, a pure-play Biopharmaceuticals company with a focus on oncology, diabetes, central nervous system disorders, and cardiovascular, autoimmune and respiratory diseases. Put simply, this is one of the highest-growth companies in the global pharmaceutical peer group. We rate AstraZeneca a 3 in our Sustainability Matrix: the company, and industry, are making improvements but Astra looks to be nearer the middle of the pack. In order to upgrade to a 2, we would want to see greater action and disclosure around areas like affordability and pricing, as well as its employee and sales practices.

Another new purchase was Aveva under *our Improving the resource efficiency of industrial and agricultural processes* theme, with the company's digital solutions helping its customers achieve sustainability goals and targets. Aveva provides technology and engineering software, where real-time data is overlaid with AI and predictive analytics that improve efficiency and support circularity and traceability. This supports the energy transition for its customers, who are often among the world's heaviest emitters.

As for sells, we exited a long-term position in Hargreaves Lansdown on the back of weaker business fundamentals. Shares in Hargreaves have been falling since interim results and its Capital Markets Day in February: net new business and earnings per share were weaker than expectations and the company also announced a higher cost trajectory for the next couple of years as it plans to reinvest in the business. We think these investments are the right thing to do for the long term, helping HL maintain its market-leading position, but they have taken too long and are not without execution risk. We continue to believe this is one of the better businesses in the UK but have concerns over management quality, and decided to exit, maintaining exposure to our *Saving for the future* theme through names such as Avanza, St James's Place and AJ Bell.

We also made the call to sell our position in German braking system manufacturer Knorr Bremse, which we added back in 2019. While we like the company from a product perspective, with strong exposure to transport safety (in trains and trucks), and returns have been high, we have been concerned about recent management churn from a governance standpoint. Most recent CEO Jan Mrosik left the company at the end of April and, to

give some history, was the third chief executive since Knorr Bremse listed in 2018. We downgraded our Matrix Rating to A4 as a result, as we have little confidence the business will be able to execute a credible strategy, not least on M&A given its aborted attempt to buy Hella – even if they insisted this was a communication issue.

While our original thesis was based around safety and braking systems in trains, fundamentals have also weakened in China, the company's biggest market in this area. Given the latest CEO departure, we believe this puts Knorr Bremse's medium-term group sales and EBIT margin targets in doubt; if it can keep to original aspirations, the company looks cheap, but having lost confidence in the senior management team, we choose to watch this from the sidelines rather than our clients being invested.

Discrete years' performance*, to previous quarter-end:
Past performance does not predict future returns

	Jun-22	Jun-21	Jun-20	Jun-19	Jun-18
Liontrust Sustainable Future Managed 2 Inc	-17.4%	20.7%	13.2%	12.8%	10.6%
IA Mixed Investment 40-85% Shares	-7.2%	17.3%	-0.1%	3.6%	4.8%
Quartile	4	1	1	1	1

*Source: FE Analytics, as at 30.06.22, primary share class, total return, net of fees and income & interest reinvested.

For a comprehensive list of common financial words and terms, see our glossary at:
liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

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