LIONTRUST

THE SUSTAINABLE FUTURE PROCESS

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Liontrust SF Managed Growth Fund: Q2 2022 review

Fund managers: Simon Clements, Peter Michaelis and Chris Foster

The Fund returned -13.7% over the quarter, underperforming the IA Flexible Investment sector average of -6.9% (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 names including 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 standard 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.

In terms of asset allocation, our higher cash weighting has continued to offset some of the volatility over the period.

Against such a challenging short-term backdrop, a handful of our holdings were still able to post positive returns in Q2, and we highlight Compass Group as underlining our long-term approach. This was among the hardest-hit stocks in the portfolio during Covid lockdowns but we kept faith in its long-term prospects and the company continues to recover from lockdowns, 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 the 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 this holding at depressed levels in the wake of lockdowns and the market is now recognising its improving prospects with a higher share price.

American Tower was also 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.

Elsewhere, 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.

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 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.

In terms of other trading, a new purchase over Q2 was US insurance business Brown & Brown under our *Insuring a sustainable economy* theme. B&B is a commercial lines insurance broker, meaning that it works on behalf of clients, namely businesses needing risk cover, to find suitable contracts from insurers. In some cases, it also does the underwriting but the balance sheet risk is held with reinsurers; the latter are willing to do this because they want to earn the premiums but might not have the expertise in a given area and therefore entrust B&B with assessing that risk.

This theme posits that insurance provides an economic safety net for individuals and corporations to protect themselves against risks they are not willing or able to fund outright. Instead of having a large buffer reserve for protection, the insured (as well as the insurers) can use the money to invest, promoting economic growth and

human development. As part of that, we argue that insurance brokers ensure businesses are appropriately covered for the heterogenous risks each customer faces. Furthermore, they also support the client throughout the product lifecycle, assisting with making claims and even litigation.

B&B also has a proven track record of buying insurance brokers/agents and successfully integrating them into its decentralised business model. It is a highly-cash generative business with significant room for further acquisitions, benefiting from insurance tailwinds while taking no balance sheet risk.

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 Growth 2 Acc	-17.6%	24.3%	21.9%	14.8%	13.5%
IA Flexible Investment	-7.1%	19.5%	0.3%	3.0%	5.0%
Quartile	4	2	1	1	1

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

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

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