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Liontrust SF UK Growth Fund: Q2 2022 review

Fund managers: Peter Michaelis and Martyn Jones

The Fund returned -13.1% over the quarter, underperforming the IA UK All Companies sector average of -8.3% and -2.9% from the MSCI UK Index (both of which are comparator benchmarks)*†.

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.

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.

There are many companies in the portfolio offering significantly higher upside potential after recent derating and we are as positive on opportunities as we have been for several years. Recent indiscriminate selling has given us the chance to increase exposure to our highest-conviction companies at more attractive valuations and we added to names including Croda, Halma, Smurfit Kappa and Ashtead (a new buy in Q1) over the period.

Against such a challenging short-term backdrop, a number of our holdings were still able to post positive returns and we would highlight two 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.

Reiterating its sustainable credentials, with the company held under our *Leading ESG management* theme, Unilever announced it has achieved top spot in the GlobeScan SustainAbility Leaders Survey for the twelfth consecutive year in June, highlighting businesses showing commitment to integrating sustainability.

Syncona, the investment trust holding stakes in privately held biotechnology firms, which we own under our *Enabling innovation in healthcare* theme, features among the top names again, benefiting from performance of companies within its underlying portfolio. In addition, the company announced it had invested $56 million in a Series B financing of SwanBio Therapeutics – taking its stake up to 80%. Syncona's vision is to deliver transformational treatments to patients by building companies around exceptional science in areas of unmet medical need; the company creates, builds and delivers life science companies.

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 posted strong returns, including Smart Metering Systems, US Solar Fund and SDCL Energy Efficiency Income Trust.

Among weaker performers, as has been the case since the value rotation began, are several technology-focused businesses that continue to suffer from higher discount rates, including Trustpilot, Molten Ventures and Learning Technologies Group. We maintain conviction in these and other indiscriminately sold-down stocks and highlight that they have all executed well on growth plans.

Trustpilot, for example, is becoming the world's leading review platform, allowing an independent and objective space for customers and merchants to interact online. As the economy continues to digitise, we believe Trustpilot's dominant position in this fast-growing market will result in strong cashflow generation over the long term with millions of reviewers and merchants on this two-sided platform. The shares have dropped precipitously since IPO in March 2021, yet the results continue to positively surprise us. The market might be keen to see profitability sooner than the company is targeting, currently guiding to EBITDA profitability in FY24, but Trustpilot is delivering exactly what it set out at IPO.

Elsewhere, Oxford Nanopore is another IPO in which we participated in last year, with this gene sequencing company a new competitor to US firm Illumina, which currently has 90% share of a $5 billion market. Oxford Nanopore has already increased revenue guidance several times and was used to achieve the fastest sequencing of the human genome ever; but again, while prospects look stronger, the share price is down 25% since IPO.

In the same *Enabling innovation in healthcare* theme, 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, doubling revenues 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.

Another benefit of recent selloffs has been to allow us to buy back into companies where higher valuations, and subsequent lack of upside potential, had forced us to move on despite remaining positive on prospects. With its shares down from around €120 in January to under €90, we were able to add long-term favourite Kerry Group back into the portfolio. This company is exposed to our *Delivering healthier foods* theme, using its IP to improve the nutritional characteristics of food, which remains a key part of reducing obesity and improving people's lives. We sold after our annual review in Q3 2021, as the share price reflected our five-year assessment of intrinsic value, but see upside potential again as the multiple looks much less aggressive after derating.

As for sells, we exited long-term positions in Prudential and 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 St James's Place and AJ Bell.

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 UK Growth 2 Acc	-23.0%	28.7%	-4.5%	6.1%	13.4%
MSCI UK	9.2%	17.4%	-15.3%	1.6%	8.2%
IA UK All Companies	-8.5%	27.7%	-11.0%	-2.2%	9.1%
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: liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

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