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Liontrust SF UK Growth Fund: Q4 2022 review

Fund managers: Peter Michaelis and Martyn Jones

The Fund returned 6.8% over the quarter, underperforming the IA UK All Companies sector average of 9.7% and the 8.6% return from the MSCI UK Index (both of which are comparator benchmarks)*†.

2022 has been the most challenging year since the inception of the Sustainable Future range of funds in 2001. We are continually challenging our conviction in our companies, and we are pleased with how our portfolio companies are navigating an extremely difficult period where supply chains have been disrupted and customer demand has been extremely difficult to forecast. So, despite the sharp decline in valuation multiples, we remain confident in the Fund's prospect over the next five years with sustainable growth drivers, high quality companies and attractive valuations.

A legitimate challenge to our approach would be to ask whether our sustainable investment themes have run their course. This would only be the case if we had solved every problem and satisfied every need; we are a long way from that! There is still plenty of growing to do for sustainable companies.

We are now operating in a very different environment to the past decade, with higher interest rates in place to try and contain runaway inflation. This abrupt change in macroeconomic backdrop has sent markets into a tailspin, with all asset classes falling to a greater or lesser extent in response to a higher cost of capital. Our job in these turbulent times is to focus resolutely on the long term and on our investment process which has delivered strong performance until the past year.

We also want to take the opportunity in these periods of extreme market dislocation to add to our holdings with the most conviction and highest risk-adjusted upside, as well as take the opportunity to buy businesses we have long admired but were not previously attractively valued.

Among the top performers over the quarter was specialist UK lender Paragon Banking Group which performed strongly on the release of robust full year results for the year ending 30 September. Held under our *Building better cities* theme, Paragon provides finance for professional landlords and SMEs, with a long history of low impairments and high service levels. Despite a challenging economic backdrop over the past year, Paragon announced that underlying profits had increased 16% to £226m. In addition, the company stated that its cautious risk appetite and high quality loan book leaves it well positioned heading into 2023.

Private equity company 3i Group performed strongly after announcing a total return of £1.77bn in its first half earnings release, or 14% on opening shareholders' funds. The company noted that its position in discount retailer Action was a significant contributor to performance, with 3i also seeing strong earnings growth and momentum in a number of its portfolio companies in the consumer, healthcare, specialty industrial and business and technology service sectors.

Exposed to our *Increasing financial resilience* theme, 3i predominantly invests in retail, infrastructure, healthcare, technology and industrial and it has strong responsible investment policies and firm exclusions on no-go areas. The company has a model based on investing and supporting businesses for growth. This helps to develop the infrastructure and technologies we need in a sustainable transition.

In its full year results announced in September, DFS Furniture noted that the upholstery market had softened significantly since April 2022, and there had been in a marked decline during July and August. However, in its trading update in November, the company reported a more positive trend, with order volumes growing relative to last year and also relative to the pre-pandemic financial year. DFS expects profits to be weighted towards the second half of this financial year, ending June 2023, given the order intake profile it has seen year to date, with its made-to-order business model and revenue being recognised on the delivery of orders to customers.

Held under our *Leading ESG management* theme, DFS is the UK's largest sofa retailer with around 35% market share; it is the biggest in both online and in-store sales with an omni-channel experience. DFS is different from other furniture retails in that it manufactures around a third of its own product and owns a delivery fleet. This enables a higher-quality product and customer experience, with a faster and more consistent delivery service.

Investment platform AJ Bell performed strongly into the close of the year after posting its year end trading update. Despite a volatile market backdrop, the company announced organic customer growth of 16% and net inflows of £5.8 billion over the year, with £1.2 billion of net inflows in the third quarter alone. Exposed to our *Saving for the future* theme, AJ Bell provides a low-cost, easy to use investment platform for individuals and financial advisers to manage their investments and savings; this has democratised an industry which previously was only accessible for the wealthy.

Among the weaker performers, GB Group shares fell after the identity verification company posted lower growth in its largest division, Identity. Within the division, the company stated that volumes were impacted by the challenges faced by cryptocurrency markets and internet-economy customers, primarily in the Americas region where a significant number of these businesses operate. Outside of these areas, Identity's performance was said to be more resilient, in particular, from established financial services and gaming.

Bus operator National Express also softened on the potential for bus and rail strikes to disrupt services and raise costs. The company is already grappling with risings costs in its US operations due to a driver shortages. Exposed to our theme of Making transport more efficient or safer, National Express operates 27,000 buses and coaches in UK, Spain and Morocco; school buses in North America; and rail services in Germany. These mass transport solution are far more efficient than individual cars, leading to lower emissions, less congestion and improved safety. However, given the weakening fundamentals our position is under review.

Home REIT was also among the detractors over the quarter with the company's share price falling sharply after the release of a short-selling report by Viceroy Research LLC.

Following the allegations made in the report and the full response from Home REIT on 30 November, Liontrust is continuing to engage with the management of Home REIT and are awaiting more information from and discussions with Home REIT before taking any decisions.

Over the two decades that the Sustainable investment team have been managing the Sustainable Future funds, a key lesson that we have learned is that 'sustainable' should not be taken to mean perfect. Investing involves making predictions about the future, which is extremely difficult. Therefore, we have to expect occasions – albeit rare – when the future does not turn out as predicted and the companies we hold become embroiled in a controversy that may challenge the initial assessment of their sustainability.

As soon as we are aware of any controversy, the next stage is to analyse the situation in detail, investigating to ascertain the involvement of the company in question, the seriousness of allegations made and how the business is responding.

In terms of portfolio activity, we initiated a position in multi-utility supplier Telecom Plus under our *Increasing financial resilience* theme. Telecom Plus acts as an aggregator of energy, communication and insurance products, bundling these and using its scale to offer compelling value for its 800,000 customers.

Aveva, held under our *Improving the resource efficiency of industrial and agricultural processes* theme, was sold over the quarter after it agreed to a takeover offer from Schneider (the company's majority owner). We felt that the deal was opportunistic and undervalued the long term prospects of Aveva, and we reluctantly exited the position.

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

	Dec-22	Dec-21	Dec-20	Dec-19	Dec-18
Liontrust Sustainable Future UK Growth 2 Acc	-25.8%	12.5%	5.3%	30.2%	-6.7%
MSCI UK	7.1%	19.6%	-13.2%	16.4%	-8.8%
IA UK All Companies	-9.1%	17.2%	-6.0%	22.2%	-11.2%
Quartile	4	4	1	1	1

*Source: FE Analytics, as at 31.12.22, 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