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Liontrust SF Defensive Managed Fund: Q3 2022 review

Fund managers: Peter Michaelis and Simon Clements

The Fund returned -5.2% over the quarter, underperforming the -3.0% IA Mixed Investment 20-60% Shares sector average (the comparator benchmark)*†.

The focus for the market over the early part of the quarter shifted away from macroeconomic drivers and focused back on how individual companies were faring in an increasingly challenging economy. Earning season in July was closely watched, and we were pleased with the way in which the majority of our companies performed.

As we moved into September, macroeconomic factors once again began to dominate equity market performance, and relative style performance drove stock markets. Inflation across the world, and particularly in the US, continues to surprise to the upside, and this drove further rises in bond yields. Yields had moved from around 3% at the beginning of the quarter in the US, to above 3.8% by the quarter end.

We view a slowing of economic growth in the UK, US and Europe as inevitable as we move towards 2023, and the evidence is emerging that this slowdown is well underway. The question now is what that recession looks like; given the strong labour market, a deep recession still feels unlikely. Our base case remains a long-drawn-out period of sluggish growth, rather than the deep recession of the type we saw in 2009. Inflation remains the key issue for financial markets, and the impact of a slowing economy, higher interest rates and pure base effects as we move towards 2023 should all provide some hope that core inflation may start to normalise. The US is likely to see core inflation as slightly more problematic, and we expect the Fed to have scope to push rates up further to combat this (given the US economy is so strong relative to Europe).

Fund performance over the quarter was held back by a negative return on its bond allocation, as the market sell-off saw yields rise across the board. The market action was particularly severe in the UK market, where gilts tumbled following the UK Government's poorly received budget announcement. However, following these extreme movements, we now view UK gilts as attractive. They offer a 4% yield, and the risk of capital loss has receded given the losses already experienced year to date. We view Gilts as better value than cash, given you now get a reasonable yield.

Our global equity portfolio fared much better over the quarter due to stronger equity markets and particularly strong currency support from US dollar holdings.

Among the top performers was Cadence Design Systems, following the release of robust Q2 earnings. Cadence reported revenue of \$858 million, compared to revenue of \$728 million for the same period in 2021, attributing the results to the company's relentless focus on innovation, continued strong execution and emblematic of the megatrends of the long-term strength of semis, systems companies investing more in silicon, and the convergence of system and chip designs.

After boosting its full year revenue forecast, Wise was also among the top holdings over the quarter. In a Q2 trading update, Wise announced 47% volume growth as active customers numbers rise. In addition, the company stated that revenue growth for the year will be further supported by increasing levels of interest income on customer balances. It plans to pass on much of the benefit to customers through lower prices, but also will use it to fund investment in the company's growth. It has raised its full-year income growth target range to 55% - 60%, a large upgrade from 30% - 35% previously.

Wise aims to bring transparency and fairness into moving money around the world; a resilient financial system helps support all in society and we look for businesses that dramatically improve access to financial services and reduce the costs for everyone. Around 1.7 billion people remain unbanked in the world and foreign exchange has traditionally been costly for individuals, especially those remitting small amounts regularly. Wise offers a significantly better rate, lower fees, and a very simple app-based approach.

Identity verification, location intelligence and fraud prevention company GB Group enjoyed a strong quarterly return after the Cheshire-based firm confirmed Chicago-based private equity firm GTCR LLC was considering a takeover offer. While GTCR subsequently withdrew its interest in early October, GB Group's depressed share price may mark it out as a potential takeover candidate in future.

GB Group is exposed to our *Enhancing digital security* theme and focuses on solutions helping to reduce fraud and aiding companies to meet their compliance obligations. Almost every facet of our lives has some on-line exposure, whether personal information, finances, commercial interactions and simple communications. The same is true for businesses, governments and international institutions. Keeping this information secure and only accessible by the right people is essential for retaining trust in all these on-line interactions.

Also among the top performers was Schwab, a long-term holding under our *Saving for the future* theme as the largest investment platform in the US, offering low-cost products to the mass market. Schwab reported strong Q2 numbers in July with net income coming in ahead of the average estimates at \$1.8 billion, compared with \$1.4 billion for the first quarter. While Schwab reported lower trading revenue, it more than made up for that with interest generated from holding clients' money – its biggest source of revenue. Net interest revenue rose 31% to \$2.5 billion as trading revenue slid 7% to \$885 million.

PayPal bounced back strongly in the third quarter having seen its share price halve this year as the company has faced pressures in recent quarters from supply-chain disruptions and once-in-a-generation levels of inflation that has hindered e-commerce spending.

PayPal said earlier this year it was pivoting away from a previous strategy of trying to add millions of new users and instead, seeking to encourage existing customers to use its app more frequently. The firm showed progress on that front, reporting in its Q2 earnings that payment transactions per active account climbed 12% to 48.7 in the quarter. In addition, the company boosted its forecast for adjusted earnings per share for the year to a range of \$3.87 to \$3.97, compared with earlier guidance of \$3.81 to \$3.93.

Bright Horizons Family Solutions reported second quarter results announcing an 11% increase in revenue to \$490 million, primarily attributable to enrolment gains at its centres and expanded sales and utilization of back-up care services. However, due to the ongoing impact of the Covid-19 pandemic, the company announced that it would be trimming its 2022 guidance – news that was poorly received by the market.

On the other side of the ledger, GlaxoSmithKline led the detractors for Q3. GSK's shares fell following increasing worry over litigation risk around the now-withdrawn Zantac heartburn drug. Zantac was a once-popular antacid drug that has drawn a flurry of US personal-injury lawsuits alleging it to cause cancer. While news of the litigation is not new, the publication of a series of reports during the quarter highlighted the potential exposure GSK faces and awoke investors to the risks.

Shares in Adobe fell over the quarter after the company announced it had entered into a definitive merger agreement to acquire Figma, a leading web-first collaborative design platform, for approximately \$20 billion in cash and stock. While the market reacted badly to the acquisition price, the combination of Adobe and Figma is said by Adobe to "usher in a new era of collaborative creativity".

In terms of portfolio changes, we initiated a position in US firm Advanced Draining Systems, the leader in the supply of plastic-based storm water drainage in the US. Fitting into our *Delivering a circular economy* theme, ADS's products are made from recycled plastics and replace concrete-based drainage systems, which are a poorer quality product as well as being more carbon intensive to manufacture.

We also added Agilent Technologies, a global leader in quality control and testing, ensuring the food we eat, the air we breathe and the water we drink does not contain harmful chemicals and contaminants. Exposed to our *Better monitoring of supply chains and quality control* theme, it is also a leader in the supply of Research & Development tools in the area of increasingly cutting-edge technology related to gene-editing.

Vestas Wind Systems was another new addition over the quarter under our *Increasing electricity from renewable sources* theme. This Danish firm, one of the three main players outside of China, is the quality leader in the supply of wind turbines globally, which are key to the transition away from Russian gas and fossil fuel dependency. Vestas' strategy to shift away from *just* turbine manufacturing towards turbine design, optimising connection to grid to yield highest cashflow and profitable service revenue look set to help them grow profitability for the next decade and beyond.

Admiral was another new purchase under our *Insuring a sustainable economy* theme. This is a motor and household insurer in the UK which is consistently rated highly by customers. We have long admired its very strong employee culture with a focus on promotion and share ownership from within that makes it stand out from other organisations. Its lower-cost operating model means it can be the most competitive on insurance rates without detracting from the quality of its cover.

Following the split from GlaxoSmithKline, we have a new holding in Haleon which we retain in the portfolio. Held under our *Providing affordable healthcare* theme, Haleon is a consumer healthcare business formed by the combination of GlaxoSmithKline and Pfizer's consumer healthcare units. We believe the company demonstrates strong sustainability credentials, aiming to help individuals take responsibility for their health before reaching the healthcare system, with over-the-counter products such as vitamins, toothpaste and painkillers. We also feel the entity has a robust credit profile given its large scale and strong diversification by geography and product line, with a dominant position across several markets. It is highly cash generative, with resilient cash flows, which should be supportive of its deleveraging ambitions over the coming years.

Last among the new additions was NatWest, a UK-focused bank that sits within our theme of *increasing financial resilience*. We feel that NatWest will benefit from a higher interest rate environment and has ambitious targets around decarbonisation from its client base, including the provision of green mortgages to help households improve their energy ratings.

In terms of sells, we exited our position in Prudential, which has been a disappointing investment as its business fundamentals have weakened.

We also sold our position in US integrated waste services firm Waste Connections. The company has performed well, but with the majority of the waste it collects being diverted to landfill, rather than being recycled, we decided to use our position to focus on a better thematic fit for our *Delivering a circular economy* theme, namely Advanced Drainage Systems.

We sold Splunk over the quarter, as we were concerned that its technological lead in unstructured data and big data analysis is coming under pressure from new competitors. Splunk's technology is increasingly adopted as a form of network digital security, and as this moves into the cloud, there is an increasing number of surveillance software competitors. We believe this may pressure pricing and returns for the business going forward.

We also completed our sale of Countryside Partnerships, with the company's share price underpinned by its bid for the company by Vistry, a fellow housebuilder. This was a disappointing conclusion to an investment based on meeting strong demand for affordable, rental and open market housing. In the end, we feel that the company executed very poorly on its strategy.

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

	Sep-22	Sep-21	Sep-20	Sep-19	Sep-18
Liontrust Sustainable Future Defensive Managed 2 Inc	-19.9%	11.7%	7.5%	8.0%	6.2%
IA Mixed Investment 20-60% Shares	-10.6%	12.2%	-1.2%	4.0%	2.6%
Quartile	4	3	1	1	1

* Source: FE Analytics, as at 30.09.22, 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:
<https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms>

Key Risks and Disclaimer

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