LF Liontrust Global Equity Fund

QUARTERLY NEWSLETTER

FOR THE QUARTER ENDING 31 MARCH 2022

The invasion of Ukraine and international ostracism of Russia, isolation of its economy and the humanitarian disaster that Putin has wrought has dominated news and our thoughts over the last several weeks. Whilst we had thought it increasingly likely that Putin would move against Ukraine (in December we started selling our small exposure to Russia), we had expected any invasion to be limited in scope to the Donbas region (Donetsk and Luhansk). Putin's moves have been larger in scale, greater in impact and thus it has become more difficult for him to succeed (or appear to succeed domestically).

We do not have the answers to what will happen with the invasion, but we have included our thoughts below to try to help readers build a better picture themselves and to spur further debate and challenge – please feel free to come back to us with disagreements, alternative interpretations and different scenarios. We are aware that this is a very fluid situation and our thoughts are with those who are dealing with immense challenges at this time.

The Russian Economic model

Russia under Putin could be described as a kleptocracy. For Putin to retain power, he has to ensure that major industries are controlled by his oligarchs and that these oligarchs remain aligned with him. Alignment is assured through his inner circle of ex-KGB strongmen or *siloviki*. There are some suggestions that the businesses that the oligarchs can most easily manage are simple, low-innovation businesses, such as extractive industries. Political power is therefore concentrated in these low value-added, export-based companies and their owners. Other businesses that are more tech-minded or creative and require more hands-on leadership aren't easily managed by people whose main qualification is a connection to the leader. These domestic-oriented businesses are more likely to be importers (of tech, machinery etc) than exporters, and offer the opportunity to create a more skilled workforce that is needed for longer term economic growth and prosperity. Businesses like that generally do not have the connections to thrive and are therefore pretty rare. In effect, Putin's regime relies on established, low value-added industries at the expense of innovation. Where items are manufactured in Russia, they often incorporate imported intermediary items into the final product or use imported manufacturing equipment. For example, a few weeks after the invasion we saw Lada car production halted as semiconductor chips were no longer available.

In short, the power structure that Putin has created effectively stimies domestic innovation and

increases dependence on imports of higher-end products. This means that sanctions are biting harder and faster than would have been the case in many parts of the world.

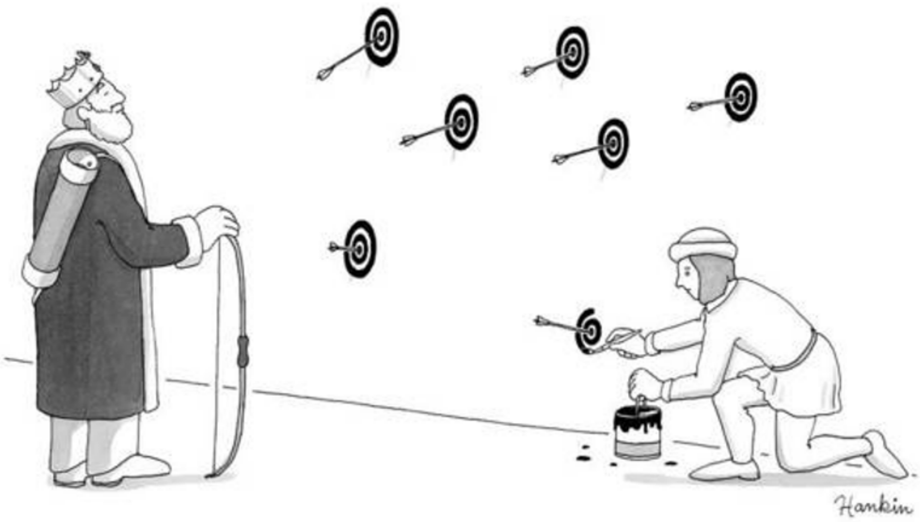
One school of thought believes that Putin is concerned over Ukraine joining the EU. If Ukraine were to be accepted and benefit from transparency, rule of law and ultimately a stronger economy (along the lines of economic growth in Poland after EU accession) it would undermine Putin's legitimacy. As former Russian foreign minister, Andrei Kozyrev states, "there has been a general movement toward more democracy and openness. This terrifies Putin." He would rather have corruption and kleptocracy on his doorstep as it enables his control. Arguably, this is how he has kept Lukashenko, and thus Belarus, in his sphere of influence.

Ultimately, Putin's power comes from concentrating wealth and influence around a handful of loyal followers and ensuring their support through a sense of threat. He also needs some popular support and has an iron grip on the media and police to ensure that.

The Russian Psyche

There is a definite risk of oversimplifying this, but there are a few things that we believe are often underemphasised. Our experience with Russian extended family members bears out the view that Russians generally believe "whatever doesn't kill us makes us stronger". There is a sense of pride in this mindset and it stretches back to tough times such as The Revolution, World War 2, and hyperinflation after the 1990s default. In Russia, World War 2 is still heavily celebrated as a victory because of Russia (in particular the Siege of Leningrad (modern day Saint Petersburg)).

This is important because the concept of striving through adversity is something that is held up domestically as one of the Russian people's greatest virtues. The natural generational response is to back the leadership and endure the hardship and come out stronger despite enduring challenges. Obviously, this is a vast oversimplification, but it is something that we feel is generally underestimated in the West. The result is that Putin's position domestically is probably more secure than most would expect given a growing number of war casualties and evidence of poor planning. After the Russian army's initial advance followed by a necessary retreat, Putin has been somewhat successful in redefining the invasion's objectives with a more limited scope.

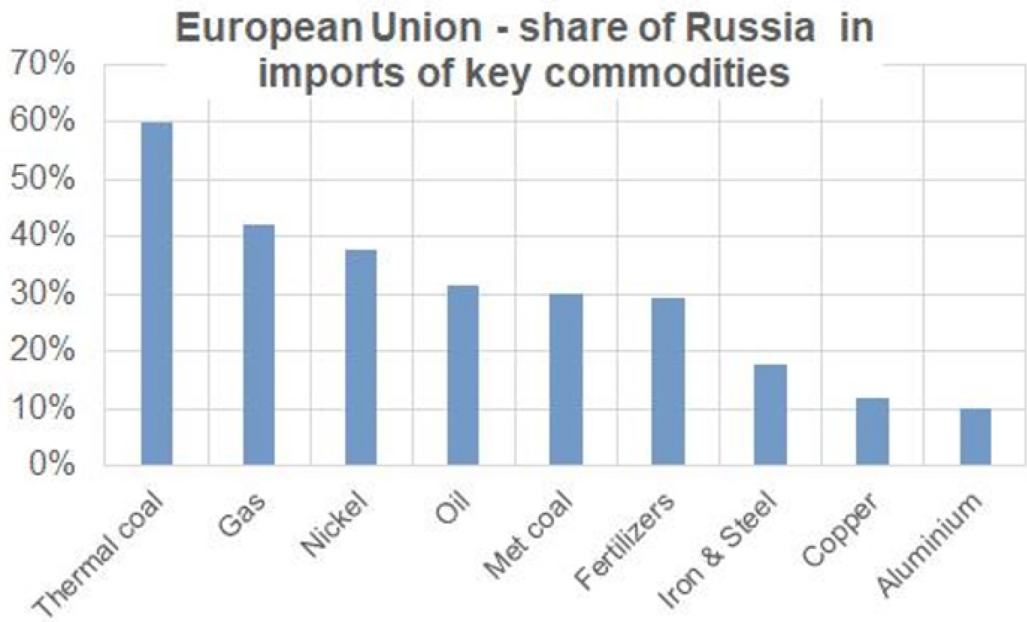


Source: Charlie Hankin / New Yorker Magazine

To summarise, it is unlikely that the 69-year-old Putin will be deposed in the near term. To retain his power, much of which comes from being the most aggressive and fastest to react, we should expect more of the same belligerence. Over the last 20 years, he has successfully overseen "strategic operations" in Syria and Chechnya; the Skripal, Litvinenko, Yushchenko and Navalny poisonings; the Nemtsov shooting; and the annexation of Crimea. The response of the West has been limited and he has felt emboldened to the point that he decided he could successfully invade and take over Ukraine.

Russian Energy

A large part of Russia's geopolitical power comes from the importance of its exports of oil and gas. Most exports flow to Europe, with a limited amount to China and the US. This source of power and Russia's nuclear arsenal together have enabled Putin to act the way he has.



Source: Goldman Sachs

One of the long lasting impacts of Russia's invasion of Ukraine is the recognition in the West that it needs energy security. For many years, western energy companies have been under pressure to cease investment in fossil fuels. The results have been two-fold – the first is an acceleration in renewable energy production, the second is that fossil fuel production has shifted towards countries that are still willing to make the necessary investments. The transition to renewables is underway, but its pace is such that we will remain dependent on fossil fuels for many years. The new focus on energy security is perhaps best illustrated by Shell's decision to reapply for a licence to develop the Jackdaw gas field in the North Sea – a project that was denied on environmental grounds in October 2021.

This change in mindset from governments, tied in with a desire to not buy the 10%+ of global oil production that comes from Russia, means that we should expect a higher oil price in the medium term than would otherwise have been the case. In the long run, the best cure for high prices is high prices – it stimulates investment in new production, as well as in alternative technologies. However, there are substantial lags and a lack of investment in fossil fuels since around 2014 has left us with a supply gap that will be difficult to fill. This was part of the upside investment thesis for our holding in Total at the end of 2020. The change in governments' emphasis away from just environmental issues and towards a more nuanced approach that

places more weight on energy security should be a positive backdrop. Over the quarter, we also added a position in EOG resources, the US Shale producer. It is a well-run operator with good assets and a strong competitive position.

Defence

The second impact of Russia's invasion that we'd like to discuss is on defence spending. The invasion of a European country by one of its neighbours is a stark reminder that defence forces (and spending) are needed to preserve the liberal democracies that we often take for granted. In the near term, we are likely to see an uptick in spending – particularly in Europe. We believe that much of this short-term spending increase will have a geared impact on defence companies' revenues (the core spending of salaries, base maintenance etc will not move quickly – the increase will be spent elsewhere, such as on equipment). Longer term, we believe that the political debate around spending has changed.

Furthermore, warfare's moves into space and cybersecurity (two topics we recently discussed on our Global Infusions podcast), will likely lead to a better industry background. In the medium term, we believe that, similar to what may occur in the energy sector, the ESG interpretation of defence companies has the potential to improve from the current situation where many stocks are excluded from portfolios, towards an acceptance of these companies' necessity, and the social freedoms they underpin. We would not be surprised to see their eventual inclusion in ESG funds. This may provide a source of new incremental buyers over the coming years.

Over the quarter, we took a new holding in Thales, the leading French defence company. Thales has strong positions in space, aerospace (particularly sensors and communications), defence hardware and cybersecurity. It also has a civil aerospace (air traffic control) business that has some post-Covid recovery potential. Thales should benefit from a retrofitting of new secure communications and sensors within existing vehicles. As well as Thales, we have also built a position in L3Harris Technologies (L3Harris), the US defence contractor that specialises in space, sensing and communication – these are areas where we expect to see growth. Although L3Harris is less exposed to Europe, we feel the business is well-positioned for the future. At current valuations, we view the shares of Thales as cheap. A 7% free cash flow yield is too high for a stock that should show defensive, dependable growth characteristics and is potentially at an inflection point on growth and perception that we think could become evident over the coming years.

The broader impact of the Ukrainian conflict

The price of energy feeds through into many other goods and services. In particular, it hits the cost of food production – energy is used to plant, harvest, dry and transport foods. Furthermore, nitrogen-based fertilisers are typically manufactured using the Haber process from natural gas. The cost of ammonia in Western Europe has soared from an average of $300/t in 2018-20 to $530/t a year ago to $1650/t today (Source: Bloomberg [GCFPAMWE Index]). The more than quintupling of ammonia prices is likely to lead to a decrease in the application of Nitrogen-based fertilisers. Alternative potash (potassium-rich) fertilisers have also increased in price from a $280/t average in 2018-20 to $600/t now (source: Bloomberg [GCFPPTNW Index]). Farmers have some flexibility and often decide to put less fertiliser on their fields when prices are high (such as for this year), and yields could suffer as a consequence. Given the conflict, Ukraine is unlikely to export much this year – in a typical year it accounts for 10% of global wheat exports, and Russia accounts for 16%. Food prices are already rising and there is a good chance they persist at a high level for the next year or so, benefitting farmers. We have built a position in CNHI, the Italian company that is the second largest global producer of large agricultural equipment to reflect the improvements in the industry backdrop, the turnaround underway at the company and the cheap valuation.

Rising food and fuel prices will have a particularly harsh impact on the consumer – especially in lower income groups. We have seen estimates that in the US the low income cohort spends over 50% of their income on food, fuel and utility bills. Frequent readers may remember the piece we wrote on inflation in 2020 when we said Covid would be pro-inflationary. Indeed, inflation has ratcheted up. Some of the reasons behind this should reverse relatively quickly – container and logistics bottlenecks, new car availability and used car prices, a temporary shift of spending away from leisure activities and into goods, and the one-off step up in energy prices. In our conversations with companies in the US, there are already signs that some of these factors have peaked. Indeed, goods inflation in the US was negative month on month in March. Container shipping rates (exemplified by the SCFI) have fallen by 15% from their peak in January. Conversations with logistics companies in the US suggest that the supply of trucking has increased and demand is now waning. There are also signs that consumer demand has been hit. RH, the high end consumer furniture retailer, reported in its public earnings call that it saw a 10-12ppt slowdown in sales growth in the last four weeks of March.

The conflict in Ukraine has poured fuel on the inflationary fire, and because so much of the spending that it affects has low price elasticity and is non-discretionary (i.e. consumers could easily cut back on buying flowers and art if prices rise, but food and heating are essential no matter their price) the higher prices of food and fuel are acting to curb demand for other items in consumers' pockets. It is therefore somewhat ironic that Jerome Powell has taken this moment to promote an aggressive schedule of rate rises, ostensibly to curb demand and therefore inflation. There is debate within the team, but many of us feel that the result is likely to be rising rates at a time of decreasing demand. This coincides with a reversal in many sources of inflation that we mentioned above. Concerns over wage inflation may be tempered by auto-correction mechanisms such as early retirees rejoining the workforce as their pensions are no longer big enough following the recent inflationary bout. An alternative rationale for why the Fed is raising rates now is to prepare for a forthcoming recession by equipping the Fed's armoury with the tools to cut rates again in the future. However, the Fed's actions increase the likelihood that any downturn is harder than it would otherwise be.

This slowdown is being felt acutely in the US and the UK, where input prices are passed on more rapidly to consumers. In continental Europe, we are seeing utility companies absorb much of the increased cost with a consequent hit to their profitability. In our team discussions, we can see how the current situation could spiral from a "cost-of-living crisis" to a demand crisis, unemployment issue and general recession. The balancing viewpoints to this negative outlook include the current tight labour market, pent up demand for goods and experiences that has yet to be satisfied by constrained supply, and strong consumer balance sheets after a couple of years of unprecedented stimulus.

We have positioned the portfolio to reflect the possibility that the next few years may be tougher and have been focusing on retaining the fund's breadth. We have investments in a wide range of companies including structural growth stocks whose growth is not dependent on the economy; companies where their valuations already anticipate a poor outcome; businesses that have a large element of self-help; and enterprises exposed to cycles that are out of phase with the economic cycle. In the short term, this dislocation and change is uncomfortable, but we still see a market brimming with attractive opportunities for patient investors.

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Investment in the Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates.

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