Liontrust SF Defensive Managed Fund: Q1 2022 review

Fund managers: Peter Michaelis and Simon Clements

The Fund returned -7.9% over the quarter, underperforming the -3.4% IA Mixed Investment 20-60% Shares sector average (which is the comparator benchmark)*†.

We have written at length about the current headwinds for our quality growth investment style, with longer-duration companies hit harder by fears of inflation and interest rate hikes intended to control it. Equities, broadly speaking, had a stronger March but we reiterate those comments, especially if this year remains volatile. In short, over the 21 years we have managed the Sustainable Future funds, we have seen many periods of inflation and interest rate shifts. During these, we have remained resolutely focused on the long-term prospects of our high-quality companies that can grow profitably year after year by making the world a better place. Our experience is that the long-term success of our investments will be determined by the compounding of growth, not the discount rate shifting up a few per cent.

Of course, this situation has been exacerbated by the conflict in Ukraine but while we are following events closely, we do not attempt to forecast macroeconomic or geopolitical factors. We continue to focus on our core competence: identifying businesses exposed to strong sustainability trends that will endure and grow their value per share regardless of the economic backdrop. At times of indiscriminate sell-offs, the market presents us with opportunities 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 by the market. We have had the opportunity to do both recently.

In terms of asset allocation, that strong end to the quarter from equities was beneficial for our exposure, helping alleviate a difficult start to the year. Our infrastructure equity portfolio has performed well given its defensive characteristics – and in line with rising power prices – and a further positive was our underweight to government debt, which continues to struggle as yields spiked in the face of inflation fears and rate rises.

On the UK portfolio, GlaxoSmithKline posted a strong quarter, with the company finally being rewarded for its restructuring and refocusing on health and consumer health. We have long believed there are two good companies within Glaxo struggling to show themselves.

Elsewhere, London Stock Exchange, where shares rallied as the group announced plans to sell a group of assets known as BETA+ for US$1.1 billion to private equity firm Motive Partners and investment firm Clearlake Capital Group. The BETA+ platforms deal with securities processing, custody, clearing, and asset servicing, as well as cost and tax basis reporting software and front-end client solutions. LSEG said its data and analytics business will target mid-single digit annual revenue growth in the medium term following the divestment of BETA+.

We would also highlight solid performance from several of our holdings linked to energy efficiency in a quarter marked by growing uncertainty around power prices and calls for greater energy security in future. Names including ThomasLloyd Energy Impact Trust, Greencoat UK Wind, JLEN Environmental Assets, Renewables Infrastructure Group, Atrato Onsite Energy, Aquila European Renewables Income Fund, US Solar Fund and SDCL Energy Efficiency Income Trust all saw their shares up over the quarter.

SDCL, for example, invests in and operates projects that reduce energy waste across a broad range of technologies and geographies. This fund is a strong fit for our *Improving the efficiency of energy use* theme, helping reduce emissions and bills while increasing security of supply. This is coupled with a lack of power price exposure, as it takes on the credit risk of counterparties, which makes the fund unique among listed renewable peers. Over the quarter, SDCL planned to raise £75 million through an issue of new ordinary shares but this was oversubscribed and the placing was ultimately £100 million.

Within the global equity portfolio, after a steep fall towards the end of last year, Splunk enjoyed a stronger quarter, buoyed by the appointment of Gary Steele as CEO to drive the business in the next stage of its growth. Steele is a highly regarded tech executive with over 30 years of experience and a track record of scaling up Software as a Service (SaaS) businesses. Splunk develops and provides operational intelligence software used to monitor, report and analyse real-time machine-generated data, regardless of the source and format, and its software enables customers to search IT systems and locate and analyse complex operational data.

Palo Alto shares also continue to tick upwards, with the company posting strong Q2 numbers at the end of February and raising guidance for fiscal year 2022. It now expects total billings in the range of $6.80 billion to $6.85 billion, which would represent year-on-year growth of between 25% and 26%. The company provides cyber security solutions for over 85,000 organisations, with a strategy to build on its leading firewall product and move to subscription-based firewall and security as a service.

Another holding boosted by results was Bright Horizons, posting revenue of $1.8 billion for the year ending 31 December, an increase of 16% on a Covid-hit 2020. This is the US market leader in corporate-sponsored childcare, which offers a range of products to support parents of young children in getting back to work. The company is built on the goal of partnering with employers to help ensure work-life balance and reduced stress in the early years of parenting, where juggling work and other responsibilities can cause anxiety. At the core of its offering is high-quality early childhood education, while innovative products such as back-up care provide additional high-margin growth.

Bright Horizons' share price has been volatile during the pandemic but we continue to believe that aim of better work-life balance and reducing stress for parents is a key long-term part of a more sustainable future when the world is able to look past the pandemic.

In terms of detractors over the period, we talked at length about DocuSign last quarter, so although the shares continue to be weak, would point to that piece as little has changed in the last three months.

PayPal has also continued to struggle, having released disappointing fourth-quarter earnings in February. 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 for the business. 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 for companies but what is unusual is that it was the first time we had heard management mention this (we have been following the company since 2017). Management have therefore decided to drop their previous target of 750 million users by 2025 – they are at 426 million as of today and only released this target 12 months ago. They still believe long-term financial ambitions are achievable, but by increasing the engagement of those best customers as opposed to a combination of increasing engagement and growing new customers.

This raises a number of questions for us: why have management only just realised their business is reliant on a portion of their best customers? Does this mean the business is much more mature than investors previously thought (and should therefore trade at a lower multiple)? Does this mask the fact that competition at virtual checkouts is stronger than ever and is the two-sided network competitive moat weaker than we thought? A share price move of the magnitude seen necessitates a full review of the position; we will take our time to think through and analyse all the above points before deciding what to do, if anything, with our position.

Spotify's shares have also been weak following its 2021 fourth-quarter results released at the start of February. The results for the quarter itself were solid and generally in line with analyst expectations but the company's guidance on Q1 2022 was slightly below what the market had been expecting in terms of new monthly subscribers, which Spotify put down to an increasingly seasonal approach to marketing and acquiring new customers. The company also announced it would be no longer providing annual guidance, just focusing on the next quarter. Any company that gives less information to the market is generally looked on with great suspicion. Spotify, however, is led by the founder Daniel Ek, who comes across as extremely thoughtful and very focused on the long term and, as such, this is not something that concerns us.

Finally, despite generating positive cash flows, Spotify posted another year of accounting losses and in this market, companies not seen as generating profits today seem to be punished more than most. Although predicting the future margin profile of this business is difficult, we believe expansion is likely to follow as it continues to grow in scale, as well as grow high-margin lines such as podcasts or the marketplace business. Spotify shares are now trading at 1.7x 2022 sales – this is the lowest multiple on which the business has traded since listing in 2018 and 25% below the 2.2x it fell to during Covid. As such, we believe our internal rate of return is likely to be driven by revenue growth from here, with potential for re-rating if sentiment in the market turns.

Meanwhile, Avanza Bank, the largest savings and investment platform in Sweden, has seen its price fall over 40% from the peak seen in November 2021. Avanza's earnings are correlated to several factors, all of which are impossible to predict, including broader market levels, interest rates, and volatility of markets. 2021 was a fantastic year for the business, where earnings reached all-time highs because of a larger-than-ever customer base, high levels of trading activity, and high absolute market levels. It is therefore likely Avanza will earn less in 2022 than in 2021, while the company continues to reinvest in people and products to maintain its competitive advantage – it is around four times larger than the nearest competitor in Sweden.

As long-term investors, however, we care about what the company is likely to earn five years from now, and its relentless focus on customer satisfaction, alongside an efficient platform, means we are confident the earnings power of the business will be significantly larger in the future. After weakness in the shares, the company trades on around 20x next year's earnings – a similar multiple to the trough reached during the Covid selloff in 2020.

On the UK side, Oxford BioMedica shares continue to be sold off, which we find hard to understand as, operationally, the business has never looked stronger. It may see less demand for AstraZeneca vaccine manufacturing as the pandemic appears to be receding but this is being replaced by higher-value contracts with partners developing ground-breaking gene therapies.

While a number of other UK holdings are down over the period, we would only note two where there are issues with the underlying business: Trainline, where the restructuring of UK rail is leading to uncertainty, and Countryside Partnerships, which had a very unexpected profit warning as housing completions were 30% lower than anticipated and CEO Iain McPherson stepped down.

Chair John Martin is carrying out a review, with no clear reason given for this shortfall. This review could lead to a restatement of medium-term targets and re-establishing the quality of the partnerships business, but we feel it is more likely these will be downgraded. This is annoying as we like the company's focus on affordable housing and houses for rental but execution seems to be poor and we have reduced our position significantly.

As for trading, a new addition over Q1 was Masimo, under our *Enabling innovation in healthcare* theme. Headquartered in the US, Masimo's core product is pulse oximetry sensors, which enable a patient's vital signs to be monitored. The company places circuit boards (referred to as drivers) into bedside monitor machines and then sells the hospital sensors to pair with these devices.

These sensors are mandated by law in ICU and operating table beds but not on the general hospital floor. Masimo believes this space was around 10% penetrated with such technologies pre-Covid but that number is now likely between 20-30%. In future, the company can derive further revenues via upselling from the basic SET sensors ($8) to Rainbow sensors ($80), which have broader functionality. It also has numerous future growth avenues based on the connecting and remote monitoring of patients within hospitals and at home.

We also added two names to our UK portfolio, Wise and Ashtead. Wise's mission is 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.

We added Ashtead under our *Delivering a circular materials economy* theme. This is the embodiment of a sharing economy, renting out industrial, commercial and general equipment across the US, UK and Canada. The company maximises use of equipment that would otherwise sit idle for long periods and offers assurance this kit is serviced and maintained properly. In doing so, Ashtead allows the businesses that rent its equipment to concentrate on their core competencies as well as reducing their own inventories. Ashtead is a rare example of a UK success story in the US, acquiring Sunbelt in 1990, then adding the US rental business of Rentokil in 2000 and NationsRent in 2006. This has led to sales going from £47 million in 1990 to £7 billion now and, financial crisis aside, returns on equity consistently above 20%.

Technogym was a sell over the period as we have lost confidence in the long-term resilience of the company's business fundamentals. While Technogym's products remain best in class, demand from traditional customers such as gyms has collapsed, as it has from a newer channel in the shape of hotels. We remain concerned the pandemic may have long-lasting impacts upon aggregate demand for both gyms and hotels, and new gym equipment is a discretionary item that can be sacrificed in times of difficulty.

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

	Mar-22	Mar-21	Mar-20	Mar-19	Mar-18
Liontrust Sustainable Future Defensive Managed 2 Inc	-0.7%	20.3%	0.2%	7.7%	4.1%
IA Mixed Investment 20-60% Shares	2.7%	19.8%	-7.2%	2.9%	0.8%
Quartile	4	2	1	1	4

***** Source: FE Analytics, as at 31.03.22, 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