RATHBONES

RATHBONE UK OPPORTUNITIES FUND

MONTHLY UPDATE OCTOBER 2024

For professional advisers only

October delivered the worst monthly performance for UK equities so far this year, with negative returns across large, mid and small-cap companies as investors tried to pre-empt the Budget. We'd been well briefed to expect higher taxes and more government spending so, broad brush, the measures shouldn't have been a surprise. But Labour's first Budget for 14 years didn't have quite the desired calming effect on British taxpayers.

Markets did need to respond to this loosening of fiscal policy and extra government borrowing. The increased inflationary pressure highlighted by the Office for Budget Responsibility means that the Bank of England (BoE) may need to make interest rate cuts more gradual than previously expected. Despite this forecast that inflation will resurge to a peak of 2.6% next year before falling back toward the 2% target, the BoE duly cut rates as expected by a quarter-percentage-point to 4.75% in early November.

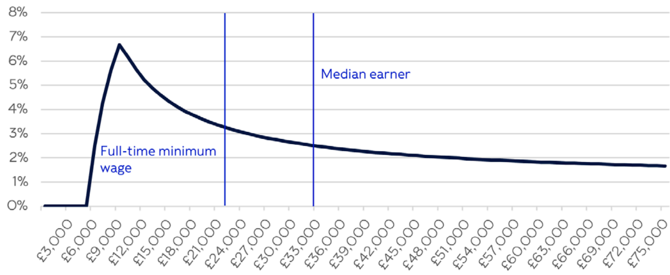
This rational reappraisal of inflation and likely prevailing interest rates drove yields of UK government bonds higher. It gave equities, particularly mid-caps, pause for thought. There's a mechanical effect going on here as well: because many of these mid-sized companies tend to faster-growing, a greater proportion of their value is tied up in future estimates for profits. When interest rates rise, it reduces the value of those future earnings in today's prices (even though the profit estimates themselves are unchanged). This works in reverse when rates fall too: it pushes up a higher-growth company's share price, as else being equal. Essentially, rates rise, rates fall, but the important thing to focus on long term is the quality of the underlying companies and the scope they have to grow.

The Budget: a clearing event?

Importantly, these moves were nothing like the crisis caused by the Truss mini-Budget in 2022, where *unfunded* tax cuts were (partly) to blame. In contrast, this Budget contained some hefty tax rises to pay for half of that extra spending.

The heavy lifting was done by increasing Employer National Insurance Contributions (Employer NICs) by 1.2 percentage points to 15% and almost halving the level at which they kick in to £5,000. Unlike most payroll taxes, Employer NICs don't come out of a person's paycheque. Instead, they are paid by the business on top of the salary. This means that workers won't notice anything – well, until coming year pay reviews or discussions about hiring more members of their team. It's a substantial cost increase for businesses which will hit very large employers with a lot of lower-paid, less highly skilled workers hardest (as you can see from the chart). We believe many of the companies in which we invest should be less impacted.

PROPORTIONAL INCREASE IN EMPLOYER COST BY EMPLOYEE EARNINGS FROM APRIL



Source: Institute for Fiscal Studies; gross salary plus Employer National Insurance Contributions, assuming employer has already fully used their employment allowance. Doesn't include 6.7% National Living Wage increase.

We were pleased to see the FTSE AIM market retain half its Inheritance Tax advantage. Shares held for more than two years are exempt from the 40% levy on estates, yet from April 2026 they will be subject to IHT at a reduced effective rate of 20%. We think this removes the incentive for further changes, allowing investors to make choices with certainty.

We sense that, for global investors who are increasingly the most important audience for UK equities, the Budget could turn out to be something of a clearing event. It's easy to get bogged down in the detail (and that detail is important, of course), but looking at the UK from the outside, there was nothing in the Budget that suggests that the UK warrants special negative treatment.

A mixed bag of sweets?

On the surface, our top performers this month have little in common – they span toy soldiers, US cement, software and greetings cards. In fact, they share at least two important factors – positive earnings revisions and returning capital to shareholders. We think these factors will continue to be the major drivers of equity performance from here, in the UK but also globally.

Wargaming business **Games Workshop** announced a further dividend payment for the year, a good signal given it pays out 'truly surplus cash' to shareholders – whatever is left after three months of working capital, tax, staff bonuses and capital expenditure (long-term investment in the business). The new Warhammer 40k computer game Space Marine 2 is selling well too. Aggregates business **CRH** (which has had a listing in the US as well as London since September last year) enjoyed a rise in its price-to-earnings multiple ahead of solid numbers. And the company share price benefited from a bit of the 'Trump trade' to boot. Finally, software seller **Softcat** expertly traded through another tricky period for its corporate and public sector customers in the UK, helping to justify its premium rating. We think a combination of the opportunities from more businesses using AI tools, a new device refresh cycle in 2025, and a more certain macroeconomic environment will be hugely supportive to Softcat's model next year.

Listed venture capital firm **Molten Ventures** paused for breath after more than doubling off its 2023 lows. Promising signals are finally emerging from VC-land in the form of 'realisations' (VC-speak for selling stakes) after several years of stasis. We trimmed our holding in the summer after the rally, just to right-size our exposure to an exciting, but volatile, asset. **JD Sports**' figures underwhelmed, as did the targets that management need to hit to get their payout. We've been reducing our holding. And in contrast to Softcat, peer **Bytes**' share price reacted poorly to possible changes in the way Microsoft (its largest product) pays for selling its software.

In addition to reducing some JD Sports, we also trimmed our holding in **Diploma**, which sells a range of essential components for computing, industrial and medical equipment, again on a very full valuation, and topped up recent IPO **Raspberry Pi**, which designs single board modular computers.

With US President Donald Trump awaiting inauguration, markets have to adjust to yet another change in the global macroeconomic order. This one is likely to be reflationary — a cocktail of more fiscal spending, tax cuts and tariffs (albeit, this last may be a negotiating tactic). On the other hand, less regulation and lower oil prices would be deflationary... So rather than forecasting what's simply unforecastable, we'll instead concentrate our efforts on being ready to adapt to whatever the next years bring.

Companies seen during the month: PensionBee, CVS, **Tesco**, Greencore, **Moonpig**, Craneware, Foresight, **Bytes Technology**, **discoverIE**, **Boku**, **Softcat**, **Kainos**.

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For more info on our fund, including factsheets, performance and fund manager views, please click here.

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