A solid defence

Defensive equity sector valuations are higher than usual but defensives still deserve their place in portfolios in the latter phase of the economic cycle

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While the Brexit deadline draws closer, the route to a deal between the UK and the European Union (EU) shows no signs of materialising. The Conservative Party’s leadership campaign is also adding to the uncertain mood, but we believe the UK is unlikely to leave without a deal – regardless of the winner.

When economic growth slows and the outlook dims, investors usually shift their equity investments from cyclical to defensive sectors. On page 3, we explore the issues associated with this traditional approach as we enter the later stages of the current business cycle.

On page 5, we explain why signs of weaker economic growth may not necessarily be cause for alarm. Although a broader range of economic indicators have fallen to indisputably weaker levels than at any time since the 2008 global financial crisis, the usual indicators of recession are yet to send a warning signal.

As the rise of online shopping continues, we explore how high-street retailers are adapting to make the most of their store space on page 6. We look at the advantages of having a physical presence, including how a shift in spending from things to experiences has created a new trend of ‘experiential retail’.

Many active investors try to identify companies or markets that look ‘cheap’ and those that look ‘expensive’ by using the price-to-earnings (PE) ratio. On page 8, we explore why factoring this commonly used measure into investment decisions can be misleading and why it is unlikely to lead to outperformance.

Finally, on page 9 we explore why US tech giants are facing increased regulatory scrutiny and evaluate the risk of a breakup within the sector. We discuss the challenges of applying antitrust law to high-tech companies and how the future of the tech titans rests on political machinations and the attitudes of those in the Supreme Court.

I hope you enjoy this edition of Investment Insights. Please visit rathbones.com to explore our latest views on the issues shaping financial markets this year and beyond.

Julian Chillingworth
Chief Investment Officer
Investing in defensive equity sectors as the cycle matures

When the pace of economic growth begins to slow and the outlook becomes more gloomy, it makes sense for investors to start shifting their equity investments away from cyclical sectors and towards defensive ones, even if you don’t think a recession is necessarily likely to ensue.

We’ve identified two issues that lead us to question whether this traditional approach may need some adjustment as we enter the later phases of the current business cycle.

In the first instance, we’re concerned about whether some traditional defensive sectors still merit their status. We explored some of the reasons in an article called ‘Today’s defensives may not be fit for tomorrow’ in the January 2019 edition of Investment Insights. For example, many companies selling consumer staples are under pressure from new-age brands that use social media to target audiences cheaply and effectively.

Healthcare and pharmaceutical companies usually enjoy relatively stable demand throughout the economic cycle but are facing increased scrutiny over drug prices in the US, where rising costs are a hot political issue. Meanwhile, in the UK utilities face a more punitive regulatory outlook and possible nationalisation if Jeremy Corbyn’s Labour Party comes to power.

What’s in a name?

As part of our ongoing research into what makes a sector or individual company cyclical, we’ve focused on equity sectors in the FTSE 350 Index. When economic activity is accelerating, cycicals are supposed to outperform the market benchmark. But we have three questions. First, do we mean the global or domestic economy? Second, when we say outperform, do we mean prices or earnings? Third, over what period should we run our analysis? After all, businesses and sector compositions can change substantially over just a couple of decades.

In order to answer these questions, we’ve analysed share prices and their earnings performance relative to the wider stock market over various periods in response to changes in both global and UK economic indicators. The returns from different equity sectors tend to be most dispersed during the contraction phase of the cycle. Therefore, identifying the right characteristics at this time could potentially generate the best relative returns. The result is a list of sectors according to how they tend to perform throughout the cycle. (Figure 1 shows the sectors that are the most defensive according to our calculations.)

The choice between defining cyclicality in terms of economic sensitivity or market beta makes little difference to the composition of our list. Similarly, whether one looks at sensitivity to a global or UK economic indicator also makes little difference to a sector’s classification, with three exceptions. We’ve noticed that general retail, construction and materials, household goods and home construction have a strong cyclical relationship with the UK economy, even though they have an insignificant or even defensive relationship with the world economy.

Figure 1: Most defensive sectors (least cyclical)

Difference in 12-month forward PE ratios between individual sectors and the stock market.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Rathbones defensiveness score</th>
<th>25 years</th>
<th>Last three slowdowns</th>
<th>Latest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmaceuticals</td>
<td>0.85</td>
<td>+2.9x</td>
<td>+4.1x</td>
<td>+4.5x</td>
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<tr>
<td>Beverages</td>
<td>0.85</td>
<td>+1.8x</td>
<td>+0.5x</td>
<td>+9.5x</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.75</td>
<td>-1.5x</td>
<td>-1.5x</td>
<td>+2.1x</td>
</tr>
<tr>
<td>Food and drug retailers</td>
<td>0.75</td>
<td>+1.3x</td>
<td>+2.3x</td>
<td>+4.1x</td>
</tr>
<tr>
<td>Food producers</td>
<td>0.70</td>
<td>-0.1x</td>
<td>-2.6x</td>
<td>+2.1x</td>
</tr>
<tr>
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<td>+3.3x</td>
<td>+3.2x</td>
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</tr>
<tr>
<td>Nonlife insurance</td>
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<td>+0.4x</td>
<td>+3.4x</td>
<td>+0.9x</td>
</tr>
<tr>
<td>Mobile telecoms</td>
<td>0.55</td>
<td>+8.6x</td>
<td>+11.8x</td>
<td>+2.7x</td>
</tr>
<tr>
<td>Electricity</td>
<td>0.50</td>
<td>-1.8x</td>
<td>-1.1x</td>
<td>-0.3x</td>
</tr>
</tbody>
</table>

Source: Datastream and Rathbones.
A solid defence may be worth bearing this in mind if the UK economy diverges from the global business cycle as a result of Brexit.

**Measuring value**

The second reason to be cautious about defensive sectors is that they look a bit expensive at the moment across various measures of value. One explanation is that equity investors have been unusually cautious over the past decade. Even though the global economy has been growing, the slow pace of the recovery since the financial crisis has dampened confidence.

But when defensive sectors are also expensive, this creates something of a dilemma. We believe it makes sense to be defensively positioned within equities, but are we really going to be better off if we’re buying expensive defensives?

In order to answer this question, we’ve explored whether today’s defensive sectors really are expensive. In deciding where to put money within UK equities, the relative valuation is important. Therefore, we’ve looked at the difference between the price—earnings (PE) ratio of each sector and the overall stock market. We’ve added the results to our defensiveness ranking (figure 1).

The third column of figure 1 shows the 25-year average of each sector’s relative PE. The fourth shows the average relative PE for the last three slowdowns (the early 1990s, early 2000s and the period leading up to the 2008 financial crisis). The fifth column provides a measure of today’s valuations compared with the past. It confirms that many defensive sectors are expensive, even compared with where they usually trade during a slowdown (which is when they are most appealing).

**Are they worth it?**

Are these defensive sectors too expensive to include in portfolios? To help answer this question, we’ve compared the initial (absolute) PE of the sectors just before the past three slowdowns with their subsequent returns relative to the market. We see no evidence to suggest higher valuations inhibit the performance of defensive sectors during a downturn.

In addition, when we differentiate cyclical sectors from defensives, we can see that cyclical sectors underperformed the market by around 11% on average even though they started with lower valuations. Meanwhile, defensive sectors outperformed by 11% despite more expensive starting valuations.

In the next stage of our analysis we put the initial valuations into a relative perspective by using valuation spreads - the amounts that sectors’ values differ from that of the total market. This does reveal a statistically significant relationship between a sector’s initial valuation and subsequent performance during a slowdown, especially when we isolate cyclical and defensive sectors.

Notably, the performance of cyclical sectors during periods when the economy is slowing are more susceptible to their initial valuation relative to that of the wider market. The higher a sector’s initial relative PE, the worse its relative performance during the following downturn.

Yet this relationship is weak among defensive sectors (particularly if we exclude mobile telecoms stocks during the dotcom bust). In most cases, regardless of the initial relative valuation, defensive sectors tend to outperform during a slowdown (figure 2).

There is a weak statistical relationship between the initial relative PE and subsequent performance, suggesting that defensive outperformance is even better when starting positions are cheaper. But this implies that valuations would have to be a whopping 15 times more expensive than the market before defensives would fail to outperform. None of our highlighted defensive sectors are anywhere near that expensive, suggesting they continue to earn their place in portfolios as the pace of economic growth begins to slow.

**Figure 2: Measuring value**

Each dot in this chart shows the return of UK defensive sectors during each of the past three economic recessions. Most times defensive sectors have beaten the market (above zero on the y axis) and it made little difference how much you paid for them (more expensive is to the right on the x axis, cheaper is to the left).

In most cases, regardless of the initial relative valuation, defensive sectors tend to outperform during a slowdown.

**Source:** Datastream and Rathbones.
Signs of weaker growth are less worrying than they first appear

A broader swathe of economic indicators – of the recent past, present and future – have fallen to indisputably weaker levels than at any time since the 2008 global financial crisis. That means we have more reasons than at any time over the past decade to be worried about the outlook for the US and global economies over the next 12 months.

For example, US industrial production is contracting quarter-on-quarter (figure 3). The volume of Korean exports is also contracting, as are orders of Japanese machine tools and global sales of microchips. The German manufacturing Purchasing Managers’ Index (PMI) – a much-watched measure of business confidence – is below 50 (commonly seen as the threshold between ‘boom’ and ‘bust’), as are a number of other manufacturing PMIs around the world.

Don’t cash in your chips

However, we shouldn’t infer from these signals that it’s time to cash in the chips. A mild contraction in many of these indicators is not actually unusual. Quarterly US industrial production growth has been negative five times now since the recovery began in 2009, sometimes for prolonged periods. This is the third time Korean export orders have shrunk; the same goes for Japanese machine tools orders and global microchip sales. It’s the fourth occasion that the German manufacturing PMI has crossed below that boom/bust threshold. The fact is, just below 50 isn’t actually consistent with bust.

Since September 2018, we’ve been noting that slowing economic momentum meant that it made sense to be positioned defensively within equity markets, while still preferring them over bonds. The bottom line is that we believe these weak indicators and the poor macroeconomic momentum they point to are reason to maintain this bias. They are not yet indicating that this is likely to be more than a mid-cycle slowdown and that a recession within the next 12 months is more likely than not. And so it’s not yet time to get out of equities and hoard cash and cash-like bonds. For sure, a recession may turn out to be the way we’re heading, but such a conclusion – at least from the business cycle indicators per se – is not currently supported by due analysis and hypothesis testing.

Moreover, in combination, the most anticipatory economic indicators of recession – those that help us assess the risks to growth over the next 12 months – are yet to send a recessionary signal. These indicators include the yield curve, the inflation-adjusted growth rate of money supply (the stock of money readily available to spend), and the difference between real interest rates and the ‘neutral’ rate of interest (all for the US). They regularly signal a recession well in advance of the peak in equity markets – five months on average since the 1960s – giving investors ample time to reposition. In other words, there is rarely any need to jump the gun by trying to anticipate the already highly anticipatory indicators.

Of course, we are vigilant of the risks and remain cautious. Business cycle indicators only take us so far and we need to ask what they are not telling us as much as what they are. The intensifying trade war makes many of us especially nervous, as we have written about many times since before Donald Trump became US President. Yet at the same time, there are also upside risks to equities. The Federal Reserve has pressed pause on its rate tightening cycle, China is likely to add further fiscal and monetary stimulus and, finally, equity market expectations are already quite depressed. In other words, despite the weak data, there is a risk that equities could rise as well as fall.

Leading indicators

We shouldn’t infer from these signals that it’s time to cash in the chips. A mild contraction in many of these indicators is not actually unusual.
Online retailers benefit from a presence on the high street

We’re spending more time than ever before shopping through our smartphones and laptops rather than braving multi-storey carparks and crowded high streets. Back in 2007, around 3% of UK shopping was conducted online. Last year this figure had shot up to 20%. Bricks and mortar retailers, from supermarkets to shoe shops, are suffering the consequences of too much store space. They expanded when times were good, only for the rise of online rivals to eat into their profits. In-store sales have taken a hit, but we think there are still valuable benefits to having a physical presence.

Race to the bottom
Consumers have certainly benefited from the rise of online-only retail. In order to attract customers and remain competitive, these businesses have offered increasingly advantageous terms. They have trained us to expect free delivery, free returns and ever-shortening delivery times. This strategy has succeeded in pushing up order volumes as online retailers basked in their first-mover advantage.

Yet traditional retailers are intent on keeping up and, because they have the big balance sheets and deep pockets to do so, they are investing heavily in their online propositions (figure 4). A race to the bottom for the lowest delivery costs and times has ensued, closing the gap between them and their online rivals. With the playing field now levelled somewhat, two main differences remain between the online players and the traditional retailers, favouring the latter.

Squeezed margins
In the first instance, consumers are asking retailers to do considerably more but they are no longer being charged a premium for it. The hefty investment of building an online platform aside, there is also the cost of storing products, picking them up from these warehouses, then transporting and delivering them in the right timeframe to the right postcode. The new terms of trade also encourage us to over-order knowing we can easily return; an extra delivery cost for retailers to absorb, plus any associated refolding and repackaging. This new environment is eroding profit margins made on online orders (figure 5).

Traditional retailers can avoid a lot of these extra costs by utilising their store footprint and offering ‘click and collect’. It hasn’t taken the online competition long to come up with their own alternative: pick-up lockers. But these lockers lack the brand interaction and spur-of-the-moment purchase opportunities that shops offer.

Experiences over stuff
The shift in spending from things to experiences is another big change for retailers who are now creating ‘experiential retail’ to adapt. This can be done online but is probably more engaging in store.

Spirits giant Diageo is an early example of this shift, with its plans to open a flagship Johnnie Walker visitor centre at the iconic 146 Princes Street in Edinburgh. The building had been part of the House of Fraser chain since 1953 but falling sales and soaring rents forced the store to close its doors for the last time. Diageo is planning to restore the building and create a visitor centre with flexible events space and rooftop bars to form the focal point of its £185 million investment in Scotch whisky experiences in Scotland.

Figure 4: Next’s online sales as a proportion of total sales
Clothing shop Next has a ubiquitous presence on the UK’s high street but its online sales continue to grow.

Source: Next and Rathbones.
picked the old House of Fraser building for the launch, which is a sign of the changing times.

With all that in mind, pure-play online retail models are perhaps not the future-proof solution they were once considered to be. Providing they are not over-spaced, there is light at the end of the tunnel for some bricks and mortar retailers – but not all will survive. We believe the winners will be those that invest in their online platforms and still make sure that customers have a reason to pop into their stores. We will continue to keep a close eye on this changing landscape to spot the threats but also the opportunities.

We believe the winners will be those that invest in their online platforms and still make sure that customers have a reason to pop into their stores.

Edible example

A subset of the retail industry that is certainly experiencing these growing pains is the market for food. To better serve changing consumer habits, supermarkets are in an arms race to bolster their online delivery capabilities. Some attempt to achieve this in-house by improving their logistics gradually.

Yet the alternative option has hit the headlines most recently – a flurry of announcements regarding partnerships between supermarkets and technology firms. These sweeping arrangements have the potential to flip the fine competitive balance overnight. The most recent example is the announcement of M&S’s deal with Ocado, giving the former a grocery home-delivery service for the first time. Another example is Amazon Fresh, which supplies Morrisons food to customers. Interestingly though, as outlined above for general retail, it isn’t all about online. Tech giant Amazon has made that point loud and clear through its purchase of Whole Foods, which gives it a physical high-street presence. These emerging relationships between traditional retailers and more modern ones means that technology is permeating the in-store experience more than ever. From in-app mobile payments to till-free shops, the pace of technological change is rapid – what will we see next?

Figure 5: UK retail sector profit margins (%)

Online retailers have been able to reduce the costs for shoppers, which has squeezed margins for the overall sector during the past decade.

Source: Quest and Rathbones.
Why a popular measure of equity valuations is often misunderstood

Put crudely, the job of an active investor is to buy low and sell high. Of course, managing risk in accordance with clients’ needs and capacities for loss is a very important part of the job too, but active managers need to outperform. Many try to identify companies or markets that look ‘cheap’ and those that look ‘expensive’, commonly employing a measure called the price-to-earnings (PE) ratio to do so.

The PE ratio is the price of a company or group of companies — divided by the underlying earnings per share for a specified period (usually the previous 12 months). A PE ratio that is considered high or ‘expensive’ is often regarded as to be avoided — the equivalent of buying high not low — and one that is low or ‘cheap’ deemed attractive.

Unfortunately it’s not that simple, and there are few situations in which factoring the PE ratio into investment decisions will lead to outperformance. Sure, there is evidence that today’s PE ratio (or, rather, a variation of the PE ratio called the cyclically adjusted PE, which divides price by average inflation-adjusted earnings over the last 10 years) helps to understand the magnitude of the returns on offer over the long term (about 10 years). But when it comes to choosing one investment over another, it is often more hindrance than help in all but a few specific situations, especially over shorter time periods.

To start with, PE ratios are a terrible tool for trying to ‘time’ the market. Analysing data over the past 40 years, we find no statistically significant relationship whatsoever between the PE ratio of the FTSE 100 at a given point in time and the return achieved over the following year. That’s not a quirk of the UK market, we draw the same conclusion internationally.

They are a poor guide for asset allocators too. To test this theory, we built a model portfolio from 22 developed market equity indices based solely on their PE ratios. Every three months, our strategy buys the ‘cheapest’ countries and sells (‘shorts’) the most ‘expensive’. Not only does it fail to generate consistent outperformance, it’s lost money with notable persistence since 2002.

We repeated the test by selecting industry sectors — and the results are worse. Buying and selling the 39 industry groups that make up the US equity market with the lowest and highest PE ratios, respectively, would have turned a $100 investment in 1983, when our data starts, into less than $30 today (figure 6). And that’s before adjusting for inflation or transaction costs. The results are similarly dire in Europe, although in the UK the results are less conclusive: the strategy has worked poorly over the last five years, but since 1983 it made money in more quarters than it lost money (a 55% success rate), albeit with no identifiable consistency.

Pick a winner

Buying and selling a sector based on how low or high it is relative to its own history also failed to deliver consistent outperformance across time and geographies — especially in the UK. Even when it comes to stock selection the results are poor, especially in the US. Avoiding stocks with high PEs was a very successful strategy between 2000 and mid-2002, but this was about avoiding the technology sector heading into the dotcom crash. Excluding the tech sector from the investible universe, our tests still show little value in using the PE to try to ‘buy low’ and ‘sell high’. Selecting UK stocks using PEs would have delivered no outperformance since 2005; though the strategy did put in a stunning run between 2001 and 2005. However, unless we can identify the PE factor outperforming consistently across time and geography, one cannot conclude that it is a source of information for generating market-beating returns.

To be clear, we are not dismissing the notion of value. Identifying companies, sectors or countries that offer good value — returns yet to be priced in — is very much a worthwhile endeavour, it’s just that the PE ratio is often not the best tool for the job, despite its ubiquity. There is one place where PE ratios do come into their own: when choosing one company over another within the same sector, based on how cheap or expensive they are relative to their sector. Such a strategy would have delivered positive returns more often than not, across time and geography to boot. So PE ratios are useful, but investors need to know the right context.

Figure 6: Buy low and sell high

An investment strategy that involved buying sectors in the US stock market with low PE ratios and selling sectors with high PE ratios would have underperformed.
America’s technology giants are in the antitrust spotlight

Just like other life-transforming technologies of the past, today’s tech giants are reaching maturity – that inevitable transformation from fresh young face of innovation to overgrown, mistrusted hulk. Telltale wrinkles appeared in May amid reports that US antitrust bodies would be investigating Alphabet, Apple, Amazon and Facebook’s competitive practices for possible violations.

Their share prices have fallen as investors fear a growth-busting breakup of these behemoths. We’ve been highlighting this inevitable development in Investment Insights over the past year, in a series called ‘The great tech breakup’. The history of antitrust in America, which we looked at in the first article in this series, suggests a bust-up isn’t imminent or the end of the road for the underlying businesses even if it comes. But further volatility is likely for the big US tech firms in the near term.

The taste of freedom
At the turn of the last century, America was waking up to the tremendous freedom and opportunity provided by the internal combustion engine. Today social media and the internet are radically changing how we communicate, transact and live. Oil was the lifeblood of the new economy of the 20th century, and increasingly controlled by John D Rockefeller’s Standard Oil.

Today’s quality data is pivotal and increasingly concentrated in the hands of a few tech giants. Standard Oil was found to be abusing its power, and was split up by the government in 1911 after taking its case all the way to the Supreme Court. They broke it up to ensure competition reigned supreme in America. Could the same happen with today’s tech titans?

Why does new technology eventually attract the regulatory control of the state? There’s a tipping point where a luxurious new gadget or service becomes so ubiquitous that it’s seen as a de facto right. There was a time – not so long ago – when indoor plumbing or electricity were beyond the reach of many Americans and Britons. Now it’s unthinkable to let a home or office be without them. Perhaps it’s enlightening to think that you should now add internet access to that list of required amenities.

But today’s high-tech businesses, with their complexity of design, operation and business models, make antitrust law – which is always evolving and depends ultimately on the view of the Supreme Court – difficult to apply, something we explored in part two of ‘The great tech breakup’. In more recent antitrust history, Microsoft continually clashed with the government. It eventually settled in 2001, and agreed to be more open with its software and coding in return for remaining intact as a business. It then languished in the doldrums for a decade before re-emerging as a tech giant once again (figure 7).

Even if one or more of Microsoft’s younger rivals are broken up, there is hope for investors that the sum of the parts may be worth more than the whole. When Standard Oil was split into Exxon, Mobil and Chevron, the combined growth of these businesses easily eclipsed their predecessor. You could say it was win-win: Mr Rockefeller got richer and America got a free and competitive oil market.

For antitrust breakups to happen, it needs both to be pushed by the government and a sympathetic ear in the Supreme Court, the final arbiter of antitrust law in the US, as we noted in the conclusion of ‘The great tech breakup’. President Donald Trump has been vocal about wanting to rein in tech companies. But the court has tacked significantly to the right after Trump’s appointment of Neil Gorsuch and Brett Kavanaugh.

Whether US tech giants will survive the coming years unscathed depends on political machinations, both at home and abroad, and the economic beliefs of two greenhorn Supreme Court Justices. Some new technology may come along to eclipse them, but we doubt they’ll be going extinct any time soon.

In today’s just-in-time environment, quality data is pivotal and increasingly concentrated in the hands of a few tech giants.

Figure 7: On the rise
Microsoft languished in the doldrums for a decade after continually clashing with the government, before re-emerging as a tech giant once again.

Source: Barclays and Rathbones.
Financial markets

Worries about global trade tensions unsettled markets over the second quarter, leading investors to seek safe assets and government bond yields plunged (prices rose). Notably, 10-year German Bund yields turned negative again and reached an all-time low, while 10-year UK gilt yields fell below 1% for the first time in almost two years.

Investors also tend to turn to gold as a safe haven against geopolitical turmoil, and prices climbed to a six-year high, trading above $1,435 per ounce. In part, the price is a reaction to the outlook for US interest rates, which some believe are about to be cut. Lower US rates tend to depress the dollar, which in turn pushes up gold prices.

**Tech troubles**

Over the first half of 2019, stock markets have broadly recovered from their poor returns last year, and the S&P 500 Index hit a new high. However, shares in big technology companies fell on fears of wide-ranging probes into their market power. Reports that America’s Department of Justice is preparing an antitrust investigation into Google sent shares in its parent company, Alphabet, tumbling. Facebook and Amazon also fell on reports they are being scrutinised.

Several of the most high-profile private Silicon Valley technology companies have been going public this year. Uber, the world’s biggest ride-hailing firm, listed on the New York Stock Exchange at the start of May. Its shares closed down sharply from the $45 initial public offering price in one of the worst debuts for a big US listing. The share price picked up but has struggled to rise above its starting price.

Oil prices continued their upward march, with global benchmark Brent crude rising above $70 a barrel. One of the reasons was anticipation of a shock to supply, rather than surging demand, after President Trump announced he would end sanctions waivers for countries buying Iranian oil.
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