# M&G UK Select Fund

## Q1 fund review and activity

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## A cocktail of bullishness

Growth with a side of inflation was the first quarter's 'plat du jour'. US President Joe Biden's enormous fiscal stimulus packages, multiple vaccines, benign monetary conditions and a recovery set against a disastrous 2020 have forced macroeconomists to re-evaluate their expectations. This wave of positive news has combined into an enticing and potent cocktail of bullishness, upon which the market is showing signs of becoming punch drunk.

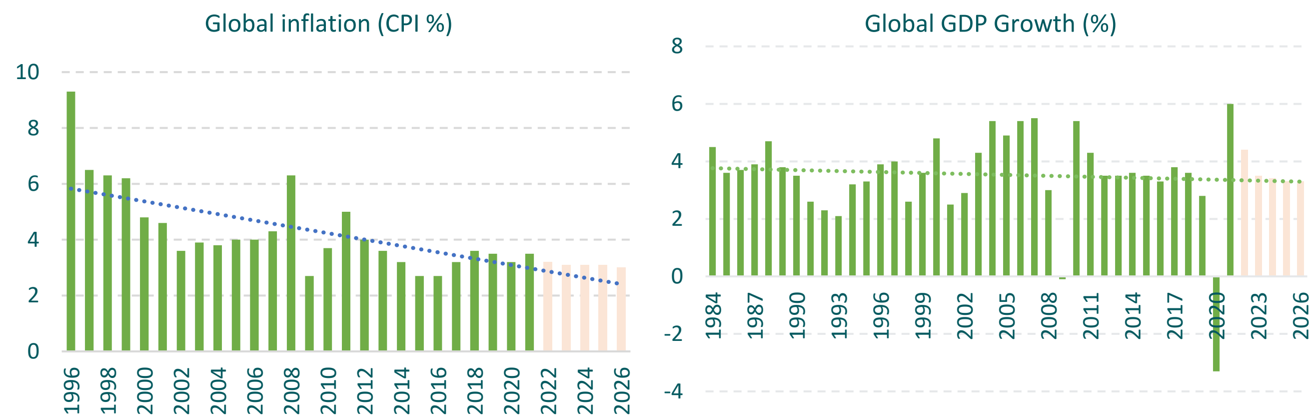
Bonds have suffered greatly. Within equity markets, leadership has flipped towards reopening plays, inflation hedges, cyclicals and low-quality 'value' stocks. Many journalists and sell-side macro commentators are feeding the frenzy, calling this 'the great rotation' and 'a new paradigm'. It feels to me like we need to restore a sense of balance and pragmatism with a reality check. I'm convinced this isn't a regime change. I'm also convinced that investing in high quality, sustainable growth companies gives us the best chance of outperforming over the long term.

## Rotation, correction and long-term prognosis?

It's worth observing that the performance characteristics underpinning the first quarter only unwind some of the shifts seen during 2020. What we're seeing is a correction in those areas of the markets that became over-extended, rather than a paradigm change. This correction stems from a realisation that we are moving towards a more normalised post-Covid environment.

For it to morph into a rotation I think you need to believe that persistent above-trend growth and inflation will endure. That would require a structural improvement in the components underpinning both of those. Biden's stimulus is a steroid injection for sure, but it does nothing to reverse the multiple-decade trend toward lower growth and inflation. The deflationary forces of debt, demographics and digitisation put a cap on the latter. Debt, demographics and China's slowing contribution to global growth will limit the former. Indeed, the IMF still forecasts both returning to trend by 2023.

Figure 1. Global GDP growth and global Inflation




Source: IMF to 31 March 2021. Forecast data from IMF to 2026.

Once Biden's stimulus has washed through, and the cold hard reality of a post-recovery economy comes into view, I believe we will return to a similar trajectory to the one on which we entered 2020. There is no doubt we're going to see some large inflation and growth numbers over the coming 12-or-so months. We'll get the usual Fed Rate dot watching as a result. Markets will probably spook and we're certainly going to see volatility. Until the coronavirus-impacted data is removed from being in the denominator of calculations, that is going to continue to be the case.

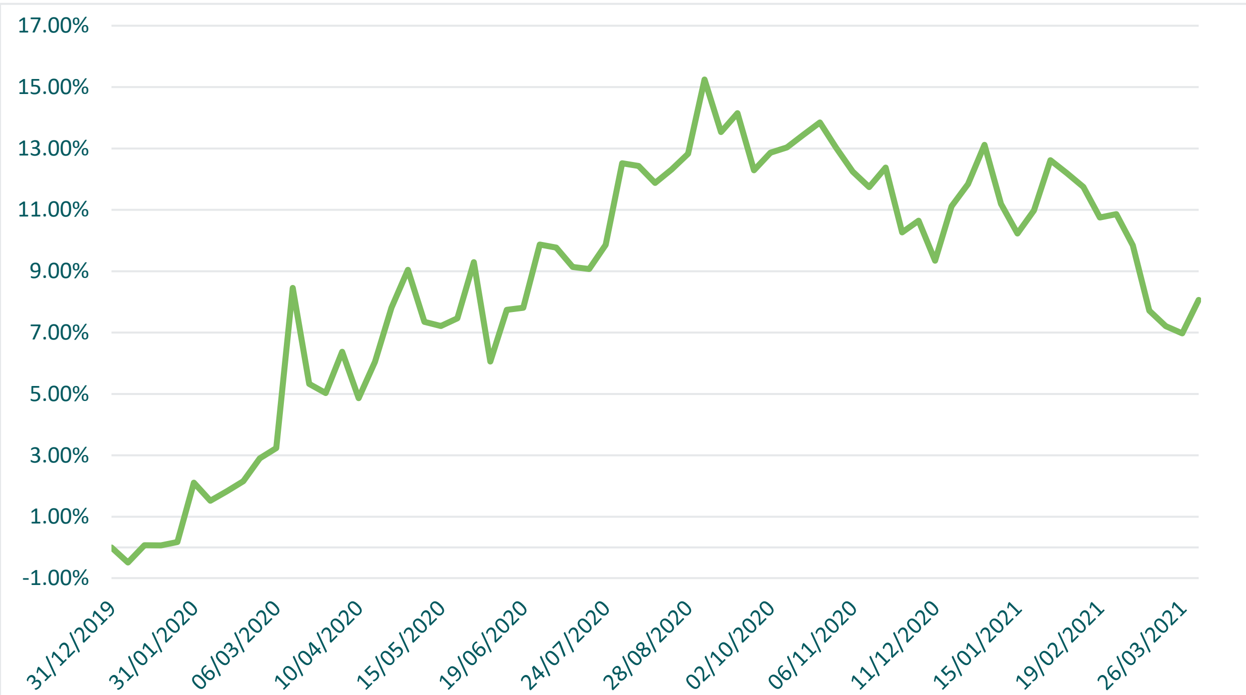
It is important not to get carried away by the misleading nature of those readouts. What we should be concentrating on is the enduring reality that sits on the other side. Correction, yes. Rotation, no. Do I feel comfortable with our philosophy and style over the long term? 100% yes.

## Keeping agile

No matter what the market backdrop, we think our process and attitude towards agile portfolio construction allows us to participate. In my 'Q4 Report and 2020 Summary' I spoke about the changes in weightings within our buckets through the year. We actively tilted the portfolio towards cyclical and future compounders to position the fund for a more risk-on environment during 2021. That has paid dividends in recent months. In combination with good stock selection, we've managed to protect much of the outperformance we accrued during the first nine months of 2020.

The market entered 2020 with 10-year US Treasuries yielding 1.8%. Having dipped as low as 0.54% they've now returned to just south of their pre-pandemic levels, essentially closing a year-long loop of market behaviour. Over the same timeframe the UK Select Fund has outperformed the FTSE All-Share by close to 8% (1 January 2020 to 31 March 2021). I think that helps demonstrate how stock selection, diverse quality and portfolio agility combine to optimise our chances of outperformance across behavioural cycles

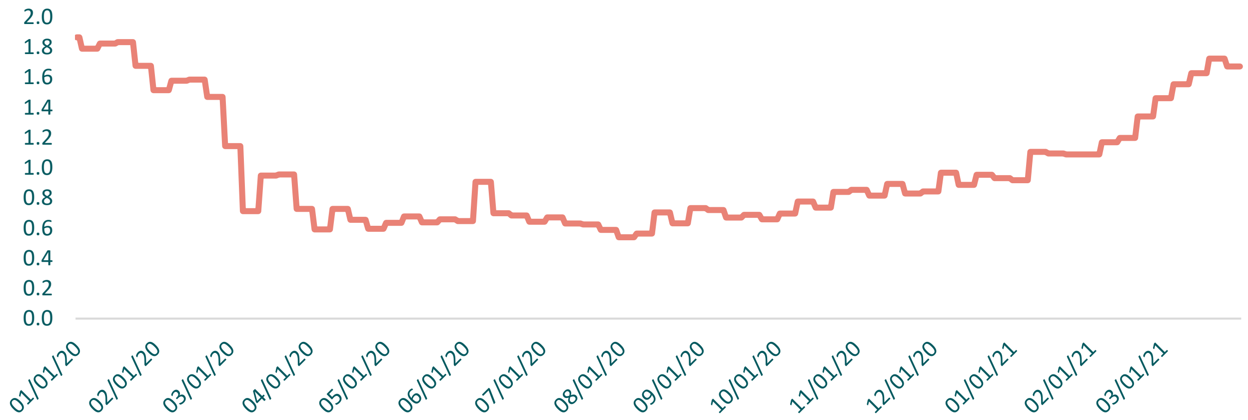
Figure 2. Fund performance relative to FTSE All-Share




Past performance is not a guide to future performance.

Source: Factset & Morningstar, Inc., as at 31 March 2021, GBP Class I Acc shares, income reinvested, price-to-price basis. Benchmark returns stated in share class currency

Figure 3. 10-Year US Treasury Yield (%)




Source: Factset to 31 March 2021

## Q1 Portfolio activity

### New holdings

- **Ceres Power**

Ceres is the global leader in solid oxide fuel cells, a technology that turns hydrogen and other fuels into low or zero-carbon electricity. We have followed the space closely and are big believers in hydrogen's role in the future low-carbon energy mix. Between ITM and Ceres we now have exposure to both ends of the hydrogen value chain in best-of-breed electrolyser and fuel cell technology. Ceres is a capital-light royalty model, with partnerships with the likes of Bosch, Weichai and Doosan. In Q1 2021 the company raised capital in order to fund future expansion and a shift into electrolysers. This coincided with a steep sell-off in renewable energy stocks, giving us a great opportunity to invest in the company at an attractive valuation.

- **Stryker Corp.**

Over recent years we have become increasingly excited about the role of robotics and technology within healthcare and medical devices. We recently conducted deep-dive research into this theme to evaluate the opportunity and competitive environment. Our conclusion was that our current 'play' in the space, Smith & Nephew, rather than being structurally empowered by robotics, was likely to be disrupted. Conversely, Stryker, with its market-leading technology, attitude to innovation, installed base and scale across orthopaedic functions gives it a huge platform to grow over the long term as penetration of robotic procedures increases.

- **Schwab Corp.**

We have had exposure to commercial and retail investment platforms for a few years now. We like the structural growth dynamics of online penetration, wealth accumulation, demographic trends, the need for advice and more responsibility being placed on consumers to save for their future. We recently re-evaluated our holdings in the space and decided that AJ Bell no longer offered us valuation upside. We think it's a brilliant business, but struggled to find compelling upside. As a consequence we decided to switch into Schwab, which offers very similar quality and growth characteristics but at a much more attractive valuation. It also provides us with a portfolio construction benefit in having direct revenue exposure to rising bond yields, due to the net interest margin earned on customer cash deposits, as opposed to platform fees that are the dominant source of income for its UK-listed peers.

- **GTT**

As we look for sustainable growth businesses, you may be surprised to see GTT on the purchase list. GTT is a technology company that specialises in designing cryogenic membranes for liquefied natural gas (LNG) carriers. They are an effective monopoly, having won every global contract in recent times. This technology is very sensitive, given the risks of failure. Rather than vilify natural gas, we think it is a core form of decarbonisation from oil and coal as we shift to more sustainable energy forms. It is a critical low-carbon fuel source for the likes of China and India. GTT helps enable that transition. Beyond natural gas, it also plays into smart shipping, LNG as a marine fuel, hydrogen electrolysis and liquified hydrogen transportation. We think this is a unique and innovative sustainable growth company that contributes greatly to decarbonisation.

### Complete sales

We exited four investments during the quarter. The sales of Total and BP represented the continuation of our ongoing strategy to transition the portfolio toward high quality sustainable growth companies. Historically the oil majors have constituted a material proportion of the fund. Over the past year we have gradually engineered a complete exit from this space.

Both AJ Bell and Smith & Nephew were sold as we switched into what we considered to be superior alternatives. AJ Bell has been a fantastic investment, but we struggle to see valuation upside and we think Schwab provides us with both better valuation and portfolio construction benefits. Smith & Nephew was sold due to our concern about the potential for it to be disrupted as robotics and technology within healthcare increases in adoption rates.

The fund holds a small number of investments, and therefore a fall in the value of a single investment may have a greater impact than if it held a larger number of investments.

## Fund performance

Quarterly performance (%)

| | Q1 2021 |
|---|---|
| Fund | 0.2 |
| Benchmark | 5.2 |

Calendar year performance, five years (%)

| | 2020 | 2019 | 2018 | 2017 | 2016 |
|---|---|---|---|---|---|
| Fund | 4.1 | 21.9 | -11.1 | 14.8 | 6.5 |
| Benchmark | -9.8 | 19.2 | -9.5 | 13.1 | 16.8 |

Past performance is not a guide to future performance.

Benchmark = FTSE All-Share Index

The benchmark is a target which the fund seeks to outperform. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and income objective and does not constrain the fund's portfolio construction.

The fund is actively managed. The fund manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Source: Morningstar, Inc., as at 31 March 2021, GBP Class I Acc shares, income reinvested, price-to-price basis. Benchmark returns stated in share class currency.

Please note that the fund invests mainly in company shares and is therefore likely to experience larger price fluctuations than funds that invest in bonds and/or cash.

Further risks associated with this fund can be found in the fund's Key Investor Information Document.

M&G Investments



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