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Rathbones
Look forward

Rathbone Income Fund

Update June 2018

Introduction

This year is panning out pretty much as we might have predicted. It does seem that the fund fares better when volatility increases and investor sentiment takes a downward lurch; conversely, more buoyant equity markets have generally presaged relative underperformance. We have been very clear in explaining our positioning in 2018, and how our caution acts as a brake on performance when bulls are in the ascendance. However, we argue that our prudence is crucial considering market circumstances, and our year-to-date underperformance is the cost of this "insurance" against a more substantial correction in equity markets.

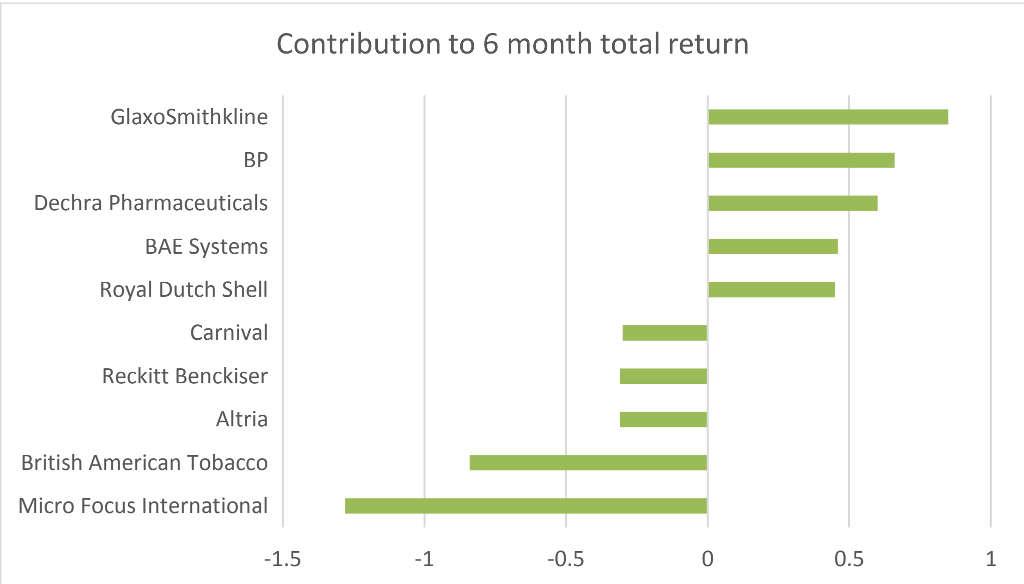
	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	7.72	1.16	1.12	23.22	52.54
IA UK Equity Income Sector	8.33	1.71	6.04	24.24	52.08
FTSE All-Share index	9.20	1.69	9.02	31.62	52.76

Source: Rathbones, FE Analytics

Q2/Three-month performance

Our fund gained 7.72% versus a sector average of 8.33% and the market's 9.20% return. These are solid gains, driven by our holdings in **BP** and **Royal Dutch Shell**. They benefited from a surge in the oil price, with Brent crude appreciating over 17% over the quarter. We also appreciated recoveries in **ITV** and **Relx**, as well as continued strength in **GlaxoSmithKline**. Laggards were not particularly consequential: **Lockheed Martin**, **Danske Bank**, **British American Tobacco** (BAT), **Carnival** and **UDG** were on the negative side of the equation.

H1/Six-month performance



Source: Rathbones, Statpro

Performance for the first half of the year was dull. Our fund gained 1.16% versus a sector average of 1.71% and a market return of 1.69%. As we stated above, our strategy has been to position the fund defensively, and this has dampened returns. However, we should tease out the other clear influences on the numbers.

Micro Focus International

The company warned in March that poor sales execution in the US combined with IT implementation issues – wrapped up in the difficulties of bedding in the HPE acquisition – had severely impacted on revenue growth. Although other mitigating factors, such as margins, debt reduction and importantly dividend remained in-line with expectations, the shares fell an eye-watering 46% on the day, a reaction which we regarded as distinctly harsh. These days the market punishes shares that disappoint.

On review, and following communication with the company, we determined to retain the shares.

Subsequent news flow has been positive. In April, the appearance of an activist investor on the shareholder list provoked excitement, and a more positive trading statement in May further improved the mood. The company releases interim results on 11 July, and we hope for a further re-affirmation of the story. The shares are 1.40% of the portfolio as of 30 June.

Mr Market turns his back on consumer staples

Our exposure to the consumer staples sector has been detrimental at a time when a broad range of names have been de-rated. Tobacco has been particularly hard hit. By way of an example, having achieved an all-time high in June last year, shares in BAT drifted around the £50 mark for the latter half of 2017, only to move steadily down through spring 2018. There were downgrades as the company talked of foreign exchange headwinds in February's earnings release; and there were fewer sales in the US. But none of this is fundamental to the long-term story. Following a love-in with investors that lasted for over a decade, tobacco stocks have had a difficult 12 months as downgrades combined with de-ratings to produce the negative share price reaction, despite the attraction of a tasty dividend yield.

We have not been inactive in this time. We did trim BAT on valuation grounds. We sold **Imperial Brands** at a very good price in March 2017, and bought in again 12 months later at a level almost 40% lower. The industry is changing: new products are coming onto the market, and BAT is at the vanguard of this effort with its Next Generation Products business, comprising vapour and tobacco-heating products. The unavoidable truth is that their core product remains the cigarette. However, in the new product arena, BAT are attempting to evoke other qualities such as design, innovation, and ultimately lifestyle. Tobacco shares have recently been showing signs of life with BAT, **Altria** and Imperial Brands progressing from their lows.

We wonder if we are beginning to see a nascent swing back into some of the consumer names after a period when growth and momentum have held court and so-called bond proxies have been dismissed. In a volatile world, we remain attracted to businesses with secure, visible and predictable earnings streams. Recent weakness reduces the price risk in many of these names, making them more attractive investments.

One of our largest holdings is **Unilever**, whose management team we regard as having the most coherent brand strategy in the industry. Unilever clearly enunciates the tension between local and global brands. Global brand strength is a huge differentiator, but they also need to develop brands that resonate on the local stage. What works in the UK may not be relevant in the US, or China, or India. Furthermore, the key learnings that they make on the ground, at the local level, need to permeate back up to the top again. It is the constant interplay between local and global, global and local that Unilever's business model attempts to leverage.

Rivals, like **Reckitt Benckiser**, have fared less well. An erstwhile darling of investors, its star has waned on operational issues, a cyber-attack, a mispriced misguided product mishap, and so on. However, the mood is changing. The challenging acquisition of infant formula manufacturer Mead Johnson has re-stoked enthusiasm for Reckitts. It still has some way to go, but at a recent conference (a more humbled) management were much more reassuring.

So, a rebound in some of these consumer staple names will be very handy for us. In addition, we are beginning to see a recovery in some of our true bond proxies: utility stocks. Very briefly, we prefer US assets, and **National Grid** (>40% of their assets are in the US) and **WEC Energy** are our core plays. However, **SSE** is looking interesting. If it achieves Competition and Markets Authority approval it will hive off its retail arm. This would leave a generation business dominated by renewables and, the jewel in the crown, the networks business. The shares have revived. Again, this is not a sector that has set the world alight the last two years. But there is value. There are clearly visible earnings. And despite the drawback of higher forecast interest rates, SSE's inflation-linked returns are attractive in a world where investors may start to become more risk averse.

Positive contributors

The biggest driver of positive performance for us has been GlaxoSmithKline (GSK). We have hedged our bets between GSK and AstraZeneca (AZN). Last year, AZN was re-rated, especially in the second half of the year, and GSK performed badly. We trimmed the former and added to the latter on the subsequent discord in valuation. This move has been rewarded. GSK did not buy Pfizer's consumer health business, but it is buying up Novartis's share of their joint venture, subject to shareholder approval. Both decisions have been applauded. Newly appointed chief executive Emma Walmsley is gradually winning over a sceptical audience and we approve of her management appointments. GSK is now our largest holding, through dealing and share performance. The dividend also looks more secure.

Dechra Pharmaceuticals is arguably our most successful investment ever. We once paid 54p a share; they now trade above £29. However, after jumping almost 40% so far this year, its price is rich, the yield is low, and it's incumbent upon us to regularly take profits.

Secondly, the oil sector has really helped us. The decision to allocate a large portion of the fund to BP last summer has proved to be the correct one. We bought the shares because they looked good value, considering its very high dividend yield supported by strong free cash flow. The rise in the oil price has been a welcome cherry on top of the cake.

A few words on the one-year numbers

We should say something about our one-year performance, which we understand attracts attention. The FTSE All-Share is up 9%, the sector averages 6% and the Rathbone Income Fund is up barely 1%. But the truth is that the trends we have written about regarding this year's numbers began in 2017.

However, we are where we are now. Provident Financial, the big hit to last year's performance, was sold almost 11 months ago. Micro Focus we detailed above, and we believe is recovering. The other two biggest drags on performance were BAT and Reckitt Benckiser. They, alongside so much of our consumer-staple/bond-proxy/ defensive-earning type businesses that hurt us last year are now beginning to help us. We gained from a big move into oil, but we were always going to be underweight the more cyclical areas of the market, especially the miners which went on a tear at the back end of last year. And momentum and growth are difficult bed fellows if we are mindful of price risk.

Outlook

Let us re-visit our comments from the start of the year:

Global interest rates are at historically very low levels
How long will the era of ultra-low rates last? What happens to asset prices when the policies of central banks revert to normality? What is the risk of policy error and the impact of this on economies and prices?

Asset prices are high
This does not mean that they cannot go higher, in a "melt up" scenario. However, on the basis that the biggest determinant factor of future returns from any investment is the price that you pay for that investment, one cannot ignore today's prices.

Volatility is at multi-year lows
This suggests complacency at the very least.

"Winning without losing"
*Two more statements define our responsibility to shareholders: our primary responsibility is to protect capital, what we call **"winning without losing."** Further, we seek to provide investors with an annual real increase in distributions, **"giving investors a pay rise every year."***

We continue to stand by these comments, and our portfolio construction corroborates this. Therefore, if markets squeeze higher without the establishment of a firmer economic and political footing, we might underperform. On the other hand, if valuations move to more reasonably reflect investment risk we may move ahead. There are green shoots out there. The US domestic economy is robust, and we are enthused by recent positive comments from the Bank of England regarding a mini-resurgence in the UK. However, there is a looming trade war, the Brexit talks are as tortuous as ever, and both will impact on the decisions businesses make to invest. The danger of a policy mistake by one of the world's central banks is high. We want to protect capital and grow our distribution. Those twin aims ultimately govern our decisions. Our short-term performance does not impact either of these ambitions

Recent trading: Principal trades for the month revolve around some profit taking in Dechra Pharmaceuticals and **UDG Healthcare**, and an addition to our existing holding in SSE following a very strong meeting with the company in May. We have also introduced a new small position in **Jupiter Asset Management**.

Companies met during the month: We met with Royal Dutch Shell, **Kainos** and **Clorox** during the month. We also attended 20 company presentations at the Deutsche Bank Global Consumer Conference.

Carl Stick
Fund Manager

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