

Rathbone Income Fund

Update January 2109

We refer to investment process in almost every presentation and letter that we produce. We want to anchor what we do to a constant. And as we frequently point out, it is not so much process that is important – indeed much of what we do is just common sense, not rocket science – but the discipline to stick to it. Secondly, it is crucial that we communicate this process in a clear and consistent manner. It is necessary and correct that the end client knows what they are buying, so it's on us to be completely clear and transparent.

At this juncture, when there is the clear potential for markets to turn for the worse, we reiterate the importance of our process. At the outset, we stress that we are not in the habit of making predictions. However, we remain anxious that the shift from a decade-long environment of low interest rates and central bank-induced liquidity (quantitative easing) to a new epoch of less accommodative rate policy and a contraction of central bank balance sheets (quantitative tightening) will inevitably presage a re-evaluation of asset prices. We therefore seek to understand what happens when a consistent process coincides with a changing investment environment.

The price of quality

We always prefer to buy great businesses at fair prices, with the perfect mix of business, financial and price risk. This appears to be the sure fire route to investment success, especially if you have the patience and discipline to hold for the long term, “so don't fix what ain't broke”. At the most straightforward and basic level, we are looking at two things here: how to define a great business and how to define a fair price.

Great businesses sell products and services that their customers want consistently, and in doing so generate high and sustainable returns on a growing capital base, with a fair margin over the cost of capital. It is this spread, and its persistence over many years, that leads to the compounding of returns. The longevity and consistency of return reflects multiple factors: uniqueness of product; barriers to entry; quality of management, and the capital allocation decisions that they make; the competitive structure of their markets; impact of new products, entrants, or new technology; impact of M&A; company culture; regulation; the list goes on. None of these factors is mutually exclusive; all have an effect on the others. For example, a firm's decision to buy another business in a different industry may not be a sensible allocation of capital because it reveals that barriers to entry can be broken (by M&A), perhaps exhibiting management hubris, and therefore impacting upon future returns.

There are clear and convincing arguments for only ever buying these great compounders. Yet, there are two obvious bumps in an otherwise smooth investment road. The first is that businesses and industries do change – today's hero is tomorrow's irrelevance. Think Eastman Kodak, to a degree Nokia, arguably Marks & Spencer. Secondly, there is the other side of the equation: the fair price. At what point does price defy quality?

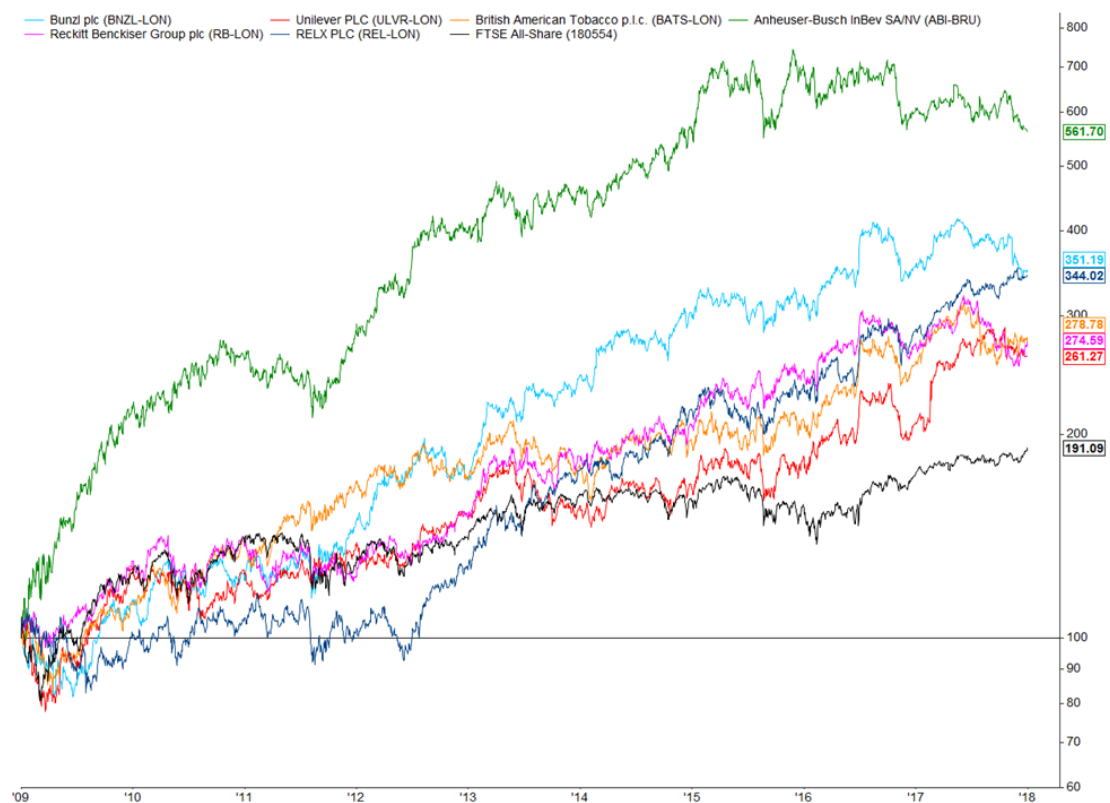
The core argument for holding these high-quality compounders is that the market consistently undervalues future returns. This reflects the belief that for all of our analysis of what constitutes a high-quality business with sustainable returns on future investment of capital, markets deny this

ability, and therefore predict the eventual deterioration of these returns through competition. Put simply, competition leads to lower returns. In order to justify higher prices, one must have the conviction that the business is able to “beat the fade”, for longer than the market is pricing in. Buying and holding compounders is the upholding of this belief.

So why discuss this now? Equity markets have enjoyed an extended bull run since the dramatic lows of March 2009. And how long ago that seems. If valuations in general have become extended, it is very relevant to reassess the quality at a fair price argument and ask whether or not fair prices do still exist, or whether they even matter to long-term investors.

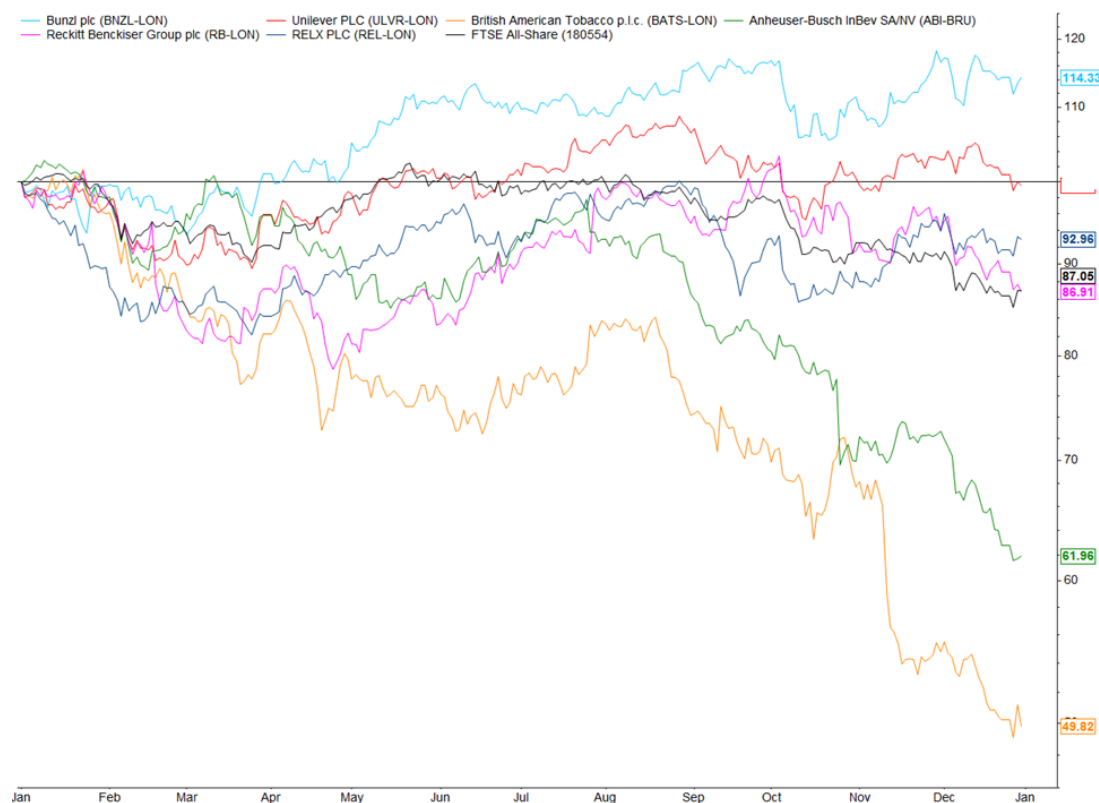
Not all compounders are the same

For simplicity’s sake, let’s look at just a selection of consumer staples and quality compounders in which we have invested over the last 10 years. Understand that we wish just to illustrate some points rather than provide a definitive and exhaustive post-mortem on performance. We also include in this basket tobacco stocks, which are not compounders in the traditional sense because they certainly cannot invest today at yesterday’s rate of return, but as a sector they experienced the same quantum of re-rating as true compounders.



Source: Factset, Rathbones

Buying quality has certainly been a successful strategy over the last decade. We benefited from owning businesses as diverse as Unilever, Relx, Bunzl, AB InBev and the tobacco stocks, not all were held for the whole period. However, in the last 12 months there has been a dramatic divergence in performance.



Source: Factset, Rathbones

All businesses undergo periods of strain. **Reckitt Benckiser**'s star has waned, with the gloss coming off the reputation of its management on account of a series of issues: the 2017 revelation of deaths in South Korea from a humidifier disinfectant, removed from the market in 2011; a 2018 cyber-attack hurting its operations; wrong product at the wrong price from their Scholl division; and the opportunistic acquisition of Mead Johnson, the US manufacturer of baby milk powder increased both financial and business risk. Higher business risk means lower price risk, and the shares have retreated. On the other hand, up until recently investors had rewarded Unilever – despite its own tribulations, highlighted by the unwanted attentions of Kraft Heinz back at the start of 2018. But even here, enthusiasm has begun to subside as this year's news flow suggests both revenue and margin pressure.

Both Relx and Bunzl remain highly regarded. The Relx story could change if its customer base in academic publishing increasingly demands open access to scholarly journals. Meanwhile, a suggestion from an analyst that Amazon was mulling an expansion into Bunzl's turf was enough for the stock to wobble precipitously. Both cases are potential fundamental challenges to the sustainability of exceptional returns – the very crux of the investment cases – but in both cases the worries have faded in investors' minds; attentions have been elsewhere, so the price risk remains high.

By contrast, tobacco, as illustrated by **British American Tobacco**, is now unloved. As mentioned before, these are not compounders because their main wares are in terminal decline, and the future returns from next-generation products are much less predictable on account of customer take-up, totally different market structure, and regulatory attention. These are very difficult to calculate, but at least they are known. However, from being pariahs in the nineties to

darlings through the noughties, they are pariahs again. Does this make them good or bad investments now? Discuss.

AB InBev joins Reckitt Benckiser on the managerial naughty step. The financiers from private equity shop 3G who control this global beer giant have been like Jose Mourinho in their fall from grace. Business risk has certainly increased here. Although, we argue that investors are focusing too much on Budweiser sales in the US, which are certainly poor, and weak Brazilian operations. Other parts of this truly global business are still in robust health. The acquisition of SABMiller left the combined company with a high level of debt, but the business generates a lot of cash, more of which is being directed at the balance sheet now the dividend has been cut. This has not become a bad business overnight; despite problems, some self-inflicted, the voting machine that is the market has swung a bit too wildly into the negative, in our opinion.

The point that we wish to emphasise in this rudimentary run-through of a few of our stocks is the fluctuating relationship between quality and value. Back in the early noughties, branded businesses like Unilever and Diageo were universally disliked. It took a combination of new management, focus, and a general thesis around globalisation and the opportunities it presented for strong brands, for investors to re-evaluate these businesses. Over time, the economic reality of a business and, importantly, investors' perception of this reality, inevitably wax and wane. At a moment like now, when there is the potential for a more fundamental and seismic shift in attitude to risk, we must pay even greater attention to this relationship between quality and value.

As we surmised at the beginning of this letter, it does feel like we are at a crossroads in market fortunes, at a time when long-term economic dynamics begin to change. The cost of capital is likely to rise, compelling a fall in future investment returns for both businesses and investors. The political and regulatory landscapes are also changing. Technological development is rapid, hard to predict, and at times destructive. Brands and business models hitherto deemed robust look a lot more delicate.

Our process remains the same, but the conclusions are likely to change. There will be businesses, priced for perfection, that do ultimately come close to perfection. They will continue to trade at a premium to the market and will reward investors willing to look through the noise and take advantage of long-term compounded returns. However, there will also be businesses that have acquired the outer gloss of quality, but for whom more difficult economics will prove to be a greater challenge. Finally, there will also be value in enterprises that have lost their lustre, where markets are pricing in the worst but in doing so are affording a greater margin of safety. It is always preferable to buy the best businesses at the fairest prices. However, when the market is at a crossroads, complacency is a dangerous thing. Be careful how you define the best, and be careful how you define a fair price.

Recent Trading: Our principal trade in the months was to heavily trim our position in **HSBC**, reinvesting half of the funds back into our smaller position in **Lloyds Banking Group**. The net result is our banking exposure has come down, but with an increased bias towards the UK. We have taken more profit from Bunzl, and have also taken the top off of **Greene King** and **Berkeley Group**, which have both been very strong in recent months. Otherwise, trading has been kept to a minimum.

Companies seen this month: Imperial Brands and Sage



Carl Stick
Fund Manager



Alan Dobbie
Co-Manager

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