

# Rathbone Income Fund

## Update March 2019

Despite much uncertainty, the first quarter concluded with equity markets posting their best start to the year since 2010, with global stocks generating gains of 11%, a remarkable turnaround for a quarter that started in such a fragile manner.

### Front page headlines augur difficult times ahead, but investors soon resume their confident poise

<i>Brexit 'bad or awful' for prospects in year ahead say top economists</i>	<b>FT, 2 Jan 2019</b>
<i>Tesla tumbles as sales figures suggest tough year ahead</i>	<b>FT, 3 Jan 2019</b>
<i>Apple's China warning sends tremors through stock markets</i>	<b>FT, 4 Jan 2019</b>
<i>Powell seeks to soothe stock markets after weeks of turmoil</i>	<b>FT, 5 Jan 2019</b>
<i>US and China under pressure to end tariff war as fresh talks open</i>	<b>FT, 7 Jan 2019</b>

Headlines reflect the daily noise; investors took note on 3 January, and markets tumbled globally, but by the following day the same investors had dusted themselves down, shrugged their collective shoulders, and continued to buy risk assets. The threat of a tightening rate cycle has since receded, so the liquidity that has hitherto supported markets remains in place. However, we are concerned that the appetite for risk assets is too strong given the signs that economies may be stalling. There remains this nagging doubt that investors are reluctant to leave the dance floor while the music is still playing and in doing so are establishing the foundations of a major hangover. We accept that our scepticism clashes with the upbeat vibe in equity markets, but we are content to maintain our defensive bias, albeit with due reference to the changing mood music around the rate cycle.

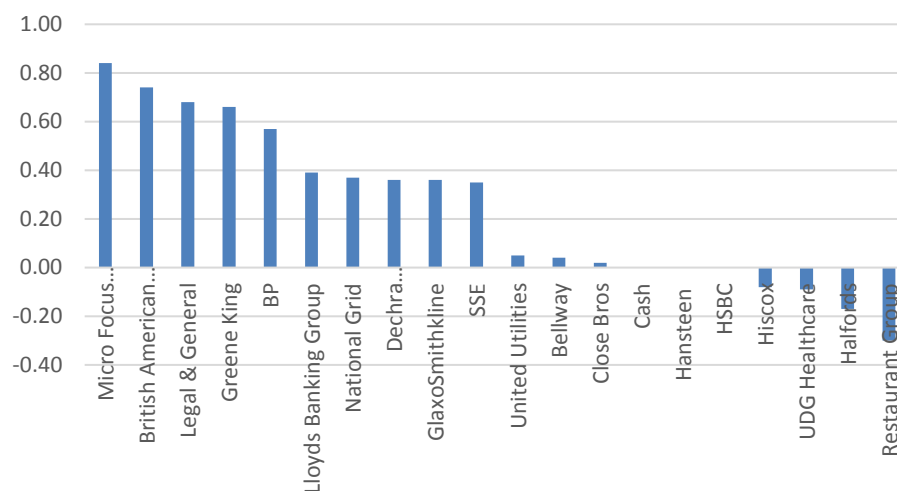
### Performance review

Despite our reticence to get up and boogie, fund performance has been strong, encouraged by positive corporate news flow. It is not too surprising that we have marginally lagged a strong equity market, but in both absolute and relative terms we are steady, if not outstanding, a result which we deem fair considering the risk-based approach we are taking.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	8.93	-1.74	6.08	19.10	34.65
IA UK Equity Income Sector	8.72	-3.10	3.59	19.62	28.11
FTSE All-Share Index	9.41	-1.80	6.36	31.32	34.47

Source: Financial Express

## Biggest contributors to performance – stock level



Source: StatPro

This time last year, we were explaining the big negative influence of **Micro Focus International** on the portfolio following a big profit warning which halved the value of the shares. Twelve months later, the shares have rebounded steadily from a low of 912p to pennies below £20. We have a little way to go before we reach the sunny uplands reached by the shares pre-warning, but we have been rewarded for our patience and our discipline in reviewing the facts before us rather than reacting in a knee-jerk fashion and selling the shares without question. The run has continued this year: the shares are the biggest contributors to our performance year to date.

A second 2018 laggard to recover in the first quarter is **British American Tobacco (BAT)**. We continue to monitor the voluminous news flow emanating from the tobacco industry, and the regulatory response to new products, especially in the US. Although we purchased shares in **Imperial Brands** at a low point in the market last year, our general experience with the sector – and BAT in particular – was painful. This year's share price resurgence reflects how much bad news is arguably already baked into the price, i.e. it doesn't take much to give investors a happy surprise. We also deem the dividend to be secure, even if the balance sheet is weaker than we would wish. This is an industry in considerable flux, with US like-for-like tobacco sales falling at a rate whereby the difference can no longer be made up by price rises. Therefore, while we remain invested, we're very mindful of the industry risk.

We have re-examined our UK exposure, recognising value in many companies, balanced by the clear business risks created by the uncertainty over our future relations with Europe and the economic stresses that may ensue. In many cases, value has held the upper hand in 2019, as evidenced by strong contributions from the likes of **Legal & General** and **Lloyds Banking Group**. **Greene King** has also continued its upward, if haphazard, journey, despite the obvious consumer headwinds; Britons continue to enjoy a pint, and Greene King's tactic of switching last year to a more adult-oriented, wet-led offering proved positive in a year when the weather was kind

Source: Factset, Rathbones

and the football World Cup kinder. This momentum has continued into 2019 despite the news that the company's long-standing chief executive is to leave the business.

This positive vibe has not extended to the **Restaurant Group**, whose shares have weakened further this year. During the autumn, concurrent with a discounted rights issue, the company purchased Wagamama, the fast-growing Asian restaurant chain. In doing so, Restaurant Group also raised debt, so transforming the company from a lower-risk, if sleepy branded, restaurant, pub and concessions business into a more growth-oriented, highly indebted entity. The dividend was also cut. Again, the risks have changed and we have to view the investment accordingly. Our mistake, in hindsight, was not to have severely pruned our position on the announcement of the deal. The share price reaction, this year, especially in the light of the outperformance by other leisure plays (like Greene King) represents an overreaction. We have bought on weakness.

Otherwise, there is little more to report on the negative front. **Halfords** is one of our more Brexit-related plays, and it is suffering at the moment from three principal headwinds: the UK consumer environment and Halfords' own relevance as a retailer; the vagaries of the British weather; and the impact of currency moves on its cost base. The shares are cheap, but will they remain so? We retain a watching brief, in the meantime paid a 7% yield to do so. Shares in **UDG Healthcare** continue to oscillate around one-year lows, but this is a long-term growth story that continues to occupy an important place in our portfolio. A lower-than-average dividend is the principal impediment to us buying more.

### **The Rathbone Income Fund – in a snapshot**

Q1 2019 produced a fair outcome for our fund. We emphasise that we are mindful of downside risk, so our positioning might feel uncomfortable when the risk-on trade holds the upper hand. Rather than trying to grab short-term gains, a long-term view complements our “winning by not losing” philosophy.

It is pleasing therefore to keep pace with the market on the back of positive corporate data, which supports our bottom-up analyses. Positive contributions from a list of stocks as diverse as Micro Focus International, Legal & General, Greene King, **BP**, and Lloyds Banking Group are a reflection of stock specific analysis and meaningful capital allocation decisions, rather than lazy style or index biases. One might argue that it should ever be thus, but it never hurts to re-emphasise the point.

To repeat, we analyse business risk – is this a good business, are returns sustainable? Financial risk – is the balance sheet appropriate? And price risk – is this a good investment? Simple, straightforward, repeatable.

We never buy the index, so our performance will be different to the index. Portfolio composition is a function of the risk balance we are willing to take across the portfolio. Never willing to put all of our chips on one call, we own businesses that best reflect this balanced-risk-based approach. Our exposure to different parts of the market is an outcome of this process.

At the end of March we went ex-dividend our interim distribution, posting a 3% increase from last year, an uplift in real terms, fulfilling our intention to provide you with a pay-rise every year.

**Recent Trading:** We have pruned our position in Micro Focus, in response the strong share price recovery detailed above. At 2% of the fund, the position now better reflects the risk that we want to take. We have also further trimmed **Astra Zeneca**. We used the funds to augment two holdings:

global brewer **AB In-Bev**, where the cut in dividend has actually improved our view of the stock because it is focusing cash flow on improving its balance sheet, thereby reducing financial risk; and **Jupiter Asset Management**, whose recent results and inflows have improved the story. These trades manifest a lean towards more value-oriented shares.



**Carl Stick**  
Fund Manager



**Alan Dobbie**  
Fund Manager

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