Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone High Quality Bond Fund

Quarterly update December 2020

The 10-year gilt yield was roughly flat over the quarter, yet there was a bit of movement during the three months. Starting at 0.23%, it got as high as 0.43% in mid-November before retreating to 0.20% by 31 December.

Credit spreads — the extra return above government bond yields for taking on the risk of default — fell again over the quarter. The iTraxx European investment grade spread index started the period at 59 basis points, it closed on 31 December at 48bps.

	3 months	6 months	1 year	31 Dec 18-31 Dec 19	Since launch (16 Nov 18)
Rathbone High Quality Bond Fund	1.19%	2.03%	2.93%	3.44%	6.47%
Bank of England Base Rate + 0.5%	0.15%	0.30%	0.73%	1.25%	2.14%

Source: FE Analytics; data to 31 December, I-class, mid price to mid price; performance is a combination of I-class units and S-class units where I-class was unavailable (I-class launched 23 July 2019).

These figures refer to past performance, which isn't a reliable indicator of future returns.

Our fund did well in the closing quarter of 2020, outperforming its Bank of England (BoE) Base Rate +0.5% benchmark. Credit spreads continued to rally, boosting the value of our corporate bonds. Meanwhile, as the UK struggled to shake off the pandemic, bondholders began to anticipate the need for more stimulus from the BoE. That drove yields on short-term government debt to fall, again, boosting our returns as we tend to hold more short-dated corporate bonds than is typical.

The value of your investments and the income from them may go down as well as up, and you could get back less than you invested.

Rolling up the curve (slightly)

Our modified duration — a measure of our portfolio's sensitivity to changes in interest rates, which is in part related to the time till our bonds mature — is about 2.9 years. That is a slight increase from where it was at the start of the quarter because we sold some bonds with very short maturities and re-invested that money in bonds that are slightly longer dated. This was a reaction to a steepening of the yield curve here in the UK. This means the difference between shorter-term and longer-term interest rates has started to rise. The driver of this, mostly, is that the price of very short-term debt has been pushed up by monetary policy and investors chasing safe havens. This has made the yields of bonds with three to five years of maturity relatively more attractive, thus our decision to "move up the curve". The flip side of this is, as we have said, we have taken on slightly more interest rate risk.

The yield curve has started to steepen much more aggressively in the US. A steeper yield curve offers higher yields than we could get in the UK for similar risk. We sold the sterling-denominated **Proctor & Gamble 1.8% Senior 2029** and bought two dollar-denominated bonds, the **Proctor & Gamble 1.2% 2030** and **Shell International Finance 2.375% Senior 2029**, and hedged them back to sterling (fixed our exchange rate ahead of time to avoid the risk of currency movements eating up our returns). The cost of this hedging has fallen recently, which improve the potential returns of these trades. Switching from European into US equivalent debt is something that we are likely to do more of in the coming months.

During the quarter we added quite a few bonds in two of our favourite sectors, housing associations and insurance. Housing associations have very strong fundamentals, especially as they have recession-proof cash flows. Sadly, demand for social housing tends to increase during recessionary periods, which means their occupancy rates remain high. These institutions are managed in a cautious way, giving them strong balance sheets and moderate leverage. We bought **Places for People 3.625% Senior 2028**, **Places for People 1% Index-Linked 2022**, **A2Dominion Funding 4.75% 2022** and **A2Dominion Funding II 4.5% 2026**. As for insurers, this is an extremely cash-generative business, which gives us much comfort that they will continue to be able to pay their bills. We tend to find attractive valuations here as well, which is why we added the short-dated bonds **Friends Life Group 8.25% 2022**, **Aviva 6.125% Perpetual-2022**, **Zurich Finance (UK) 6.625% Perpetual-2022**. We also purchased **Munich Re 6.625% Floating Rate Subordinated 2042**, which has the option of being 'called' or bought back by the issuer in 2022. We expect this to happen, and if so it would mean we would have received a higher yield for our investment while avoiding having to hold it past two years.

In October and November, an interesting opportunity opened up in BBB-rated bonds, as they became more attractive relative to the higher-rated corporates that make up the overwhelming majority of our portfolio. We added a small amount to lower-rated securities, including **Scottish Widows 5.5% 2023** and **Barclays Bank 2.375% Floating Rate Senior 2023**. We also bought two BBB-rated bonds at issue: green bond **Enel Finance International 1% Senior 2027** and the **Verizon Communications 1.125% 2028**.

US telco and internet provider Verizon should benefit from the shift to remote and flexible working that we believe is here to stay. It has ramped up its investment in technology and 5G roll-out that should improve its competitive position. Another purchase that links with this theme was the Australian-dollar-denominated **NBN 1% 2025**. This government-backed infrastructure company is rolling out ultra-fast broadband and 5G Down Under and has impressive regulated cash flows to show for it (revenues are adjusted by government to ensure NBN earns an adequate return for the capital it puts up). It is currently loss-making because it's still in the build phase, but it is very well capitalised and we expect it to turn profitable by 2023/24. As its earnings improve, it has the potential to improve its credit quality, which could lead to capital gains.

The pandemic has hit cities hard, and London is no different. With the streets emptied, demand for public transport has evaporated. As COVID-19 continued to linger — and government support seemed to waver — we felt the long-term impact on Transport for London was too great. We sold all of our investment in the **Transport for London 2.25% 2022**.

A very long engagement

Heading into 2021, COVID-19 is still with us. Time scales of recovery have been posed, blown through and re-posed. Now we have viable vaccines, we should be able to push back the virus and return to some normality. However, as always, the crucial question is 'when'.

Mutated strains have become more virulent even as inoculations begin around the world. It really is a race between the virus and health services. We're still optimistic about our ability to defeat the pandemic and move on with our lives. However, we are trying to stay grounded about how swiftly that may occur. Not only that, but this whole episode has shown just how vulnerable our societies (and our commerce) are to epidemics. Hopefully we will learn the lessons of 2020 and ensure we are better able to mitigate the next one that arises.

In the meantime, we're focusing hard on the cash flows and solvency of our investments. Bond investors are always looking at this stuff, because we can only ever lose. You know the total return you're getting up front when you buy a bond: the capital and the income payments. You can get some windfalls too, if interest rates move and someone else is willing to pay more than a bond's face value. But in the main we spend our time looking for things that could go wrong, where a company may not be able to repay its debts and how much we're likely to recoup if it does default.

As many countries, including the UK, fall back into lockdown, some businesses will struggle to generate the cash they need to pay their bills and service their debt. The intense fiscal pressure on companies has so far been seen mostly in the retail space and among energy prospectors. Many of these businesses were struggling to stay relevant even before the pandemic. However, apart from a few other exceptions, the massive disruption hasn't driven a commensurate rise in broad measures of company default. Much of this is due to extraordinary levels of support from governments and central banks. While it seems unlikely that this support will be removed anytime soon, the method of the government aid means that things may get harder for some. Interest-free loans will shift to interest-bearing, deferred taxes will finally fall due. You get the picture. So we're trying to think about how this may cause a shake-out, in time, and ensuring we're prepared well in advance.

Despite the gruelling year, we're actually happy with how 2020 went investment-wise. And we're very excited about the prospects for our holdings over the coming years.

Noelle Cazalis
Fund Manager

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000
Fax 020 7399 0057

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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