

Rathbone Income Fund

Update May 2019

In May we revisited the notion that markets can go down as well as up. The deteriorating news flow from trade discussions between the US and China, and the subsequent realisation that the second-derivative effect of increased antagonism will hurt global supply chains, are weighing on investors' minds. Trade is certainly the principal factor behind this notable shift in sentiment over the past few weeks. However, it is too soon to determine whether this change presages a more meaningful correction in markets. It is important to recognise that equity markets are still firmly in positive territory year to date, meaning the bulls still have the upper hand, but momentum has altered.

Winning by not losing

Do you remember when Usain Bolt was performing in his heyday? I'm talking a decade ago when he was truly imperious, culminating in his destruction of the world 100-metre record at the Berlin World Championships? Most of his races followed a pattern: the rest of the field would just about be in touch for the first half, but there was always a point, after about 60m, when he would stretch away. Well, that's how it appeared. The truth is, not even Usain Bolt can accelerate for the full 100m; at the precise point that he is moving away from the field, he is just slowing down at a lesser rate than his competitors. He was the fastest man over 100m by slowing down the least at the end.

Since the start of 2000, when Carl Stick began his tenure as manager of your fund, it has been the top-performing name in the IA Equity Income sector. Admittedly, the constituents of the sector are now very different from almost 20 years ago, with some having inevitably fallen by the wayside and others moving to a different sector. However, from 1 January 2000 through to 31 May this year, a period of 19 years and five months, your fund has generated a total return of 358%, compared with a sector average return of 190%. Most importantly, we have outperformed the FTSE All-Share Index, which is up just 135%. Understandably, this is a record **across many market cycles**, of which we are very proud.

This is not intended to be an exercise in indulgent self-congratulation. What we wish to discuss is a specific characteristic of how we've built this record.

We have cut this period of time down into individual months, 233 in total, so a pretty good data set. We are interested in looking at all of those months in which the FTSE All-Share made gains and, separately, all those months when the index fell. We want to understand how our fund performed in good months and in bad months.

The results do seem reasonably conclusive. In up markets, our fund has a record of marginally trumping the sector, but lagging behind the index. In months when markets fell – and investors pulled on their selling boots – the sector has, on average, clearly outperformed the index, and our fund has likewise made much lighter losses than the sector. The margin of the beat when markets fall is greater than the lag when markets rise. Over an extended period of time, this has delivered considerable outperformance. The achievement cited above in the numbers has not been accomplished through making the greater gains, but rather through mitigating the losses. Our risk-

based approach has informed the mantra, “winning by not losing”, and the data does seem to show these aren’t empty words.

The exciting bit about investing is spotting undervalued businesses, or the next growth idea, and harvesting the capital gains. But the key to capital accumulation should be much more mundane. We pose the questions: What is the downside risk? What is the margin of safety? Before Warren Buffett there was Benjamin Graham, and his entire philosophy was based upon limiting the downside rather than imagining the upside. Indeed, the best way to maximise the compounding effect on the upside is by not frittering it away on the downside, and so our record has proved.

There are practical challenges for us to face. The capital markets industry is geared to positive spin. It is a given that the number of research notes advocating buy recommendations far outnumber sells, because sell recommendations do not beget corporate fees. But on a more philosophical level, markets do in the very long term trend upwards. It is fine to be bearish, but being bearish when markets are rising is a very painful experience.

We have avoided too much pain, despite our concerns about equity valuations dating back as far as 2012, two-and-a-half years into the current bull market. By the start of 2017, we were even more worried about prices; in 2018, we enunciated clearly a strategy for trying to stay invested while taking a more defensive tack. Although in hindsight, we might have done better if we had been willing to take on more price risk, this would have been detrimental to our principles. Nevertheless, over the last two years, it does seem to us that the pattern of just managing to keep pace with markets in bullish phases, while outperforming when risk is taken off the table, has been maintained.

One practical difficulty persists however.

This is a market where there is a clear bifurcation of viewpoint. Quality, which means businesses with predictable and sustainable earnings, is expensive. On the other hand, businesses operating in challenging environments have gotten cheaper, and there has not been the catalyst for this to change. In uncertain markets, the investment zeitgeist certainly has been to pay up for certainty, and there has been no price low enough to generate the margin of safety necessary to make value attractive once more.

This is a broad generalisation of course. In hindsight, you can easily spot value mismatches in specific cases. **Greene King** was never as poorly placed as some of the more negative analyst comment of recent times; the shares have comfortably outpaced the market in the past six months. **Lloyds** at 50p was also pricing in very little good news, to cherry pick just two examples. But in general, value has remained cheap, and when such a diverse spread of FTSE 100 businesses as **Imperial Brands** and **British American Tobacco**, **SSE**, **Legal & General** and **Aviva**, **BP** and **Shell**, and **HSBC** are all serving up dividend yields in excess of 5.5% – in some cases substantially more than this – we know there’s a dramatic divergence in sentiment in play across the market.

The difficulty is always in the timing. Get it right and you are a hero; on the other hand, value without a catalyst remains cheap at best, a trap at worst. There is a very obvious reason why the UK is bargain basement material. Uncertainty around Brexit, its conclusion, and its consequences, means that global investors are unlikely to come flooding back into UK markets any time soon. Companies exposed to the UK economy are even more widely loathed. Yet, at some point in the

future, the dark clouds will clear, and outlooks will improve. If prices reflect the worst possible outcome, it does not take much good news to change the tune.

Investment is a marathon, not a sprint. We own high-quality businesses, but the price risk could act as a brake on future performance. On the other hand, UK value companies may be reinvigorated if the political noise fades away. We do not know what the future holds, but recent changes to our portfolio reflect a bias towards value. If equity markets go up, we hope to keep in touch; if they retreat, we hope that we are positioned to win the race by slowing down the least.

Recent trading: May saw an uptick in trading activity, reflecting the increased volatility in the market and the opportunities that arose. The theme continues to be an awareness of price risk. We have taken profits from both **Unilever** and **WEC Energy Holdings**, two large positions in the fund, and also sold out of **Sage**. These funds have been put to work consolidating existing positions in **Bellway**, **Aviva**, **Imperial Brands** and **United Utilities**, and also adding to three overseas stocks, **Anheuser-Busch Inbev**, **Roche** and **Novartis**.

Companies seen this month: **DCC**, **Halfords**, **Euromoney**, **UDG Healthcare**, **Relx**, **Big Yellow Group**, **National Grid**, **SSE** and **Tate & Lyle**.



Carl Stick
Fund Manager



Alan Dobbie
Fund Manager

This is a financial promotion relating to the Rathbone Income Fund. Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in the context of the constitution of the fund and in no way reflects an investment recommendation. The information contained in this note is for use by investment advisers and journalists and must not be circulated to private clients or to the general public. Source performance data, Financial Express, mid to mid, net income re-invested.