Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Update June 2019

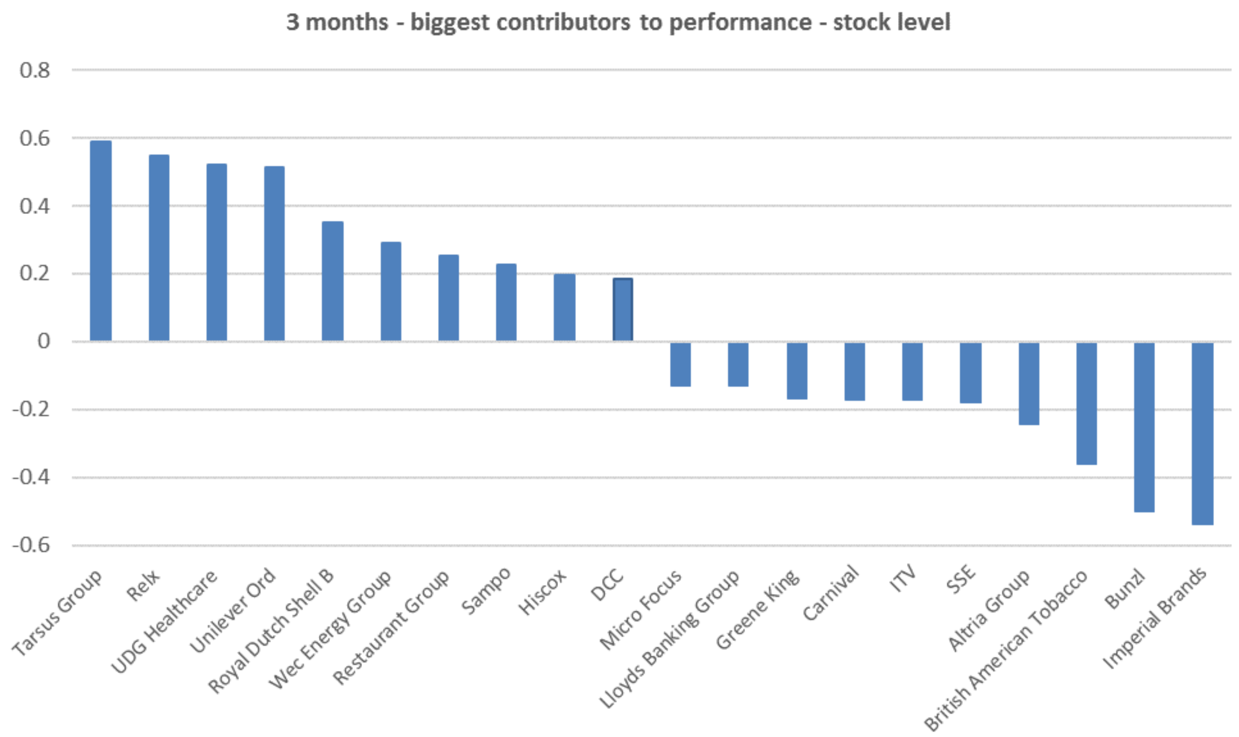
Halfway through the year and so much in a state of flux. In the UK, political intrigue remains front and centre as we await a new leader of the Conservative Party, and a new leader of the country. The future of the European Union (EU) seems even shakier, with France and Germany seemingly on the verge of falling out with each other and Italy under the severest economic pressure. Trade wars, tension in the Gulf of Hormuz and a US president headlining on a daily basis help to foment a global melting pot of tension and uncertainty. And yet equity markets keep rising. Are central banks adding further fuel to the fire by looking to lower rates once more, or do they see things around the corner that we do not? Loathe as we are to make predictions, it does feel as though we are on the cusp of a change in direction, not necessarily downwards, but certainly different. With this uncertain backdrop we complete our regular critique of performance.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	2.49	11.64	0.93	22.62	35.70
IA UK Equity Income sector	1.92	10.81	-2.54	23.33	29.58
FTSE All-Share Index	3.26	12.97	0.57	29.51	35.81

Source: FE Analytics

Three-month performance

Your fund gained 2.5% versus the sector average of 1.9% and the FTSE All-Share Index total return of 3.3%. Media company **Tarsus Group** announced a recommended offer for the company at a substantial premium to the then-market price and the shares are currently trading above the level of the bid. We have taken some profit and, unsurprisingly, the shares are the biggest contributor to performance this quarter. Quality and growth have been the dominant thematic drivers, with **Relx**, **Unilever** and **UDG Healthcare** also performing well. Oil stocks moved higher, as rising geopolitical tensions in the Persian Gulf elevated oil prices. Three of our principal laggards are tobacco stocks, the industry weak amidst loud rumblings from the US Food and Drug Administration with regard to next-generation products. Unsurprisingly, the companies have been robust in their response, but the noise has hurt sentiment. Elsewhere, downbeat trading statements put pressure on the shares of both **Bunzl** and **Carnival**.



Source: StatPro

Six-month performance

In the first six months of the year, your fund generated a total return of 11.6%, which compares favourably with a sector average of 10.8%, but does still lag the 13.0% return from the FTSE All-Share. On a stock level, the biggest contributor to our fund's performance was **Micro Focus International**, consolidating gains made at the start of the year. **Legal & General** has been very strong despite the negative UK vibe which can dampen investor enthusiasm for the shares. US utility **WEC Energy** has continued to perform strongly, highlighting the vast difference between the environments for utility companies in the US and the UK. We have been mindful to trim all three positions. On the downside, UK domestic stocks continue to face headwinds, given particularly poor investor sentiment. Retailer **Halfords** and leisure business **Restaurant Group** featured in our top-five negative contributors, alongside **Imperial Brands** (tobacco sector weakness) and the aforementioned Bunzl and Carnival.

Investment review

There is a swathe of companies afforded valuations that reflect their quality in more than ample magnitude. Indeed, we own many such names: core compounders like **Unilever** and Relx, long-term growth favourites such as **Dechra Pharmaceuticals**, **UDG Healthcare** and **DCC**, and turnarounds like **AstraZeneca**, which was widely avoided a few years back, but is valued now as if nothing can go wrong (although, to be fair, very little has gone awry over the last two years). These are all businesses where investors are willing to pay premium prices for security, for certainty, for visible growth in a world of noise, of uncertainty, of perceived economic and political fragility. Our ownership of these stocks, and others of similar hue, reflects a qualified acceptance of this investment reality.

However, we have also been consistent in maintaining the balance of risk across our portfolio. We sleep easier knowing that we are not over-exposed to any one particular strategy. Even if the business and financial risks of a cohort of stocks are perceived to be low (and remember, nothing is without risk – wheels can always fall off the best of businesses), there will still be a point at which prices offer inadequate compensation for this risk: paying too much for a company may sting you. Our view is that we are close to that point now, so we have been less tolerant of price risk in the portfolio, and have been more aggressive in our harvesting of profits; not selling out, but neutralising some of the price risk.

That is the easy part; the conundrum is where to reallocate the money. We want to avoid jumping from the frying pan into the fire, but we are inevitably exchanging one risk for another. Nevertheless, it is important that we analyse our allocation to "value", and explain where we feel it is appropriate to take on greater business and/or financial risk as a *quid pro quo*.

The value trade

This allocation is crystallising around three broad, but not necessarily mutually exclusive, themes or sub-sets.

In one, we have a broad representation of businesses whose fortunes are linked to the vagaries of the UK economy, whose valuations are impacted by Brexit noise and, by extension, the absence of any global investor appetite for investing in UK plc. We consider housebuilders (**Berkeley Group**, **Bellway**), retailers (Halfords), leisure businesses (**Greene King**, Restaurant Group), life assurers (**Aviva**, Legal & General) and UK-based financials (**Close Brothers**, **Lloyds Banking Group**) as positioned in this group. We are comfortable with the spread of business risks across these holdings, but are unlikely to add in any meaningful way until greater clarity is achieved on life post-Brexit. On balance we believe a benign conclusion helps, a dramatic exit hurts.

The second sub-set is a specific cohort of businesses whose fortunes probably hinge on a binary event. We refer here to utility stocks (**National Grid**, **SSE**, **United Utilities**) where there is the threat of a Jeremy Corbyn-led Labour government pushing through legislation leading to their re-nationalisation. We deem the chances of this happening as low, but the ramifications would be serious. We also include tobacco stocks (BAT, Imperial Brands, **Altria**) in this bucket. The tobacco industry has existed for decades with existential threats, but at the moment the regulatory noise is cacophonous. This is why Imperial Brands is trading on just 7x earnings, and sports a dividend yield of over 10%. The value is extreme, but so is the angst.

There is a third sub-set of ideas, influenced by a change in macroeconomic drivers and a concurrent shift in investor priorities. Our optimistic view with regard to late-cycle industry may be distilled to the following three-stage argument:

> The dramatic reversal of US interest rate expectations, with the now widespread forecast of two cuts this year at least, is not necessarily a precursor to a recession in the US. Indeed, US economic data is not supportive of this view. Nevertheless, the rally in stocks has been maintained by an insatiable desire for quality; the underperformance of value has been extreme. After all, owning a stock that warns on profits has been a painful experience. However, if the US Federal Reserve is buying an insurance policy rather than reacting to a downturn, this may be the right time to take on more business risk, not less. Could the sector leadership baton be about to change hands?

The US dollar may also change course. Fear has elevated the greenback, so less bearish global market sentiment may introduce a spell of dollar weakness, especially if it coincides with a slowing US economy, lower rates and an improved global backdrop. Global instability tends to send investors flocking to the dollar as a safe haven. Although the current geo-political environment is fractious, any easing in trade or political tensions may reverse this trend. Further pressure may be applied by a president who has an agenda to talk down the currency in order to reduce the US trade deficit. However the dollar trades, currency risk remains a key risk for UK funds, over-exposed as they are to global consumer goods companies.

We re-emphasise our preference for late-cycle value. We are increasing our exposure in late-cycle industry in general, and to the energy sector in particular. A combination of strong operational performance manifesting in excellent cash flow and improved capital discipline encourages us to increase our large positions in **Royal Dutch Shell** and **BP**. A softening dollar and easing trade concerns would support this argument. The background drumbeat of Middle Eastern tension further elevates the commodity price, but we hope this particular influence fades. We will also look elsewhere into the industrial space for cyclical value and beyond we may even review our financial exposure. Past experience teaches us that any rebound in value is led by commodities and financials, and the value is certainly there.

Conclusion

It is best not to over-complicate this narrative. The tactics outlined above are a natural extension of the positioning outlined last year, where we tilted towards late-cycle industry sectors. This bias now exhibits less tolerance towards price risk, so less reliance on consumer staples and expensive pharmaceuticals. Instead it means greater exposure to cyclical value, predominantly energy, but open to other industries if the prices are right. Furthermore, if the risk/reward aligns, we may even choose to increase our exposure to financials.

A note on liquidity

For many years we have had a procedure in place to monitor liquidity in our fund, helping us to understand how we might raise large amounts of cash if the need were to arise. And, more importantly, it helps us comprehend the stresses that this process may put on our fund in terms of portfolio management and construction. Nevertheless, in light of recent events, we have reviewed all of our procedures in order to ensure that they remain as robust and up to date with current market conditions as possible. You should be confident that we continue to make every endeavour to safeguard the interests of all of our clients.

Recent trading: In accordance with the analysis outlined above, we have taken profits from Relx, AstraZeneca, Unilever and WEC Energy, and have added to Imperial Brands, **Close Brothers**, BP, Royal Dutch Shell and Carnival. We have also trimmed our holding in Tarsus Group.

Companies seen this month: London Metric, RSA Group and Bellway

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