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Rathbones
Look forward

Rathbone SICAV Income Fund

Update September 2019

According to the United Nations website, "all 193 Member States of the Organisation are represented in the General Assembly...to discuss and work together on a wide array of international issues...such as **development, peace and security, international law** etc."

The 74th session, which began in late September, belied such a spirit of cooperation and teamwork. The abiding memory is of teenage activist Greta Thunberg berating the assembly of global leaders in a highly emotional speech. She accused them of robbing her generation of their future and destroying the world's ecosystems; they clapped politely in the pauses, a few in the back whooped like schoolkids, completing the eerie role reversal.

President Donald Trump himself delivered a long, ponderous, meandering, dull and tired lecture that was long on "Make America Great Again", and short on co-operation and constructive contribution. And UK Prime Minister Boris Johnson left early, returning home after an historic Supreme Court ruling that his prorogation of Parliament was unlawful. Mr Johnson returned to the Palace of Westminster in combative form, stoking the fires of an incendiary Parliament – described as a pit of "fear and loathing" by BBC political correspondent Laura Kuenssberg.

So then, very little development, peace, security and law at evidence of late. Yet these are the times in which individuals and businesses have to live and make decisions, in which markets have to function.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	1.82%	4.36%	2.54%	15.08%	36.58%
IA UK Equity Income Sector	1.08%	3.05%	-0.15%	14.22%	31.73%
FTSE All-Share Index	1.27%	4.57%	2.68%	21.69%	38.89%

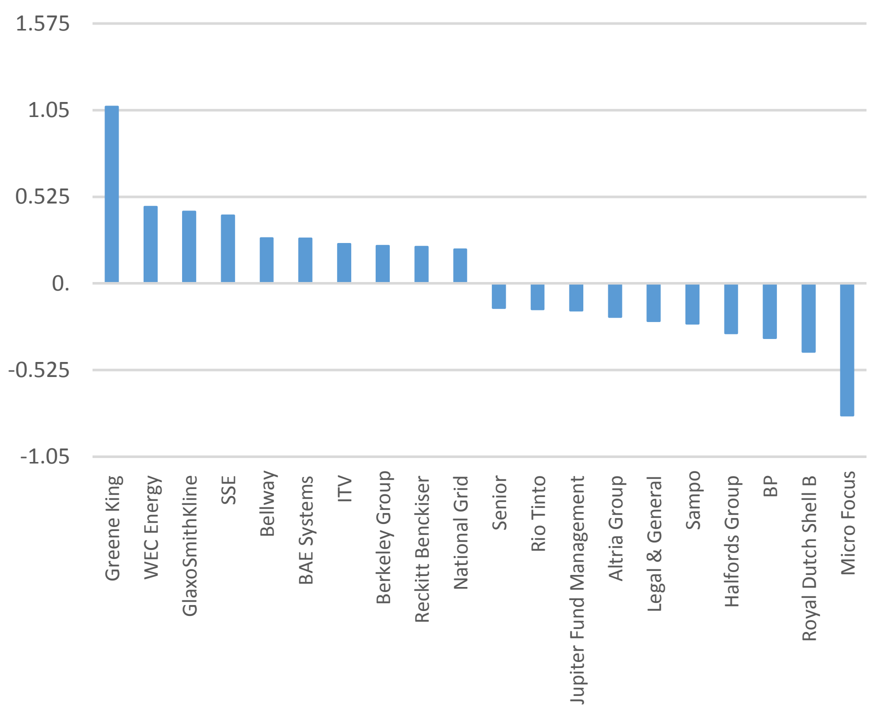
Source: FE Analytics

Third-quarter Performance

In the three months to September's end, our fund edged up 1.8% versus a sector average of 1.1%. Over the same period, the FTSE All-Share Index rose 1.3%. Such small moves disguise the volatility of underlying markets and frequent dramatic intra-day gyrations in individual stocks.

Our biggest contributor to performance was UK pub company **Greene King**, after its board recommended in August that shareholders accept a cash offer from Chinese investor CK Asset Holdings. An increasing bias towards more defensive companies helped boost our utility holdings **WEC Energy** and **SSE**, pharmaceutical giant **GlaxoSmithKline** and aeronautics and defence company **BAE Systems**. On the downside, **Micro Focus International** revealed once more how volatile it can be, warning once again on its profits. Despite tensions in the Gulf, both **BP** and **Shell** gave up ground. **Legal & General** and **Halfords** suffered from a general UK malaise. Nordic finance group **Sampo** fell back in July, because investors worried that ongoing challenges for Nordea may presage a cut in the dividend.

Three-month – biggest contributors to performance – stock level



Source: StatPro

Year-to-date performance

This year's performance has been strong in both absolute and relative terms. Our fund achieved a total return of 13.7%, ahead of the 12.1% sector average albeit behind the FTSE All-Share's 14.4% gain. Greene King was once more our principal driver, its shares having performed very well even before the bid. The roster of positive contributors includes WEC, Unilever, GlaxoSmithKline and Tarsus Group, a small events business that also received a bid – further evidence of increased M&A activity. On the negative side, we include the aforementioned Halfords, tobacco stocks Imperial Brands and Altria, Bunzl, and Carnival. Carnival has disappointed once more with its latest guidance, and this was compounded by its sensitivity to a slowdown in global growth. However, it trades at a very large discount to historic valuations, and we persist with our position on the basis that the industry is not in structural decline. We are prepared to be patient.

Investment review

We have consistently identified three areas of potential value that we have sought to exploit in varying degrees through 2019. This review offers an opportunity to revisit them. In summary, we have imagined three, non-mutually exclusive, buckets of potential value, areas where we might wish to reallocate capital, especially from names where maybe prices have moved ahead too far, thereby exchanging business risk for price risk. This tactic should not surprise any of our investors.

The Brexit bucket includes businesses with operations predominantly or exclusively in the UK. We have been very cautious in allocating further capital into this area. Our hope that value will be realised sometime soon has been dampened by the lack of progress at Westminster. However, the fact that M&A activity has increased, as evidenced by the bid for Greene King and an aborted attempt by the Hong Kong bourse to takeover the London Stock Exchange, does suggest that there are other parties out there with capital to invest and a long time horizon. This supports our policy of spreading risk across a basket of businesses in different industries.

In instances, we have got this wrong, however. Halfords has been a disappointment. We think that the different management teams have tried very hard over the years to re-energise the business, but maybe the structural headwinds have been too strong. Halfords still needs further investment, which may mean a cut in dividend despite the strong balance sheet and high cash flows; we do understand the rationale. We also agree with management that there is no point ramping up investment if the returns cannot be guaranteed. Of course, Brexit does nothing to improve visibility in this regard. Halfords is a worthy business that has faced and continues to deal with many difficulties. We remain holders for three reasons: it is a differentiated play on UK retail; it should benefit from a benign Brexit and the subsequent spike in sterling that is likely to occur; and the shares, backed by strong cash flows, offer deep value to a suitor. Nevertheless, the challenges are large.

A second bucket may be labelled binary outcomes, and includes our utility and tobacco holdings. Once more, we have seen mixed results. In general, our utility stocks have performed well. WEC Energy in the US has been outstanding, reflecting the stark difference between the US and UK utility models. Across the Atlantic it is much easier to think about returns on investment feeding through into revenue and thereby profit and dividend growth. Nevertheless, in the UK the mood has perhaps lightened a fraction, despite the political noise, and so SSE had a stronger quarter. When the retail business is finally removed from the group, this should become a more focused renewable energy generation and infrastructure business, which may resonate well with investors. The risk remains of a Labour-led government attempting to re-nationalise utilities, or at the least reducing the targeted returns that they make on investments. However, our job is to rationalise this eventuality against the price that we pay for the shares and the dividends we get as compensation for holding them.

Tobacco stocks are finding life a lot tougher. Regulatory squalls, which the industry has had to battle for most of the last few decades, are still there. But the passage for next-generation products – once seen as the industry's lifeboat – seems a lot rockier now than it did at the start of the year. The very recent management upheaval at Juul, the e-cigarette business in which Altria has a major stake, is both a symptom and a result of a trading environment that has deteriorated over the summer. Again, value and dividend are the reward, but the business risk has increased markedly.

The third bucket is more general, and may loosely be described as global value. These are multinational UK businesses that should shoot upward if there is a rotation away from momentum into value. We saw the early tremors of such a rotation at points during August and September. There were days when this rotation was quite extreme, so we want to make sure that we do have some chips in the game, but without betraying our investment principles. This grouping includes businesses included in the aforementioned tranches. However, a new purchase in media business WPP plays into this theme, and we continue to explore other new ideas in different industries. Global cruise business Carnival also fits into this cohort.

Outlook

We believe that our fund's performance over the last nine months has been very credible. What is perhaps harder to trust is the overall strong return from the stock market as a whole. We are very happy to have kept in touch with these gains, but we nevertheless worry about what is around the corner. We would suggest that our record of keeping in touch when markets go up, outperforming on bad days, and generally doing better when the momentum trade is off the table, has been maintained this year. Few surprises there if you have been reading our notes for some time. On a positive note, we should be able to raise our final dividend by about 8%, which increases our total distribution for the year by more than 6%, a very welcome pay rise for you.

As suggested in the introduction to this review, there are three major themes that are going to dominate not just the headlines, but also increasingly the decisions that companies make with regard to how they allocate capital:

Climate change: A few years ago, most companies paid no more than lip-service to the sustainability agenda. In the last couple of years, many more businesses are recognising the need to reduce their carbon footprints, and specifically cutting single-use plastic, water and energy consumption. Now the issue is front and centre, it is going to have a far greater impact on both the decisions that companies make, and the valuations attributed to businesses that do or do not act responsibly. When sovereign wealth funds decide to pull capital from entire industries, we have to take notice.

Global growth: Globalisation does seem to be a bit of a busted flush. Mr Trump is promoting an America-first agenda that affords bilateral rather than multi-lateral agreements, but he is doing so using the blunt instrument of tariffs. The possibility of a US recession combined with a Chinese slowdown and Europe slamming into reverse – exacerbated if Mr Trump trains his sights on the Eurozone – all aggregate to a difficult prognosis for global growth. And that's before you consider the change of the UK leaving the EU without a deal.

Brexit: The extreme polarisation of debate and febrile political mood makes it increasingly difficult for businesses to make investment decisions. This will have an impact on jobs and growth. While the increase in M&A activity does remind us that, in the very long term, there will be a light at the end of the tunnel, we do seem to be doing our best to prolong the discomfort. We're not sure about you, but we often go to bed harbouring the hope that there will be a time when pragmatic discussion and compromise comes to the fore once again. In the meantime, it makes investment very difficult.

Recent trading: A very quiet month in which we added to **Restaurant Group** and WPP, and trimmed GlaxoSmithKline.

Companies seen this month: Dechra Pharmaceuticals, Close Brothers and Legal & General.

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