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Rathbones
Look forward

Rathbone SICAV Income Fund

Update March 2020

So we come to the end of an extraordinary quarter. The Rathbone Income Fund fell back 26.2%, outperforming the IA Equity Income Sector, down 28.1%, but in line with the FTSE All-Share benchmark, midday to midday.* Unsurprisingly, the recent swathe of dividend deferrals and cancellations have also weighed on the sector … but more on this later. Our fund has succumbed to losses, which is never a nice experience, but there are three important silver linings:

We are outperforming the sector, despite being hurt by our UK domestic exposure, which we had expected to come good after last year's election;

	3 months	6 months	1 year	3 years	5 years	10 years
Rathbone Income Fund	-26.21%	-23.02%	-19.67%	-18.45%	-3.71%	77.90%
IA Equity Income Sector	-28.14%	-23.00%	-20.64%	-17.56%	-6.23%	54.82%
FTSE All Share Index	-25.13%**	-22.02%	-18.45%	-12.19%	2.89%	53.57%

Source: FE Analytics, mid-price to mid-price; **this figure is from close of day to close of day, not midday to midday

We are sitting on a decent cash pile (7.6% at period end), a war chest that we wish to put to good use;

We have put through a 3% rise in our interim distribution.

The biggest drags on our performance were **Carnival** (which has now been sold), **Restaurant Group** (which we have reduced), **Bellway**, **Legal & General** and **Lloyds Banking Group**. Carnival became an obvious high-profile casualty of the coronavirus pandemic, so we sold the shares ahead of its call to raise more debt and equity funding. We saw Restaurant Group just prior to the market correction, and our initial view, despite the dividend cut, was to persist with the holding on account of the strength of the Wagamama concessions and its pub businesses. There was also a belief – which we still hold by the way – that the managers are doing all the right things. However, the UK lockdown could prove an existential threat and, at the very least, casts doubt as to when and at what level the dividend will be resumed. At time of writing, we had sold the majority of our stake.

Bellway, Legal & General and Lloyds Banking Group remain core positions in our fund. Legal & General surprised the market by reassuring investors that it intends to maintain its dividend, despite pressure from the regulator, helping its shares recover strongly post-period end. Bellway is very well capitalised, and we hope that it will prosper once the housing market returns to normality. Lloyds is perhaps a greater potential headache, but prior to the current events its capital position was in a far stronger position than it was ahead of the global financial crisis. That makes it better placed to withstand the pandemic. These three stocks are all very economically sensitive.

Positive contributions to fund performance came from US utility **WEC Energy** (which we pruned on valuation grounds, prior to the recent sell-off), **Roche**, **Reckitt Benckiser**, **United Utilities** and our cash position. Swiss pharmaceutical giant Roche has been strong, as have all pharmaceutical stocks, but the shares have also been buoyed by the news that it is launching a clinical trial of a potential new COVID-19 drug.

We sold our holding in United Utilities back in February, and have created a position in Irish paper and packaging company **Smurfit Kappa**.

Dividends, dividends, dividends

During the second half of March the number of companies deferring or cancelling dividends accelerated, along with the suspension of guidance for the rest of 2020. The reasons stretched from prudence through to existential crisis. As at the period end, eight of our businesses had suspended payments: **Senior**, **Restaurant Group**, **Halfords**, **ITV**, **Headlam**, **Micro** Focus, Bellway and **WPP**. The latter two have very strong balance sheets and remain central to our plans. We are taking action to protect against further downside, and have been reducing Senior and Restaurant Group.

A little while back we might have argued that almost half of our portfolio's assets are in company shares for which there is a reasonable expectation that dividends will be declared and paid. These included not just consumer staples, pharmaceuticals and utilities, but also key individual businesses such as **DCC**, **Smurfit Kappa** and **Dechra Pharmaceuticals**. However, on 2 April Bunzl, one of the UK's limited number of 'dividend aristocrats', with a history of rising payouts going back 27 years, suspended guidance and announced it will no longer propose a dividend for the year to December. This despite strong first-quarter trading and a robust financial position. If a business of Bunzl's quality and record deems it important to make this decision, any business we own may come to the same decision. **The rules have changed.**

Oil & Gas

Royal Dutch Shell and **BP** are important constituents of our portfolio, but the oil & gas industry is facing extreme challenges. Massive supply meets plummeting demand: Saudi Arabia is flooding the market with oil in its stand-off with Russia, and the world is not travelling so using less of the black stuff. Our premise for holding these businesses is established upon a notion of deep value, but that argument is defunct if oil stays at $20 a barrel or lower for much longer.

The companies still have a few levers to pull, by cutting capex and halting share re-purchases, which will save cash and support the dividend in the short term. On the other hand, what if the news changes? Indeed, on Thursday, a tweet from US President Donald Trump *vis à vis* conversations between himself, Saudi Crown Prince Mohammed bin Salman, and Russian President Vladimir Putin regarding cuts to production, sent oil and share prices surging from very low levels. Now, we are careful to view such stories with a strong dose of scepticism, and we recognize that the oil industry will take a long time to recover from the multiple shocks of the first quarter. However, both Royal Dutch Shell and BP do have the funds to maintain their dividends if they choose, and are financially strong enough to weather this storm.

It must be emphasised that, whether it be oil plays or other industries that are under stress, we must remain alert to the possibilities of a change in the tide. News does not stay bad for ever, as evidenced by the events of this week for the energy companies. When markets recover, it will not be the safe havens that outperform.

Financials

On 1 April, the Bank of England's Prudential Regulation Authority (PRA) stated that it "welcomes the decision by the boards of the large UK banks to suspend dividends and buybacks on ordinary shares until the end of 2020, and to cancel payments of any outstanding 2019 dividends in response to a request from us." In February, upon release of their annual results, Lloyds looked like a good play on a UK economy recovering from three years of tempestuous politics, set relatively fair with full employment, the promise of fiscal impetus, and the owner of very secure capital structure feeding through to a healthy dividend. Six weeks later, the Bank of England is concerned that the financial industry will come under stress, despite the fact that balance sheets are in far better shape than they were in 2008, and is therefore taking the prudent course. This is not a repeat of the global financial crisis when the banks were the villains, and indeed we think that they will be part of the solution, through loan forbearance, for example. But the economic challenges are immense and the regulator is taking no chances. Operationally, we would suggest that Lloyds will be in a strong position when recovery comes.

And if the banks do not pay their dividends, what about other financials? The PRA is encouraging, rather than requesting financial firms to do the "right" thing. Legal & General is very well capitalised, and felt it could resist the pressure and confirm its dividend. Aviva is in a less strong position, and Close Brothers has also suspended its dividend, something it didn't even resort to in the GFC. Big Yellow Group, Hiscox, Sampo, will all be reviewing policy.

BUT – these are all good companies. What they need to do today with regard to their dividends, whether encouraged by the regulator or taken on their own discretion, should not detract from the long-term opportunity.

So why are we confident?

Last week we wrote about our strategic approach:

- Capital Preservation – "Winning by not Losing"
- Sustainable Dividends
- Total Return
- Steady Distribution Growth – "A Pay-rise Every Year"

The decisions taken by Bunzl and Close Brothers, two dividend stalwarts, mean that bullet point four is likely to be off the table for us all. We are not going to chase dividends this spring because we cannot know with any certainty what will be declared, or paid, by any company. For most of our businesses any decision to postpone will be one of prudence, not of weakness; for some a fair reflection of economic stress; for a very limited number, for survival.

Let's think about what we look for in companies.

We want to invest in businesses that are generating sustainable cash returns on capital, evidenced in cash profits. These profits are currently under stress, no matter the industry, but some clearly more than others. Our job is to identify the profit streams that we want to own, at the right price – always has been, always will be.

Businesses use these profits to pay their creditors and tax; therefore we ask if they are appropriately funded, or overly indebted? Can they fulfill these obligations? Same questions as always, but even more relevant now.

They can use the cash left over to fulfil maintenance capex – investment just to keep the lights on; and expansionary capex, which does seem unlikely at the moment. However the best companies will have the financial firepower to take advantage when the environment improves. We would want to own some of those. Capital invested now is the basis for future earnings and dividend growth.

Finally, what happens to the cash that is left over? Dividends are a discretionary payment and, at the moment, prudence has the upper hand. But the strongest companies will have cash to redistribute to shareholders. These businesses will be the foundation stones of the future pay-rises that we intend to give you.

So, the plan is straightforward.

If we put to one side, for once, an overall dividend target for our fund, we maximize our chances of avoiding mistakes. **Our first priority is to preserve capital**.

We focus on the businesses that can exploit the points highlighted above – **sustainable cash returns on investment**.

And our price discipline means that we endeavour to **maximise our total returns** by being patient on price, because there will be opportunities to buy some very good companies at very keen prices.

And **we have the cash to exploit these opportunities**.

Recent Trading: We have added to our positions in **Rio Tinto**, Royal Dutch Shell and **AB InBev**. We reduced WEC Energy, **Senior** and Reckitt Benckiser, and sold Carnival.

Companies seen in March: At the very beginning of the month we managed to see the management of Hiscox, Senior, Grafton Group, Cairn Homes, Relx, Unilever, Legal & General, Jupiter, and Reckitt Benckiser.

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