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Rathbones Look forward

# Rathbone SICAV Income Fund

## Monthly update April 2020

*"And once the storm is over, you won't remember how you made it through, how you managed to survive. You won't even be sure, in fact, whether the storm is really over. But one thing is certain. When you come out of the storm you won't be the same person who walked in. That's what this storm is all about."*

Haruki Murakami, *Kafka on the Shore*, 2002

*"...it's my view that if you're experiencing something that has never been seen before, you simply can't say you know how it'll turn out."*

Howard Marks, *Knowledge of the Future* memo to clients, 2020

*"...one of the unusual features about this crisis is how it feels like the world is at a complete standstill and yet things are changing at an extraordinary speed."*

Alan Jope, Unilever CEO, Q1 conference call, 23 April 2020

**How to best construct an equity portfolio is the topic of this letter. More pertinently, how is our fund positioned, and what are our tactics, our strategy, our plan?**

Of course, it helps that we have an outcome in mind – maximising total return, providing a sustainable (and preferably growing) income stream – but we must also recognise that there is only so much we can control. This is why it is fundamental that we focus on process rather than being overly fixated on outcome, especially in the short term. Of course, we are not ambivalent to outcomes, it is just that we comprehend the limits of what we can know and control.

In the current environment, the almost incessant news flow, and moreover, data, lots of it, may make us feel that we should always be adjusting the tiller. That we should be diligently changing course whenever the news changes, making a decision after every headline, before or after the jobs report, the OPEC meeting, the latest COVID-19 update, the PMI data. But what really changes in that instant? The world is an infinitely complex system and we should not fool ourselves into overvaluing our own forecasts and reactions. Therefore, if we profess quite rightly our own ignorance, portfolio construction becomes less about predicting what we can get right, and more about trying to balance prices and risks. At the very least our fear of losses should act as a healthy counterbalance to our desire for gains.

In his book *Thinking Fast and Slow*, Daniel Kahneman describes "the illusion of understanding", where people are ingrained to distil their past experiences into simple narratives – easy stories – that explain histories, winners and outcomes. It is easy to do this with investment ideas, reducing an argument down to small bullet points on a PowerPoint slide and forgetting the complexity of the system. Veteran investor Howard Marks is flipping this gaze to the future, warning us that we definitively do not know what tomorrow brings. Investment decisions should be established upon this foundation of uncertainty. There should be a humility that recognises the gaps in our knowledge, not an arrogance that assumes the impermeability of our argument. However, that does not mean that there is no method, or that we can get away with indecisiveness.

**It is a positive that our approach to portfolio construction reflects this failure to know the future**. In the last two months we have sold three companies where we worry about their very existence: UK leisure business **The Restaurant Group**, global cruising enterprise **Carnival**, and latterly, **Senior Group**, a fine business that is beholden to an aeronautical sector under terrific stress. Our exits reflect an awareness of future risks and a calculated assessment of possible downside.

If you look at our portfolio today, about a third of the fund may be labelled core compounders: high-quality businesses with resilient business models. This quality comes with a price tag, which may or may not reflect the true risk of the businesses, especially in light of the current crisis. Indeed, it was sobering to listen to Alan Jope, CEO of **Unilever**, at the latest quarterly earnings call. He explained why even his company has had to retract guidance for 2020, and admitted that he believed this global recession will have legs. At the very least this reminds us that no company should be priced for perfection, and our stock picking and position sizing should reflect this.

A quarter of our fund is currently in cash cows: primarily utilities and tobacco (both approximately 9%), Most, but not all of the companies in this class are maintaining their dividend payouts, so representing, we hope, some form of defensive ballast. They are unlikely to give us much bang for our buck if markets recover.

Having made the aforementioned sales, a minority of our fund (7%) is in higher-risk situations where we judge the business risks to be elevated, but the prices of the shares fair compensation. We are not now relying on dividend flow to reward us for taking this risk, although we expect the income streams to return in time, but we do hope that diversification across five businesses (**Anheuser Busch-InBev**, **Halfords**, **Lloyds**, **Aviva** and **Micro Focus**) gives us opportunities to surprise on the upside.

The remainder of our fund, representing a not insubstantial 28%, encompasses those businesses that we would choose to classify as cyclicals. Again, they are spread across a broad range of industries – energy, mining, industrials, housebuilders, media and financials. We are not trying to predict a bottom to this market, but we believe that a balance between cyclicals on the one hand, and compounders on the other is a fair reflection of the economic risks with which we must contend.

The final allocation is to cash, which currently sits at about 8%. Again, this is no reflection of any market view, rather a function of very steady, even dull, inflows and outflows for the fund, and the completion of a couple of sales. **We have a long list of potential new ideas for our fund**, and as we have written in previous notes, it is comforting to have the resource of a meaningful cash balance.

We need to recognise that the current situation could have a longevity that would have seemed shocking at the start of the year. The tenor of Unilever's comments certainly reflect this consciousness. We think that we also need to understand that behaviours and practices may be forever altered. We must be mindful that certain industries, especially in consumer-facing sectors, could take a long time to recover. Global supply chains are hugely disrupted. Governments, central banks and companies will evolve their investment priorities, driven by cultural change. The shift to online consumption of produce and media has taken a massive forward step. Will people globally review how they live, work, play, travel or study in light of this year's events? Whatever investment decisions we make over the next few months must reflect the fact that we face a new reality. Let us not look backwards for our models. Instead let us be inquisitive as to what the future may hold, and accept the challenges and opportunities that lie ahead.

### Royal Dutch Shell

Two of our companies released trading statements on the last day of the month, but one attracted the greater attention. Royal Dutch Shell decided to cut its dividend by two thirds, the first reduction since the Second World War. The first-quarter trading statement included an outlook comment that was substantially more downbeat than peers, citing extreme economic uncertainty and a drastic deterioration in global demand. The news, while not a huge shock, may now begin a different discussion. And it relates not just to Shell, nor only the broader energy sector, but all businesses: the quantum of cash returns to shareholders.

The dividend cut saves Shell about £10 billion a year. Also, going early and going big is probably a good thing, despite the share price reaction. In the short term, the cash will be used to reduce debt, a real threat in the current environment, but maybe it should never have got this high in the first place. Indeed, more questions will be asked of companies that pay high dividends at the expense of balance sheets. If the oil price recovers, cash generation will accelerate and then the company will have new decisions to make. Where should capital be allocated and are there enough opportunities to put cash to work, especially as they transition towards a zero-carbon future? If Shell does generate excess cash at some point in the future, who or what has the greater right?

In the new normal, whatever that is, there will be more questions asked around where the cash generated in a business is distributed, and about the importance of all stakeholders, including employees and customers. This will have profound implications for dividends. We have explicitly emphasised our tilt towards total returns in light of current market conditions, but we are very aware that a fundamental shift in attitudes may occur. While it is too early to call, we should be open to the possibility.

The other company to report was **Reckitt Benckiser**, our largest holding. The company posted an eye-watering 13% increase in like-for-like sales, driven by stockpiling of cleaning products, and the strength of its consumer health franchise. Better share price performance for us, far fewer column inches in the press.

**Recent trading:** As mentioned above, we have sold **Restaurant Group** and **Senior**.

**Companies seen this month:** We hosted a conference call with **Lockheed Martin**.

**Carl Stick**
Fund Manager

**Alan Dobbie**
Fund Manager

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