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Rathbones
Look forward

Rathbone SICAV Income Fund

Monthly update May 2020

Wishful thinking, or at a tipping point?

"There can be few fields of human endeavour in which history counts for so little as the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."

"You Can't Predict. You Can Prepare"

Howard Marks, Memo to Oaktree Clients, 2001

"Stocks are cheapest when everything looks grim."

Ibid

As income fund managers, are we guilty of wishful thinking in imagining that the last few years bear a passing resemblance to the dotcom-hyped market of the late 1990s?

Now let us be clear. We are not comparing the very profitable and cash-generative technology hegemons of today with the flighty flashes in the pan of 20 years ago. However, at times, there does seem to be just one game in town. In a world of low growth and even lower interest rates, you buy growth, you buy momentum and you buy defensive quality compounders. This is the only strategy that works. To think otherwise is foolishness.

We don't think that we are 20 years out of date. We argue, however, that it is unwise to remain too comfortable with the drivers that have directed markets over the last few years. It is prudent at the very least to consider alternative futures.

Reports of the death of equity income are an exaggeration

Up until recently, the seemingly inexorable rise of equities has been driven by an increasingly narrow cohort of stocks. Any nervousness around the weakness of the global economy was trumped by the confidence that the derivative effect of accommodative central bank policy will support asset prices. These effects – lowering the discount rate used to value investments – have a greater impact on 'growth' stocks and compounders than on 'value' stocks and yield plays. That has helped reinforce the investor stampede into that narrow section of stocks that has led markets ever higher both so far this year and for the last decade.

Quite evidently, we are not disinterested participants in this debate, because the other side of the coin is the contention that value investing has been debunked. Headlines decrying the death of equity income, and especially the UK Equity Income sector, are another resounding echo of the late nineties. Indeed, the evidence for the prosecution is strong:

- According to the Link Asset Services UK Dividend Monitor Q1 2020, 45% of UK companies had scrapped their payouts to shareholders by the end of March; Link's best case scenario was for dividends to fall by 27%, worst case by 51%, and in the two months since the end of the quarter, these numbers have surely edged down
- Enterprises like **Royal Dutch Shell**, upon whose promised income legions of investors and pension plan holders rely, have slashed their dividends, after decades of growth
- The value strategies that once generated market-beating returns have now lagged for too many years to be comfortable. Even Warren Buffett is admitting mistakes, selling all four of the positions he had in the four largest US airlines. Indeed, there is a strong argument – with which we do not disagree – that value is a less relevant long-term strategy in developed markets where economic growth is bound to be slower
- Once a sector replete with star managers, the reputation of the UK Equity Income sector has been tarnished. Now it's dowdy and unattractive, and there are much shinier things to buy

"Income investing, anyone?"

We beg to differ

The argument over the future of equity income began before COVID-19, but the pandemic and its consequences has upped the ante. Many businesses, whose values have been perceived in the dividend yield they offered, have reduced, deferred or cancelled their payouts. For some, this was inevitable: if your market is closed, if your customers are in lockdown, you cannot generate revenue, so you can't make profits. Then there is the moral question about paying cash to shareholders when staff are on furlough. So much has happened that was out of companies' control.

However, in hindsight, some could have done better. Our defence of equity income is established upon an honest reckoning of the ill-discipline that has accompanied cash returns to shareholders, for many years. This ill-discipline may or may not have been found out during the last few months, but whatever the judgement, the current crisis gives businesses a great opportunity to reset priorities.

Cheap funding enabled businesses to over-distribute cash, while avoiding adequate discussion about the investment needed to lay the foundation for future growth. Furthermore, in the UK there has been too great a concentration of dividend income being generated by a narrow list of companies, many of which have been anchored to maintaining these payouts regardless of other priorities and, in some cases, common sense.

The events of 2020 must be the impetus to redefine what equity income means. **Equity income is not dead, but quixotically chasing dividend yield most certainly should be.**

So what is the way forward?

The cash returned to shareholders should be the by-product of prudent, sustainable investment in business, not the ultimate aim. Tails should not wag dogs. Nevertheless, remember that the income you receive from a business is your share of their after tax profits, and is the only real tangible return you get from owning shares; once received, it cannot be taken back. The value from the inflation in asset prices is only crystallised if you sell the shares.

When we look at a business, we seek to understand the cash flow returns that are generated from the capital that is invested over time. Every business is different, not all can compound their earnings year after year. For some, the rates of return are cyclical, and this should influence management decisions about when and how much they invest and when they don't. But the crucial piece of evidence is the cash return generated. This return is used to pay interest on debt and taxes. Then there must be an allocation to maintenance expenditure, money needed to keep the business at a steady state. What is left is a sensible notion of free cash flow, and what companies choose to do with these funds determines their growth and their sustainability, by creating the foundation of their future cash profits, from which dividends are ultimately paid. Dividend income is a discretionary result determined by the profits generated from previously invested capital; it should not be a function of what was paid last year. It is an outcome of all of these inputs.

And this outcome is established upon the capital cycle inherent in every business and every industry, although the nature of the cycles vary. There are industries where the cyclical dynamics are very clear, such as the global energy sector. Currently the industry is suffering from simultaneous shocks in demand (pandemic-fuelled global downturn) and supply (Saudi-Russia spat), trauma experienced now which will influence serious long-term capital investment decisions.

Alternatively, you could look at consumer staples businesses and argue that from a demand perspective, consumption of their products is relatively stable and predictable, which supports pricing and facilitates investment decisions. However, what if a business overstates a market opportunity and misallocates capital, for example, in making an expensive acquisition? What happens to profitability then? Are we adequately pricing in the frailty that exists in any business, however stable it may seem?

Of course, in these two oversimplified examples, we are not comparing like with like, the risks are totally different. But what we're driving at is that it is the capital allocation decisions of businesses that ultimately determine future profits. And that the sustainability of those future profits ultimately determines how much can be paid in dividends. The investment analysis around these decisions is as relevant now as it has ever been. The important outcome for equity income funds is a sensible distribution of cash after these decisions have been made. Equity income viewed in this way is far from dead. Indeed, we argue that it has been given a new lease of life now that these high-yield anchors have been cast away. We expect companies to use this shake-up as an opportunity to re-frame their capital allocation priorities.

So what about our fund?

We are living through an extremely rare course of events. Massively reduced company earnings means that dividends are not sustainable in the short term, so we have to adjust to this reality. This year's final pay-out will be markedly lower than previous years. We do not wish to distort our process or dismiss our philosophy just to fight this tide. What is important is that we recognise that this is a rare event, that we need to plan for future, and that we put the welfare of our unitholders ahead of any short-term expediency.

Over the past few weeks we have meaningfully adjusted the bias of our fund from compounders (price risk) towards value and quality cyclicals (business risk).

Our reasoning:

– Prices are low, which affords us a greater margin of safety

– Expectations in the market are low, but sentiment is beginning to change; scepticism regarding a rotation is being eroded

– Economic activity was decimated at the height of the pandemic, and recovery will be painful and slow, but it will recover

– Any economic recovery will be supported by massive monetary, and fiscal, stimulus

In the period following the bursting of the Technology Media and Telecoms bubble in 2000, markets fell back as the headliners were sold. But within the bear market, there was a bull market in many value stocks. We wonder if today's nascent rotation into value and cyclicals is perhaps more than a passing phase.

In the last month, we sold our position in US utility **WEC Energy**. This has been an outstanding investment, but we have chosen to cash in our chips, fearing an adverse share price reaction if there is a rotation as described above. Similarly, we have trimmed many of our core consumer staple and pharmaceutical positions. A lot of good news is priced in.

Slight reductions in our housebuilders **Bellway** and **Berkeley Group** gave us the cash to buy a new holding in **Persimmon**, diversifying our company-specific risk, but increasing exposure to the sector. Other new holdings are **Royal Bank of Scotland**, mining company **BHP** and US-listed chemical business **Linde**, three different plays on value and cyclicality.

We are happy with the current positioning of our fund. Cash remains near 8%, a reasonable war-chest to deploy if opportunities arise. Tactically, we are now keeping an eye on the economic data. There are still many obstacles ahead and it is too difficult to forecast the rate of recovery, the impact of policy, or the likelihood of a second wave of COVID-19. We must also throw into the mix a volatile US election and Brexit (remember the B word?). However, if green shoots do appear, the value rally may continue. At that point we may choose to reallocate further assets.

If there is a change in style leadership, we could see a bear market as growth de-rates, yet within this headline stock slump there could be a stealth bull-market in value. However, we do caution that this will likely be of shorter duration. But let us not count our chickens, let us just deal with today with today, and deal with tomorrow tomorrow.

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