

Rathbone SICAV Income Fund

Monthly update June 2020

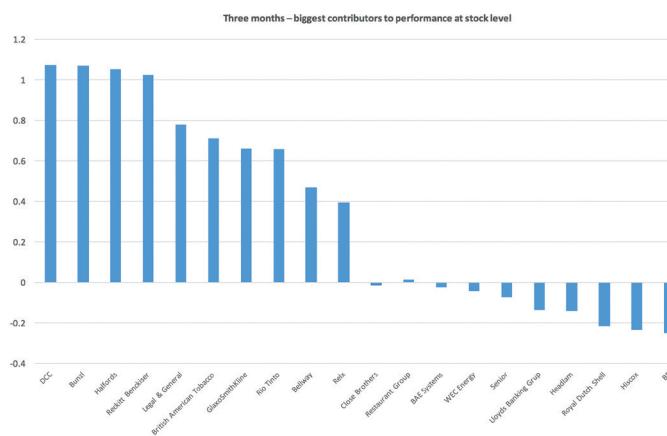
Despite a strong recovery in markets through the second quarter, the UK Equity Income sector is still reeling from the severe pandemic-induced market retracement of March.

Investors, having to come to terms with the reality of smashed-up business models and tattered dividend records, must look for a way forward. Our experience of the first half of the year has certainly been testing, but we do believe that we have a clear strategy, not just for the coming months, but for the next few years. We hope this opportunity will inspire investors to recognise once more the attractions of equity income.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	10.9%	-18.2%	-13.1%	-11.3%	8.1%
IA UK Equity Income Sector	11.0%	-20.2%	-13.6%	-10.7%	4.7%
FTSE All-Share Index	10.2%	-17.5%	-13.0%	-4.6%	15.2%

Source: FE Analytics

Three-month performance



Our fund participated well as the market rally continued into the second quarter, ahead of the FTSE All-Share Index and only marginally behind the IA Equity Income sector. Our medium-term numbers still look unattractive, as our 'value' orientation created a headwind in the later stages of the bull market in risk assets that we all enjoyed prior to this year. However, over the last few weeks, investors have more frequently rotated towards more cyclical and value-oriented areas of the market, a trend that has certainly been to our benefit. We have reallocated a larger portion of the fund into a select group of cyclical businesses, whose earnings are more reliant on wider GDP growth. The timing of this move has been fortuitous.

Nevertheless, three of our strongest contributors in the last period were core quality compounders. Irish distributor **DCC** is a key business for us, and its exposure to both the technology and healthcare sectors proved a substantial buffer to any weakness it might have experienced in its dominant petrochemical divisions during the crisis. More importantly, DCC's balance sheet is very well financed, providing both defensive security and, importantly, the firepower to make acquisitions at a time when cash is certainly going to be king. Strong cash flow means a strong dividend, too. **Bunzl**'s first-half trading statement was so positive with regard to COVID-related sales that it appeared to us that its management were actually being excessively cautious when they reported early on in the year. And investors continued to support **Reckitt Benckiser**, warming to its exposure to consumer pharmaceuticals, vitamins and cleaning products, and perhaps forgetting the trials and tribulations of its recent past.

Halfords was a business we considered selling at the onset of the crisis, but we held off, and right we were. The shares have multiplied in value since their lows. Deemed a key retailer by the authorities, Halfords has been fed a lifeline by the spike in demand for bicycles. Again, we are now a little bit more cautious in terms of price, and have taken some profit, but management are doing all the right things.

Not every industry has prospered in the market recovery. A combination of supply-side shocks and plummeting demand created a perfect storm in the oil and gas sector. **BP** and **Royal Dutch Shell** have struggled to convince investors that they can navigate these choppy waters while managing the long-term transition to a zero-carbon world. A principal casualty was the slashing of the hitherto sacrosanct Shell dividend. We await BP's results at the end of July to see if it succumbs to the pressure to make a similar decision. We expect BP to cut its dividend – indeed, a central point of discussion in this sector is the appropriate use of capital. We believe there are important investment decisions that need to be made in order to ensure the industry's long-term future. We want them to exhibit capital discipline unhindered by an unsustainable dividend.

Insurer **Hiscox** faces other challenges. Its brand is its business, so questions over its treatment of business customers forced to close on account of the pandemic – irrespective of the terms of the policies – will damage Hiscox's brand. Especially given it has long been known for its "no questions asked" philosophy around payouts. We expect insurance earnings to be cyclical, we expect the company to be very careful about when and where they invest, and we expect Hiscox to be prudent in the cash it returns to shareholders and when. Therefore, the suspension of its dividend came as no surprise. However, we are disappointed at the diminishment of its brand.

Six-month performance

The drivers of our six-month performance are pretty much the same as at the end of the first quarter, such was the impact of the market turmoil in that period. So, on a six-month view, the contributions made by leaders such as Reckitt Benckiser, DCC, **Rio Tinto** (mining stocks have been surprisingly strong this year, as the iron ore price has held up very well), **Roche** and Bunzl have been superseded by laggards such as **Carnival** and **Restaurant Group** (both now sold), **Lloyds Banking Group**, **Shell** and **ITV**.

Investment review

We have a clear strategy, and we feel that it is incumbent on us to advocate for the disciplines that are the foundation stones of an equity income mandate, and to reinforce the arguments that give relevance to the sector. With this in mind, let's strip the discussion down to three themes:

Rebase: As the world has changed in 2020, we all have had to come to terms with new realities. And we understand that there are likely to be further upheavals over the coming months. Who knows what normal is? Some of us will go back to doing certain things the same way that we always did, but for many people – and for many activities – normal will be something very different. Some businesses, some industries, will not survive; others will adapt very successfully and thrive.

The businesses in our universe have faced multiple challenges and opportunities. Recognising that some industries will break, we sold companies where we feared existential threats. We have focused our minds on preserving capital, owning businesses that we expect not only to survive but to be profitable, and to therefore be in a position to pay dividends in the near future. In the short term, we have prioritised total return over dividend growth. We have endeavoured to be as transparent as possible in our communication of this strategy. Our distribution will be lower this year, but its diminution should be less than that suffered by the UK market as a whole. Crucially, we expect to have a good chance of generating real growth as we come out of this crisis.

Reallocate: We want to emphasise the importance in comprehending the decisions that companies make around how they allocate capital. Investment in a business, whether maintenance capex just to keep the business operating, expenditure fueling organic growth, or an acquisition strategy, all contributes to the foundations of future earnings growth. Understanding the cash flow returns on capital invested is the central tenet of our concept of business risk. So, for example, when we meet Shell, we seek to understand not only why it chooses to cut its dividend, but where that substantial cash saving will be deployed. How does it invest for the transition to a greener economy, and how has it modelled the future rates of return?

We ask all our companies versions of these questions because, in the end, capital allocation decisions made today determine the earnings, and therefore the dividends, of tomorrow. We are happy for companies to withhold cash from us, the shareholders, as long as that cash is being put to good use. None of this is ground-breaking stuff, but it comes back to basic investment principles, principles that support the rationale for equity income funds. Our allocation of your cash is determined by these same fundamental disciplines.

Reward: They may not be fashionable these days, but the tangible reward for equity ownership is the income that you receive as dividends. Anything else is just paper profit, until you sell the shares. Of course, the headlines have not been good this year. However, if the COVID pandemic is the catalyst that flips the switch from overdistribution to sensible balance sheet management and investment, then that can only be positive.

Everyone is concerned about getting returns in a low-return world. Therefore, a sensible distribution, at a level that can grow, and a yield that does not need to be sky high to be competitive in a low-yield environment, is an attractive and sustainable equity income strategy.

Outlook and positioning

We are looking to balance risk across our portfolio, not wishing to put all of our chips on black or red, because the outlook is so uncertain. Global economies may rebound, but there is also the very real risk of a second wave of infection. Euphoria around a return to shops, to pubs, to foreign holidays, may be replaced by the economic hardship of lost jobs and lost industries. In the UK, we also have Brexit: the forgotten challenge in a year of challenges.

On a positive tack, people and businesses have adapted and new enterprises will prosper because of these changes. There was a point early on in the year when expectations were so low and fear was so high that it was difficult to see beyond the virus. From a market perspective, there are many opportunities where prices are overexaggerating risks, as well as situations where the converse holds true. To this end, we have reallocated some of your money towards more cyclical parts of the market, not in any attempt to hit the proverbial ball out of the park, but recognising good value, and good dividends, where we see them. A more aggressive move in this direction would require further substantive evidence that economies really are recovering, and that the virus is receding. We are a little way away from that eventuality at the moment.

Of one thing you can be sure: we will continue to communicate with you. We are looking forward with confidence, despite the long road ahead, and we wish to share this optimism and sense of opportunity with you.

Recent trading: In a continuation of the trading theme from May, we continued to prune positions in some of our defensive-yet-expensive 'compounder' stocks within pharmaceuticals (**GlaxoSmithKline, Roche, Dechra**) and consumer staples (**Unilever, Reckitt Benckiser**). We used these funds to bolster new positions in miner **BHP Billiton** and lender **Royal Bank of Scotland**. Evidencing our commitment to seriously considering how capital is being allocated, we reduced our very large holding in UK utility **SSE**. Its core renewable and network businesses are highly attractive, but its commitment to a high dividend payout may hold it back from achieving the most from these opportunities. We remain very supportive, but we want to rein in our position.

Companies "seen" this month: **Legal & General, SSE, Big Yellow Group, Shaftesbury**, and at virtual conference, **Unilever, British American Tobacco** and **Anheuser-Busch InBev**.



Carl Stick
Fund Manager



Alan Dobbie
Fund Manager

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