

Rathbone SICAV Income Fund

Monthly update July 2020

Over recent months we have written regularly on the outlook for UK dividends and the impact this will have on our fund's future distributions. With our fund's September year-end fast approaching, now is the time for us to give greater clarity on how much income you can expect to receive from us this year. This letter will also outline our initial thoughts on dividends beyond the current financial year, highlighting what we believe will help our fund generate an attractive, sustainable and growing income stream over the years to come.

This year's dividend

The completion of the latest corporate results season has given us greater visibility on the dividends we expect to receive before our fund's 30 September year-end. We are now confident in expecting our full-year distribution to be approximately 20% lower than the previous year.* For a fund with a proud record of annual dividend growth, stretching back many years, it is disappointing to report a reduction in our annual pay-out. More importantly we fully understand the importance of a reliable and predictable dividend stream for many of you. It is for this very reason that over recent months we have increased our level of communication regarding the expected level of future distributions.

Those who have followed our updates will appreciate that the reduction of approximately 20% is a significantly better outcome than we had feared during the dark days of late Q1 and early Q2. While this doesn't diminish the impact of the cut, we believe it shows the resilience of many of our holdings in the face of an immensely challenging and unique set of circumstances. To put the reduced pay-out into context, third-party estimates of UK dividend cuts in 2020 remain significantly higher (albeit over a slightly different time period). The well-followed 'Link Asset Services – UK Dividend Monitor' expects UK dividends to fall by 39-43% in 2020. Unsurprisingly, financial, oil, industrial and consumer discretionary sectors look set to bear the brunt of the cuts. Classic defensive sectors, such as consumer staples and healthcare, are proving once again to be more resilient in a crisis.

Looking beyond September

At the present juncture, predictions about the future should be treated with the appropriate degree of caution and humility... how many of us entered 2020 knowing the situation we'd find ourselves in just 11 weeks later? Despite our reservations, investing is solely concerned about the future (profits, cash flows, dividends, etc.) so it is important for us to share our current thoughts on dividends over the next 12 months and beyond.

The extraordinary events of late Q1 and early Q2 resulted in corporate boards switching focus from a 'we must protect the dividend' mindset to 'we must protect the business'. Cash became king, bank facilities were drawn down and investor distributions halted. While this response was appropriate given the novelty and severity of the situation, for many of our holdings the pausing of dividends was an act borne out of prudence rather than necessity. In truth, for some it was about being seen to be 'doing the right thing' – especially with so much suffering in the world. The passage of time has brought a greater degree of understanding of both the science behind the virus and its economic impact. As a result, board confidence has improved over recent weeks, leading to increased visibility regarding expected future dividends.

*This is our current estimate at time of writing. It remains subject to numerous factors that are out of our control, so it should be used with caution.

In addition to the numerous companies within our fund which have maintained dividend payments throughout the crisis (**Unilever, Reckitt Benckiser, GlaxoSmithKline, Jupiter Fund Management** and **Rio Tinto**, to name just a handful) several others have already returned to the dividend register. Companies such as **BAE Systems, UDG Healthcare** and **Bunzl**, while quick to suspend dividends in April, have been equally swift in reinstating them over recent weeks; making up for any missed payments. Others such as **Persimmon** have taken a more cautious approach. They have made a partial payment towards their 'missed' dividend with a commitment to reassess the remainder of this payment later in the year when they hope a little more of the economic fog may have lifted.

Another group of companies we hold are those which have already taken their medicine (sometimes belatedly). These companies enter our new financial year with their dividends at a rebased and hopefully more sustainable level. Energy companies **Royal Dutch Shell** and **BP** stand out as two of 2020's highest-profile dividend cutters. While painful in the short-term, their large dividend cuts (66% and 50% respectively) should increase their flexibility regarding capital allocation. We believe this could be a first step in rejuvenating a struggling industry. We hope to write more extensively on this subject in a future investment letter.

The final important group to consider are the financials. While we remain underweight the sector versus the FTSE All-Share Index, it is nevertheless an important contributor to our annual distribution. Although this sector contained some of 2020's biggest dividend cuts, many were done at regulators' 'request'. In our view, the blanket ban on dividends from the 'big five' UK banks was more about prudent supervision of the financial system than concern that any of these banks were undercapitalised. While not wishing to downplay the immense pressure facing the banking sector, we are comforted by the conservatism and discipline demonstrated by the three banks that we hold: **Natwest, Lloyds** and **Close Brothers**. Our own models assume little by way of dividends from these three names next year, yet we believe they represent an attractively priced option on a sooner-than-expected return to the dividend register.

So where does this leave us?

The upcoming year will likely be both unusual and challenging for income generation. The FTSE All-Share's dividend yield will be blown this way and that as some companies return to the dividend register and others make 'catch-up' payments (so-called 'double dividends'). For us, taking into account our dividend rebase, we expect our fund should yield more than 4%. In our opinion this is an attractive level in a world of ever-diminishing yields. Further, we believe we have created a firm foundation for future dividend growth in the years ahead. While 2020 has been immensely challenging for UK equity income investing, we believe the fundamentals are now increasingly attractive. With tentative signs that the clouds may be beginning to part, we approach the future with optimism.

Recent trading: In light trading this month, we trimmed positions in **Smurfit Kappa**, Bunzl and Reckitt Benckiser, and sold most of our holding in **Daily Mail & General Trust**.

Companies seen (virtually) this month: **Micro Focus International, Halfords**, and Rio Tinto.



Carl Stick
Fund Manager



Alan Dobbie
Fund Manager

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