

Rathbone SICAV Ethical Bond Fund

Monthly update January 2021

The 10-year gilt yield stood at 0.20% at the start of January, rising to 0.33% by month-end as investors sold 'safe-haven' government bonds on hopes of a post-pandemic economic recovery this year.

Credit spreads – the extra return above government bond yields for taking on the risk of default – widened over the month. The iTraxx Crossover European high yield spread index started January at 243 basis points and ended it at 270 bps. Since month-end it has dropped again to near 240bps.

Our fund did well relative to our peers in January as we remained light on those longer-dated government bonds that are most sensitive to changes in interest rates/yields. Meanwhile, we have been focusing on adding bonds we believe have scope to deliver returns and income in the current COVID-impacted environment – and beyond. This involved more buying into several of the longer-term themes that served us well last year.

Buying up US bargains

One of the big trends of recent months has been the dramatic drop in the cost of hedging dollar-denominated investments back to sterling. Because US treasury yields are markedly higher than gilt yields, US credit investments can offer much more attractive yields than their UK counterparts. But pricy currency hedging costs used to wipe out some of this yield boost. It's now much cheaper for sterling investors like ourselves to hedge out the currency risks associated with dollar bonds, so we've been adding significantly to our US dollar exposure, hedged back to sterling.

As we've mentioned, we still like many of the kinds of bonds that did well for us last year. But we are buying these bonds in dollar-denominated issues when we can. Because many global companies issue bonds in several different currencies (dollars, sterling and euros) to tap the widest possible investor base, we can often buy bonds issued by UK and European companies that are denominated in dollars. For example, we bought dollar bonds issued by Swiss insurance group **Zurich Finance 3% 2051**, and also by UK insurer **Phoenix 4.75% Floating Rate Note 2031**.

Another key theme that has performed well for us to date has been our decision to buy select 'legacy' tier-one bonds issued by insurers and banks to shore up their capital positions in the wake of the financial crisis. Many of these financial credits offer sizeable coupons and some are being bought back by their issuers because the regulatory framework is changing and the legacy bonds are being superseded. Many insurers and banks have been offering to buy back their legacy debt and replace it with new borrowing on more generous terms to bondholders.

This trend gives us scope to lock in attractive price gains when we exchange or tender our legacy bonds with the issuers. It's also a trend we expect to continue throughout 2021, and quite possibly into next year too.

Taste for technology

We also continue to favour bonds issued by companies which should benefit from ongoing demand for technology to support remote working, learning and shopping, as well as digital entertainment. We bought dollar-denominated bonds issued by European telecoms group **Orange 8.5% Senior 2031** and US telecoms giant **AT&T 4.5% Senior 2035**. The rollout of 5G had something of a hiatus last year because of COVID, but we expect it to accelerate in 2021. In our view, appetite for faster data speeds and better network support will likely increase still further this year even as offices, schools, shops and cinemas start to open up again. Our greater reliance on technology isn't going to disappear as we start re-engaging with the world outside our front doors either. We expect this to benefit the big network operators like Orange and AT&T.

In addition, we bought dollar-denominated bonds issued by US data storage centre provider **Equinix 3.2% Senior 2029**. Equinix looks likely to continue to thrive on the back of strong demand for a robust digital infrastructure as tech-driven practices remain firmly embedded in most workplaces, schools and homes.

Funding the preservation of nature and healthcare

In January, we helped fund the charitable organisation **The Nature Conservancy** by purchasing the dollar-bond **1.154% 2027**. As its name suggests, the US-headquartered Nature Conservancy seeks to protect nature and wildlife by preserving ecologically critical wild spaces and waters worldwide.



Responding to travel industry woes

We don't need reminding Lockdown 3.0 entails tight restrictions on what we can do and where we can go. UK holiday facilities and operators have been severely challenged by the ban on leisure travel. Given the lack of clarity about when the ban will end, we opted to sell bonds issued by holiday village operator **Center Parcs Senior Secured 3.588% 2042** and by its funding arm **CPUK Finance Senior Secured 3.69% 2047-28**.

Seeking better opportunities in financials

We also sold some of our lower-yielding bonds in the financial sector. These included bonds issued by UK insurance group **Hiscox Senior 2% 2022**, as well as several floating rate bonds issued by banks that we'd bought when yields spiked towards the end of last year. These floating rate bonds' coupon payments track changes in interest rates/yields. Given our expectation that Gilt yields are likely to trade in a pretty tight (and lowish) range in coming months as the economy begins to open up again, we opted to sell out of some of these bonds, including **Clydesdale Bank 4.3271% Floating Rate Senior 2024** and **TSB Banking Group SONIA Floating Rate 2024**.

Green shoots ready to sprout?

As we head into 2021, most backward-looking economic data remains grim. The UK economy shrank by 9.9% last year -its biggest contraction in more than 300 years. With Lockdown 3.0 in force in early 2021, we don't expect this year's first-quarter data to bring much cheer. But some green shoots may start to sprout. In particular, the pace and reach of the UK's vaccination programme is encouraging. Prime Minister Boris Johnson is expected to lay out a "cautious, but also irreversible" gradual reopening in coming months. This could pave the way for a consumer-driven rebound later in the year as people start spending money saved during lockdown. Bank of England chief economist Andy Haldane has even claimed that the UK economy is "poised like a coiled spring" to release pent-up spending.

There are many reasons not to get ahead of ourselves. The extent of the COVID-driven slump means the UK has a lot of ground to make up to get back to where we once were. And while government support programmes have kept a lid on job losses and underpinned household incomes, we can't expect this support to continue indefinitely. We're trying to think about how the withdrawal of some supports may cause a shake-out, in time, and ensuring we're prepared well in advance.

We're focusing hard on the cash flows and solvency of our investments. Bond investors are always looking at this stuff, because we can only ever lose. You know the total possible return you're getting up front when you buy a bond: the capital and the income payments. You can get some windfalls too, if interest rates move and someone else is willing to pay more than a bond's face value. But in the main we spend our time looking for things that could go wrong, where a company may not be able to repay its debts and how much we're likely to recoup if it does default.

Despite the huge uncertainties that lie ahead, we're excited about the prospects for our holdings in 2021 and beyond. Many of our investments are helping to improve the world, whether through protecting our natural resources, by financing ethically minded businesses, or by providing good housing and healthcare for those in need.



Bryn Jones
Fund Manager



Noelle Cazalis
Fund Manager



Stuart Chilvers
Assistant Fund Manager

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