Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Income Fund

Quarterly update September 2021

Answers on a postcard please: how do we make sense of the last quarter, with so many conflicting signals? OK, the last three months may not have been the most cataclysmic of the last six years — no Brexit, no Trump and no COVID-19 (well, obviously not no COVID, but it does seem like we're learning to live with the virus). It may be that it's the lack of any huge events during the quarter that make its trends harder to read. That said, some things have stayed the same. Recent comment in the trade press contends that the UK remains unloved as money has continued to be withdrawn from UK funds, which means we must continue to do a major PR exercise on the UK Equity Income sector. The silver lining is that the combination of economic recovery and attractive valuations suggest that the UK should be viewed as a more compelling investment opportunity.

Performance review

We may deem it 'compelling', but first impressions might suggest otherwise, at least as far as your fund is concerned. Performance has been middle of the road. This is frustrating and, to be honest, a little surprising. From a corporate point of view, we have had a good run of news, with very few (if any) shocks and the dividend story has come through very much as we had hoped. In absolute terms, we are fine; but relative to the market and our peers, underwhelming.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	1.4%	6.6%	29.4%	9.5%	22.9%
IA UK Equity Income Sector	2.3%	7.5%	32.7%	9.6%	25.4%
FTSE All-Share Index	2.2%	8.0%	27.9%	9.5%	29.8%

	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19	30 Sep 17-30 Sep 18	30 Sep 16-30 Sep 17
Rathbone Income Fund	29.4%	-17.5%	2.5%	2.5%	9.5%
IA UK Equity Income Sector	32.7%	-17.2%	-0.2%	3.4%	10.6%
FTSE All-Share Index	27.9%	-16.6%	2.7%	5.9%	11.9%

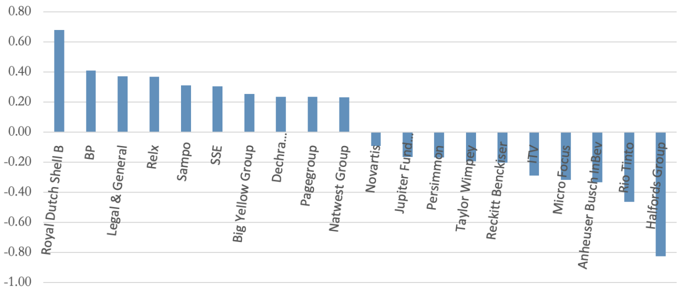
Source: FE Analytics; data to 30 September, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future performance.

Our honest appraisal is that there has been a lot more volatility within the equity income sector as a whole. Those funds with greater 'quality' and 'growth' biases have had a far harder time over the last 18 months, but they at least made hay before then. On the other hand, after a long period of pressure, deep 'value' has finally come good. We've been pragmatic in our approach, looking to tilt meaningfully towards 'cyclicality' and value over the last 18 months, which has certainly paid off, but our risk-based approach has maybe dampened rewards. This is no bad thing because we never intend to put all our chips on red or black, but it's a tad frustrating nevertheless.

The value of your investments and the income from them may go down as well as up, and you could get back less than you invested.

Q3 contributions



Source: StatPro, Rathbones

The outstanding positive to come out of the quarter has been the validation of our faith in the oil majors. The journey of the last 18 months has been eventful. The price of oil traded on future contracts turned negative back in April 2020 as COVID bit and OPEC and Russia fought with each other over supply levels. Profitability was slashed, dividends were cut and environmental, social and governance (ESG) pressure pummelled an industry seemingly on its uppers. A year and a half later, the big issues have not gone away, but the mood (along with the oil price) has improved dramatically. The oil price has been the primary driver of this about-turn, boosting profits and allowing both **Royal Dutch Shell** and, more surprisingly considering its earlier messaging, **BP** to increase their dividends. Any rotation towards value and cyclicality will sweep along these giants, yet they still look cheap to us versus the broader market.

Investors also seem more sanguine about the oil majors' transition towards a net-zero world. We, however, maintain our healthy curiosity about their plans. As so often stated in these letters, we have yet to be convinced of the security of returns in many of the areas into which they're venturing. Just how much money can be made from investing in electric vehicle charging pods? How disciplined will the pricing of offshore wind assets be? Nevertheless, we are satisfied with our positioning in the sector. We remain necessarily underweight due to the large weighting of Shell A and B shares in the index, but our exposure is very big in absolute terms: BP and Shell were the two largest holdings in the fund at quarter-end, with a combined total of over 8% of the portfolio.

If power prices are definitely 'of the moment' in news terms, supply chain issues have been a persistent headline grabber. Last month we reviewed **Dechra Pharmaceuticals**, a business seemingly well-placed to deal with inventory challenges. This month, **Halfords** is in the spotlight. After shining brightly in the second quarter, the shares have given back some of their gains as difficulties in sourcing product offset what was otherwise a strong trading statement.

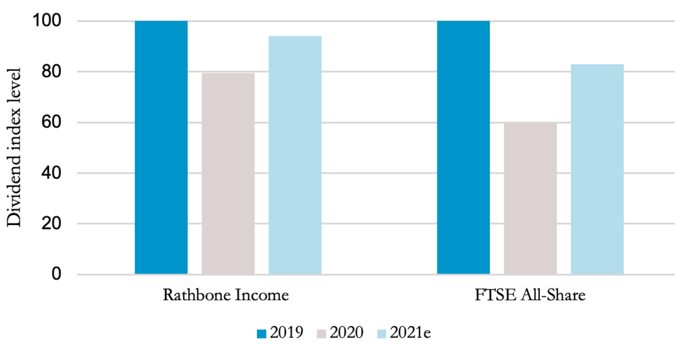
Halfords has recovered very strongly from its pandemic lows in terms of business strength and the staggering rebound in its share price. Its Autocentres division looks to be going from strength to strength, though it is getting harder to recruit service technicians. Despite this undoubted success, especially with new initiatives like its 'Halfords Mobile Expert', this is lower-margin business. Halfords' electric offering is exciting and we are not convinced that the market yet understands the sales potential for electric bikes and scooters – e-mobility was up 184% in the first half, though it's slowed since then. However, the fly in the ointment is supply chain disruption, and by this we mean factory closures, component shortages and freight disruption. Stock is starting to come through again. But if you cannot buy the Voodoo Bizango men's mountain bike that you've been hankering after now, do you wait or do you look elsewhere? And what about Christmas?

Now this is not all bad news, but it is 'new news' so we must adjust our forecasts accordingly. We still like Halfords: its long-term strategy is sound, management is strong, the business generates a lot of cash and we think the shares are cheap. But staying upbeat on the stock does demand an improvement in its supply chains and stock levels. We maintain a watching brief.

Dividends

The undoubted win for us this quarter has been the income that our portfolio has generated. Early in 2020 we pivoted to focus on capital preservation, allowing our distribution to unitholders to settle at the appropriate level (-20.5% versus the market's -40%). The tilt back towards value and cyclicality since last summer has resulted in a healthy recovery in income flow as miners have paid out bumper cash flows (analysed in our July letter), oils surprised and financials got back on the dividend payments list (should they ever have been off it?). Global distributor **Bunzl** has paid an extra dividend in the past 12 months to make up for one lost last year, and consumer-facing stocks, such as our housebuilders and the aforementioned Halfords, have also rewarded shareholders for their patience and loyalty. Having gone ex-distribution at the end of the month, we can now estimate an 18% increase in our final payment. While we are keenly aware that 'special' dividends are by definition generally not repeated, we are hopeful that this year's strong rebound will stretch to inflation-beating growth next year.

Our dividends were more resilient than the market



Source: Rathbones; dividends indexed to fiscal year 2019

Outlook

If we are persisting with our PR exercise for the UK Equity Income sector, we must put a positive spin on what we see around us. UK GDP soared in the second quarter, job vacancies exceeded 1 million for the first time, the housing market is very strong, and Jefferies' economic activity radar shows the UK economy finally surpassing its pre-pandemic level. Yet the UK stock market remains unloved and valuations are at bargain basement levels. UK shares are 'ON SALE!'

Of course, there are clouds to these silver linings: supply chains are a big headache and inflationary pressures could over-cook. Does the labour force have the right skills to match the vacancies? How successful will we be at living with COVID? And what happens to sterling if the UK takes on more debt? On balance, we believe the value of the UK market offsets these clear and present challenges.

We conclude with the refrain that we have repeated like a steady drum beat throughout the year. If investors want income, if people want to supplement their earnings with their investments, if savers are frustrated at basement level savings rates, if property funds offer the threat of being locked in, if fixed income markets look too risky at current levels, surely the UK equity market should at least be considered as a viable option? Yes, of course, there are risks: there always are. But the attraction of this market is the deep discount it offers because it is so unloved. We believe it makes these risks are worth taking. Your fund yielded 4.2% at the quarter-end and we are aiming, as ever, for real growth in the coming year. That is a most valuable proposition.

Recent trading: In a relatively quiet month for trading, we continued to build up a position in housebuilder **Taylor Wimpey** and added to **Barclays** and **NatWest Group**.

Companies seen during the month: Shaftesbury, Bunzl, Dechra Pharmaceuticals, **Jupiter Fund Management** and **Close Brothers**.

Carl Stick
Fund Manager

Alan Dobbie
Fund Manager

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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