Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update September 2021

The energy price spike is building a wall of worry about stronger inflation and weaker economic growth.

Government debt prices have fallen in response as investors sold these bonds because their low fixed returns look unattractive in a world where inflation and/or central bank interest rates are higher. The yield on 10-year gilts stood at 0.72% on 30 June, but shot up to 1.02% by quarter-end (when bond prices fall, their yields rise). The yield on US 10-year Treasuries also increased, albeit less dramatically, rising from 1.47% on 30 June to reach 1.49% by quarter-end.

Inflation and growth concerns also unnerved credit markets, driving credit spreads — the extra return above government bond yields for taking on default risks — wider. The iTraxx Crossover European high yield spread index began the quarter at 232 basis points (bps) and widened to 253bps by 30 September.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	0.02%	2.33%	4.74%	21.07%	29.49%
IA UK Sterling Corporate Bond Sector	-0.46%	1.30%	1.26%	15.03%	15.85%

	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 Ethical Bond Fund	4.74%	5.67%	9.39%	0.54%	6.38%
IA UK Sterling Corporate Bond Sector	1.26%	4.21%	9.02%	0.10%	0.61%

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 returns.

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.

Energy price spike jolts bond markets

At the start of the quarter, government bond yields were meandering gradually upwards as investors anticipated the eventual withdrawal of pandemic-driven policy support. They seemed reassured by policy makers' repeated insistence that immediate inflationary pressures triggered by supply chain bottlenecks in the wake of COVID-19 shutdowns would likely prove 'transitory' and wouldn't, therefore, drive sudden policy tightening.

But the energy price spike in September triggered a big shift in investor expectations about inflation. The price of Brent crude oil rose above $80 per barrel for the first time in more than three years. And shortages of European natural gas drove its price to record highs: the gas price in the UK and Europe shot up to $200 a barrel of oil equivalent — nearly three times the price of crude.

This forced a sharp rethink about the inflation outlook, prompting concerns that a lengthy bout of high inflation could pressurise central banks into raising rates earlier than investors had previously expected.

Rising inflation expectations hit most big government bond markets, quickly driving up bond yields. These increases have proved particularly steep in the UK, suggesting that investors believe a particularly challenging period may lie ahead. UK bond markets are now pricing in an interest rate rise as early as December.

Prioritising credit quality

Well ahead of September's moves, we've been expecting bond markets to grow more volatile. We sought to protect our fund from future fallouts by gradually dialling down our exposure to longer-dated (long-duration) bonds, which are most sensitive to changes in yields/interest rates. In July, for example, we sold our **British Telecom 3.625% Senior 2047, Verizon Communications Senior 5.25% 2037** and also our **M&G 6.25% 2068** bonds.

Importantly, we've been very careful not to overstretch in the search for yield by buying bonds issued by less creditworthy companies with weaker balance sheets that might struggle to stay solvent in an environment in which inflation and/or interest rates are higher.

The outlook for many businesses has undoubtedly grown murkier during the third quarter. Business and consumer confidence have weakened, job growth has underwhelmed and supply logjams are everywhere. The energy price spike has sharply intensified worries about inflation's capacity to undermine the post-pandemic growth rebound. Will it dent company profitability and crimp consumer spending? Could the slowdown from the furious initial pace of the rebound prove much sharper than previously expected?

For some time now, we've been buying bonds issued by select banks, insurers and investment firms that we regard as well-capitalised, profitable businesses that manage their risks very carefully.

We view Dutch lender Rabobank, for example, as a high quality and resilient business, underpinned by its low-risk domestic mortgage loans. During the quarter, we bought its **4.625% 2029** bonds and its **6.5% Tier 1 Perpetual** bonds. The latter offer an attractive extra coupon payment at year-end. This comes about because the bond is very junior in the bank's credit structure, giving it some equity characteristics despite being a bond. When the European Central Bank banned equity dividends early in the pandemic, this bond wasn't allowed to pay its coupons. The year-end extra coupon is a bumper payment to make bondholders whole.

In the financials space, we also bought investment firm **Investec**'s **1.875% 2022** bonds, as well as **Banco Santander**'s **2.25% 2032** floating rate notes.

Tapping into the broadening green bond opportunity set

COVID may have thrown a huge spanner into the works of supply chains, labour markets and virtually everything else, but thankfully it hasn't slowed the seemingly inexorable surge in green bonds. More and more governments and companies are issuing them to earmark funds for environmental projects aimed at combatting climate change. This year, green bond issuance has hit record highs, topping well over $350 billion.

In late September, we bought the UK's first-ever **Green Gilt 7/8% 2033**. The UK government's debut green bond raised £10 billion, the largest inaugural green issuance by any sovereign. Investors placed more than £100 billion in orders for these bonds, beating all previous records for British government debt sales. We expect this success to encourage more and more companies to start issuing green bonds as they recognise the strong demand for such securities.

We're already seeing more companies operating in mainstream sectors (i.e. outside things like wind and solar energy) getting in on the green bond act.

In August, we bought the first ever green bonds issued by UK house builder **Berkeley**. The money raised by these **2.5% Senior 2031** bonds will be used to develop green properties (energy efficient homes) at several of Berkeley's large-scale brownfield regeneration sites.

What do we think about when we're deciding which green bonds to buy? We must always prioritise downside risks. How much money could we lose if the issuer can't make repayments? We must also be certain that the money raised will be ringfenced for a specific green purpose. The issuer must have a clear sustainability goal from the outset that we're confident is achievable and will bring measurable environmental benefits. We're looking for maximum transparency on what happens to the money raised: we expect the issuer to report back regularly on what's been spent and its environmental impact.

Getting this level of comfort involves a lot of painstaking work. But it's critical to ensure that the green bonds we own really can help fight climate change.

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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.

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