Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update October 2021

Like dogs with their proverbial bones, we will not let our rallying cry lie: UK equity income is a solution to many investor needs. Not the *only* solution, but *a* solution. The UK Equity Income sector has generated a return of 38% over the last 12 months.

Let's pause just a moment and think about that return. Money has continued to flow out of the UK over the last 12 months, reflecting severe misgivings about the health of the UK economy, but 38%? Versus the paltry return from cash in the bank?

Our UK positioning

The UK market is cheap, but it's cheap for a reason. Our pleading its case has been, until the last 12 months or so, a somewhat fruitless task. The positive economic data that supported our view over the summer has suddenly become more mixed, and the hurdles to full recovery more evident. A recent IMF report argues that the UK will be the slowest of all the G7 nations to recover from COVID-19. Many of us have a lot more money to spend, but fewer things to spend it on. This level of cash in many peoples' pockets means that the demand is there, but the supply isn't, whether that's understaffed restaurants or shops with empty shelves.

Perhaps our messaging has been too blunt to reflect some nuances. Our biggest exposure to the UK economy has been through our financials, primarily banks and life assurers. We have benefited from a general slow grind upward in their share prices. By month-end, UK financials represented 23% of the fund. Housebuilders' share prices have fluctuated over the year as positive results jousted with broader market concerns. We have no leisure or travel exposure and our one retailer is **Halfords**, which has struggled with supply chain woes, as documented in our quarterly review. Finally, we own staffing businesses, which are global in their focus, but have exposure to the UK employment market.

We are a UK fund so we have a strong interest in the UK doing well. Our argument for investing in the UK market rests not solely on UK economic revival, but also on the value that we believe is inherent in the FTSE All-Share Index collectively and relatively, and the economic cyclicality of its big, global names.

COP26, the planet and valuations

COP26 has, quite rightly, focused the global gaze on the serious travails of the planet. And the world is looking to the politicians who should pull the strings to try to make a difference.

How are these travails affecting our investment decision-making? A few weeks ago, a 'buy' research note on American business Plug Power landed on our desks and prompted a lot of discussion. The company is 'enabling the paradigm shift to an electrified world by innovating clean, cutting-edge hydrogen fuel cell solutions across a broad spectrum of transportation, aerial, and stationary applications'. This sounds like an extraordinary endeavour. We all know about the rapid adoption of fully electric and hybrid vehicles. But hydrogen, as the next step, is an amazing concept.

Plug Power would never be an investment for our fund, but taking a brief look at it should illustrate something extremely important about how we invest. Next year, it's forecast to rake in revenues of $811 million so it's a near $1 billion business in terms of sales. But the market is currently valuing the business at $25bn, that is 29 times its sales. The research note outlines a case for that value almost doubling. That's a truly eye-watering price, no matter how much the company may epitomise the modern zeitgeist.

We believe you can never ignore the price you pay for any investment. Price will invariably determine your eventual return. While this particular maxim has not helped us much over the last few years, with growth and momentum powering shareholder returns, we still believe it holds true over the long run.

Running a UK equity income fund

Reliant as we are on the dividends from oil stocks, miners, tobacco and banking names, and focused on the UK market, we must try to ensure that our fund engages with the investors of today. Our task is to keep doing our job well, but also to ensure that what we do resonates with our investors. How can we ensure that the income investing tradition appeals to people who are minded to look after the planet, work from home and think very differently about the world from their parents and grandparents?

One of our biggest concerns is being accused of 'greenwashing' by giving something a label that just isn't appropriate. That's why we always take pains to emphasise that our fund is not an environmental, social and governance (ESG) mandate. But we continue to invest more time in understanding how ESG risks could impact our fund. To that extent, we are an ESG-aware fund, as we jolly well should be.

The point is, for a non-green fund, ESG risks are just some among the many we need to assess. Our two biggest positions are currently **BP** and **Royal Dutch Shell**. As we consistently stress, these businesses may be part of the eventual solution to the climate change challenge. But we still need to think about the risks associated with how they allocate capital (and, indeed, the cost of that capital) in a greener world. Let's think about the promises that these businesses are making. It is too easy to dismiss their proposals out of hand, with too many coming to the conclusion that all fossil fuels are bad and we should just get rid of them. A far more sensible approach involves constructive debate about who are the best stewards for existing oil and gas assets that need to be managed (and, indeed, to generate profits). It is unsurprising that activist investors are putting these very questions to Royal Dutch Shell.

Our engagement with mining and materials companies should be similarly constructive. If the global economy is to grow, we will still require more iron and more cement. And if we want electric vehicles, we need heavy metals for their batteries. We should be thinking about the cleanest ways of producing these commodities, not just washing our hands of the problem.

Let's get back to our rallying cry for the Rathbone Income Fund. A market-beating yield of 4.1%, with a dividend up 18% year on year, and a focus on securing real capital growth, which is important for savers and pensioners alike. An investment approach that is centred upon risk – and which, therefore, absolutely encapsulates the sustainability factors that are so important these days. It is these sustainability credentials which we need to emphasise, if we are to make this fund resonate with investors grappling with the issues of today: the income fund can be a vehicle that is compatible with these challenges, by virtue of the companies in which we invest, and not despite them.

Recent trading: A very quiet month, with a healthy prune of our position in **National Grid** the only trade to report, reflecting a more cautious view on rising interest rates.

Companies seen in the month: **Close Brothers**, **Bunzl**, **Legal & General**, and Royal Dutch Shell.

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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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