Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update November 2021

So 2021 is nearly over. We don't have to worry about get-togethers getting cancelled as income fund managers don't get invited to parties anymore! That's a bit of a shame, because we have a lot to celebrate this year, including a strong recovery in distribution, and more importantly, as detailed in our last investment letter, a very strong autumn reporting season which fed through into a lot of earnings upgrades. We will review the year more comprehensively in our next investment letter. Fingers crossed, we'll have a good story to tell.

Getting our story across has been our biggest challenge over the last 12 months given the deeply entrenched, and long-standing, pall hanging over UK equity income sector. The last decade has witnessed its consistent retreat from being an answer to investor needs to being referred to very much in the past tense. This decline began with the global financial crisis (GFC), the misdeeds of banks decimating the income narrative, among other things, and highly leveraged businesses being found out for over-distributing to shareholders.

We have learnt from our mistakes and introduced a more robust risk framework into our investment process. However, the sector's former glow has absolutely diminished.

Will life find a way for equity income?

Is this situation likely to change soon? Probably not, if we're realistic. But that doesn't mean that we shouldn't keep on banging the drum because stresses are beginning to appear in global markets. To use the line attributed to Mark Twain that's so often repeated that it's become a bit of a cliché: "history does not repeat itself, but it does rhyme". It is with gallows humour that we include the following in our presentations as a reminder that the sector has recovered before: *"Equity income funds, written off by some as the dinosaurs of the fund management world, have become fashionable again, topping the Investment Management Association's fund sales charts in each month from June to December 2004." Financial Times*, 25 February 2005.

By some freakish twist of fate, the following appeared in the Financial Times on 1 December 2021: "*London is becoming the Jurassic Park of stock exchanges… It is time the income fund sector was phased out and replaced with funds that are more focused on growth than dividends, on the future rather than the past.*" This comment obviously perturbs us, as any existential threat would. We disagree with much of the substance of the article from which it came, but it does reflect the modern investment zeitgeist. We may not like this point of view, but we must deal with it.

The article's author, Paul Marshall, who heads up leading hedge fund Marshall Wace, reflects on his frustration at the share price reaction to **SSE**'s better than expected first-half results. We share his pain. The company has made steady progress over the last few years, selling its retail arm and pulling back from thermal power generation to major on its renewables business and its incomparable (at least in UK terms) portfolio of offshore wind assets. In Mr Marshall's reductive argument, the market's failure to appreciate the supremacy of this investment strategy, and the necessary reduction in its dividend to finance it, are symptomatic of a disease that riddles the whole of the UK market and he damns the UK equity income sector very specifically to the prehistoric dust heap. OUCH!

SSE's teachable moment

As we have mentioned many times in the past, SSE is the only business to have been ever-present in the fund since Carl took over the mandate at the start of January 2000. Back then, SSE's former CEO sketched out for us the structure of the business on a big sheet of paper. Renewable energy generation featured in the sketch, but investors were scornful about its potential at the time. They worried about the government subsidies propping it up and back then felt it wouldn't deliver attractive returns on the capital invested. Right at the centre of this very large diagram was the word 'dividend': SSE's promise of a real increase in its distribution was its mantra for decades.

Year after year, SSE has plugged the renewables story. Its networks business has always been the quality jewel in its crown, but renewable energy generation has added the sparkle. SSE has consistently invested money into creating these assets, moving them on to other operators on maturity when the price was right, and has partnered with the right people. The story, in its telling, has been so robust that we have frequently asked SSE about its dividend strategy: if it has these compelling growth opportunities, why keep on handing out cash? If the returns make sense, let's have that discussion. We absolutely applaud SSE's latest decision, even if it does mean a reduction in its dividend because a good return on invested capital story is as central to our process as it is to theirs. We don't care if the initial stock market reaction proves downbeat — we're in this for the long-term.

Seeking the best possible return

To be classified as an income fund, we must provide a yield in excess of the FTSE All-Share's on a three-year basis. That's a constraint for us, not a goal. Our goal is to provide the best possible total return for our unit holders, which includes a decent yield, while keeping price, business and balance sheet risks in check. We spend a lot of time discussing capital allocation with our companies. If they can get a good return on their own through investment, and do so without a lot of gearing, that's likely to be much better for us in the long run than restricting their growth prospects by over-spending on dividends. This dictum applies to SSE as it does to every business we own. And it applies just as much to share re-purchases, acquisitions and software implementation, or indeed anything on which a business is spending cash that could belong to shareholders.

Will the tide ever turn? Yes, possibly, but who knows when? Markets have recently got much more volatile as investors have pondered central banks' next moves. The inflation debate has advanced, as have expectations for more imminent rate rises. Economic data has been strong on balance, but there's not a lot of certainty about anything in our COVID-19 world and much fear about policy mistakes. If inflation and rates go up, the net present value of future earnings will come down, particularly if those earnings are but distant promises.

No, this isn't a repeat of 2000, because businesses like Amazon, Tesla, Adobe, Netflix etc have truly changed how we live, work and play. Back in the early 2000s, we bought 'value' businesses like House of Fraser and HMV, which made money for us, but have long since gone bust, plus a whole swathe of water companies, consolidated out of existence, and engineers like FKI and McKesson, also long gone. The landscape has certainly changed dramatically. But now, like then, there is a big valuation mismatch between entities that promise vast profits tomorrow, and those which offer more modest profits *today*.

We heard someone remark recently that valuations don't matter and the only things that count are revenue growth and earnings upgrades. We must disagree, valuations do matter. We are not talking about trying to time the market and predicting a big rotation. We're talking about basic returns on invested capital. Yes, a business may be great, or it may promise the world, but if you pay too high a price for its shares, your investment return will fall. If a company buys back its shares at the wrong price, it will generate a poor return. And the same thing will happen if it acquires a portfolio of offshore assets at the wrong price. Likewise, buying a government bond with a baked-in negative real yield is going to generate a poor return. Sticking your money in the bank is risk-free but won't prove rewarding.

This isn't 2000, but the vibe feels the same. Income funds are described as 'Jurassic', which seems odd when financial repression is rife. Savings accounts offering 4% and a real return seem closer to extinction. If inflation rises, a pound earned today is worth a lot more than a pound earned tomorrow. The volatility of the last few weeks suggests that investors are waking up to this reality.

By virtue of history, the UK market (although not its economy) has a lot of exposure to banking and extractive industries relative to other big markets. This doesn't make the UK a dinosaur. It does make it a bit special.

When making big calls between regional equity markets and between investment styles, investors must always take their risk tolerances into account as they take a long hard look at what they hold. Could there ever be a point when tech stocks *didn't* look appealing? Of course, there could. It's happened before when the market was too generous in its profit growth assumptions for these sectors: a sharp correction ensued and the UK market returned more than twice as much as its US counterpart in the seven years from mid-2000. Maybe we're in a tech bubble now or maybe we aren't. What's very different between then and now is interest rates. US 10-year treasuries yield only 1.5% and 10-year UK gilts yield 0.76% when inflation is considerably higher than those numbers. Will rates be higher or lower in a year or two? If you think they *might* be a bit higher, we would have thought that at least some extra exposure to financials and materials would be warranted, if for no other reason than they could offer a bit of insurance as tech gets more and more expensive. Holding a bit of the UK market is a natural hedge, even if you're a 'tech forever' bull. And if you're a saver, surely holding a bit of the UK equity income is sector is a natural antidote to an inevitable dose of financial repression?

Recent trading: We trimmed a few holdings, including **Aviva**, **Big Yellow**, **Bunzl**, **Close Bros**, **Relx** and **Sampo**. However, the principal trade this month was the creation of a new position in **OSB Group**, a bank which offers mortgage and asset finance to professional property owners in the UK.

Companies seen in the month: Big Yellow, **DCC**, **Lloyds Banking Group**, and **MicroFocus International**.

Carl Stick
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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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