Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Quarterly update December 2021

It is with a combination of relief and pride that we look back on a very strong final quarter. Three months that have added a welcome gloss to all our performance numbers and supplemented the good rebound in dividends that we were able to announce in our previous quarterly review. Our relief reflects the fortune required to navigate highly unpredictable equity markets; our pride arises from several notable successes which bolstered an already positive autumn results season. If we are to promote a pragmatic approach to managing risk across the portfolio, which may appear at first sight to be noncommittal, we do need to support it with good stock-picking, and Q4 2021 backed this up.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	5.3%	6.8%	20.6%	27.9%	26.6%
IA UK Equity Income Sector	3.2%	5.6%	18.4%	26.9%	26.4%
FTSE All-Share Index	4.2%	6.5%	18.3%	27.2%	30.2%

	31 Dec 20-31 Dec 21	31 Dec 19-31 Dec 20	31 Dec 18-31 Dec 19	31 Dec 17-31 Dec 18	31 Dec 16-31 Dec 17
Rathbone Income Fund	20.6%	-10.6%	18.6%	-8.6%	8.2%
IA UK Equity Income Sector	18.4%	-10.7%	20.1%	-10.5%	11.3%
FTSE All-Share Index	18.3%	-9.8%	19.2%	-9.5%	13.1%

Source: FE Analytics; data to 31 December, I-class, mid price to mid price.

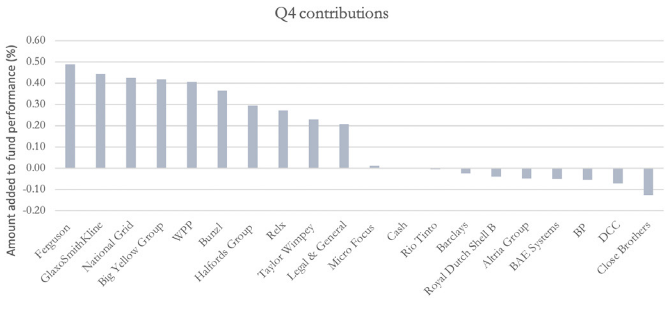
These figures refer to past performance, which isn't a reliable indicator of future performance.

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.

In the final quarter of 2021, our fund gained 5.3%, comfortably ahead of both the sector average and our benchmark, the FTSE All-Share Index. Over the full year, the fund generated a total return of 20.6%, which compares very favourably with the UK Equity Income sector average of 18.4%, and the FTSE All-Share's 18.3%. In combination with the 18% recovery in our full year distribution, we are pleased to be commenting on a satisfactory year.

Three-month stock review

For us, the final quarter came down to stock-picking, as evidenced by portfolio returns data that do not point to any clear trends in the market.



Source: StatPro; Rathbones

Our top contributor was **Ferguson**, the plumbing and heating business that, having sold its British business in January 2021, now generates all its revenues in North America. Results, released in September, highlighted strong sales growth, but more importantly, an impressive ability to pass on costs, crucial at a time of inflation and supply chain issues across all industries.

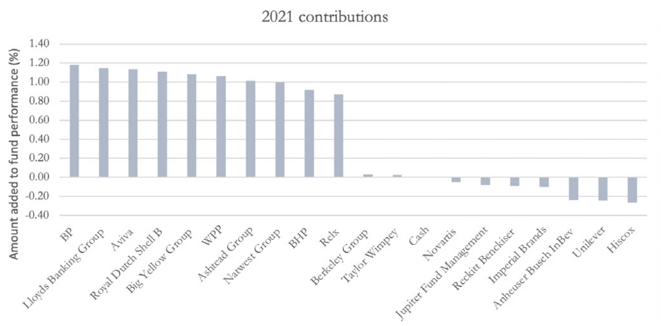
The contribution from pharmaceutical business **GlaxoSmithKline** was perhaps less predictable, but solid third-quarter numbers were received well by investors already enthused by the prospect of the intended spin-off of the consumer health division. Shares, energised by the amalgamation of good news, strengthened into the end of the year. Media giant **WPP** produced terrific numbers, with most regions ahead of where they had been back in 2019, that is, pre-pandemic. It raised guidance for the full year, with like-for-like revenue and margin forecasts both improved. These results were better than our own expectations and, in all likelihood, better than the market was looking for.

We should also mention the fundraising completed by automotive and cycling goods retailer **Halfords**, in which we participated, to finance the acquisition of Axle Group Holdings, the owner of National Tyres and Autocare. Halfords negotiated a very tricky couple of years, dealing like all retailers with the pandemic and, latterly, with the same cost pressures and supply chain issues afflicting so many. Halfords' performance has been excellent, and this good deal rounded off a strong year.

Unsurprisingly, in such a strong quarter, laggards were less influential. UK finance group **Close Brothers** drifted lower for most of the quarter. This was less due to results – which were generally in line with expectations and inspired a late recovery in the shares – and more probably due to profit-taking. Distribution company **DCC** was also a dull performer throughout 2021, failing to convince a more sceptical market that its fossil fuel-oriented divisions can be part of the energy transition solution.

Otherwise, over the quarter there was a mild, but not significant, recycling of money out of 'cyclical' industries such as financials and commodities. This is understandable after a very strong previous 12 to 15 months; however, more on this later.

12-month stock review



Source: StatPro; Rathbones

By contrast, you can see some clearer sectoral trends in the 12-month data. Most positive contributors to our performance were in more value-oriented, cyclical and economically sensitive sectors, such as commodities (**BP**, **Shell**, **BHP**), the financial arena (**Lloyds**, **Aviva**, **NatWest**) and media (WPP). In contrast, the laggards were generally more defensive plays, those more vulnerable to the valuation shock of rising interest rates, epitomised by consumer staples (**Unilever**, **AB InBev**, **Imperial Brands**, **Reckitt Benckiser**). We lightened the load early in the year, through the sales of Unilever and Imperial Brands.

Strategy and outlook — a bird in the hand is worth two in the bush

Notwithstanding COVID-19, which seems to be having a diminishing impact on financial market sentiment these days, investors are grappling with one primary question: if economies are recovering, and inflation expectations are genuinely more hawkish, are we coming to the end of over a decade of quantitative easing? And if so, what does this mean for markets, valuations and asset allocation?

US investors got an early test of resolve this year, upon the release of the latest US Federal Reserve (Fed) monetary policy committee minutes. The committee opined that it may be necessary to raise interest rates both sooner and faster than previously anticipated. Serving up a double whammy, they also explained that they may need to reduce the size of the Fed's balance sheet, which could mean selling bonds, not buying them – quantitative tightening (QT) rather than a more gentle phasing out of quantitative easing (QE). If the Fed sells bonds, prices will be pushed down and yields will go up. The Fed is minded to be less accommodative in light of elevated inflation and this change in stance is supported by more robust economic data.

The market reaction was immediate and dramatic. Higher rates and higher inflation diminish the present value of future earnings (and therefore share prices, all else being equal). The prospect of QT rather than QE and the prize of economic recovery combined to empower a rotation into more cyclical (and likely more value-oriented) areas of the market, at the expense of 'growth'; a greater need to own the earnings of the present, rather than the promise of something in the more distant future. Now, of course, we've been down this road before, with growth having then gone on to recover even more strongly. But some commentators are sensing a difference this time.

This trend is important for British savers. Interest rates may also rise in the UK, but the paltry returns being offered to savers, relative to the corrosive power of inflation, mean that the spending power of cash in the bank will inevitably be depressed. This is what's referred to as 'financial repression'. Higher inflation is also the least painful way to ease the large public debt burdens facing governments and central banks, including the Bank of England. But that doesn't help savers.

We contend that equity income remains a valid solution to this problem. In our view, attractive yields, the prospect of real growth in income and capital, and a cheap UK equity market does at least provide some margin of safety. This argument remains valid and a compelling one, in our belief. It hasn't been an attractive proposition over the last few years, but if this rotation, like the inflation that has catalysed it, proves to be more than transitory, then the argument will regain its lustre. Throw in the potential for economic recovery in a world grown used to living with COVID, and the ingredients are there for a strong 12 months.

Last year was a very good one for your fund. It was a very good year for UK Equity Income in general, but it possibly passed by unnoticed. If the coming year is anywhere near as good, it will be difficult for investors to ignore.

Recent trading: December was a quiet month for trading. We participated in the Halfords deal, and continued to build up our position in **OSB Group**, the specialist property lender. We took a little profit from **Big Yellow**, Aviva, **Sampo**, and **Bunzl**.

Companies seen in December: Reckitt Benckiser and DCC.

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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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