

Rathbone Strategic Income Portfolio

Quarterly investment update, October to end December 2021



Hot topics – ‘Top-down’ (market and macroeconomic)

The Grinch. When Omicron first appeared before Christmas, investors panicked at its increased infectiousness and its ability



to circumvent some vaccines. The fear being that it might force countries to rethink pandemic mitigation strategies founded on inoculation. The potential for yet more lockdowns, for shuttered shops, for closed borders was suddenly back on the table. Now, we've been expecting to see more variants pop up over time – it's something that is typical of viruses. Early reports of its lessened severity, despite increased infectiousness gave us confidence that it may be the beginning of the end of the pandemic – where COVID-19 evolves to endemic status. So, we took the plunge and bought into the bouts of stock market weakness during the fourth quarter and also in early January. COVID risks still abound mind, not least that there is large variation in how governments are reacting to the new strain – even within the UK. Some policymakers may find it hard to adjust their strategies as facts and circumstances change, which would impact investments.

Inflation nation. If we are right about the COVID cloud starting to recede then the global economy should continue to pick up into the higher gears. All things being equal, that will flow through to higher inflation hanging around for longer, which will push central banks to raise rates and cut back on quantitative easing (buying tonnes of government bonds to keep borrowing costs low). We've thought that inflation would probably run hot for a couple of years or so since about May 2021. Longer-term, it will be dragged down by those 800-pound gorillas that have been part of the fabric of the global economy for many years: rampant automation and digitisation, a highly indebted world and ageing populations. But in the coming years higher prices and (slightly) higher interest rates are probably on the menu. Global supply chain and shipping tangles look more complicated than most people first thought, and further COVID-related disruption could continue to support higher inflation. Because of this, we have been steadily building our positions in 'quality cyclicals', strong businesses that should benefit from rising interest rates and higher GDP growth. Mostly, these are blue-chip



industrials and manufacturers and select banks and other financial companies. This hasn't been a wholesale shift from the 'growth' stocks that we have favoured for a good many years, rather we felt it was time to introduce more balance across our equity portfolios.

Tech wreck. As rumblings of tighter monetary policy grew louder in December and January high-growth technology stocks took a beating. On our Christmas episode of *The Sharpe End* podcast we spoke about how the technology space can be broadly separated into three categories: 1. Mature companies with quality business models and attractive long-term growth prospects; 2. good companies with quality business models, perhaps a bit smaller, so the pandemic boost to their activity lit a fire under their share prices, sending them to astronomical valuations; 3. immature companies with speculative business



models, limited profits and ballooning share prices that many have since labelled 'spec tech'. We own the first bucket, and we have been consistently taking profits in those shares we own that are straying into the second. The third bucket – 'spec tech' – we won't own, and it's here where the worst recent tumbles cluster. These moves can – and do – bleed into more sensible tech stocks though. And with all the algorithmic trading funds and robots buying and selling based on short-term factor analysis – the characteristics of stocks based on quantitative metrics, for instance, 'growth' companies as a bloc – these sorts of sell-offs tend to be more volatile than in the past. This can be stressful, but it does offer us the chance to buy and sell at a wider range of prices, which helps us make money. When rate hikes do come through, this year and into next, it will be a headwind for the valuation of many of these strong mature tech companies. If rates go higher than markets expect, that will flow through to our growth companies because it will hit their price-earnings multiples due to the higher discount rate. That's just mathematics. Yet we still want to hold these businesses for many years, because we are confident that they can continue to push through earnings growth. For these reasons, though, we have rebalanced our equity portfolio to reduce our exposure to this growth factor and ensure we have other stocks that will do better if rates rise faster than expected.

Portfolio activity

Key purchases/additions	Key sales/trims
Morgan Stanley (new purchase)	Close Brothers (sale)
AJ Bell (new purchase)	Unilever (sale)
Barclays (addition)	Accenture (trim)
US Treasury 4.5% 2036 and 5.25% 2028 bonds (additions)	Baillie Gifford Japanese Income Growth Fund (trim)
Lockheed Martin (addition)	

Source: Rathbones

As part of our drive to rebalance our equities towards more interest-sensitive businesses, we added US investment bank **Morgan Stanley** and UK investment platform **AJ Bell** to our portfolio and topped up our position in UK multinational lender **Barclays**.

We added Morgan Stanley because the American economy is booming and inflation is higher than at any time since the 1980s. All this bodes well for a dealmaker, trading house and lender to households and businesses. If bond yields steepen (yields of longer-dated bonds rise more than shorter-term ones), then it should make the bank's loans more profitable. There has also been a raft of new listings, bond issues and M&A, which are the bread and butter of investment banks. Above all of these reasons to buy, however, is that Morgan Stanley has been expanding its wealth management business, significantly improving the quality of its earnings. By 'quality', we mean the fluctuations in its earnings are lessened by the smoother recurring wealth management fees. When this happens, it leads investors to put a higher value on the earnings, boosting a company's price-earnings multiple.

AJ Bell is a simpler business that we swapped in for **Close Brothers**, which we sold completely after an uncomfortable meeting with management. AJ Bell fits better with our existing exposure to this space. It is an investment platform with a keen pricing policy which is popular with both retail investors and advisers. It is also steadily growing its dividend payments each year.

We added to our holding of **US Treasury 4.5% 2036** and **5.25% 2028** bonds in November as yields continued to rise. Around the same time, we bought **Australian Government 4.75% 2027** bonds too. These bonds all pay a high coupon which helps create the cash we use to pay your monthly income.

We exited UK consumer brands company **Unilever** during the quarter because we felt our money would be better used to add to our holdings of US aerospace contractor **Lockheed Martin**.

We also added **UBS Nasdaq Put Options** to our portfolio, which give us the option to 'sell' a slug of exposure to the index at a level roughly 10% below the price level where we bought. They were a similar price to put options on the S&P 500 index, but the Nasdaq has more of the highly valued technology companies that are most at risk of their price-earnings multiples falling if prevailing interest rates rise. This is the risk that we most wanted to hedge.

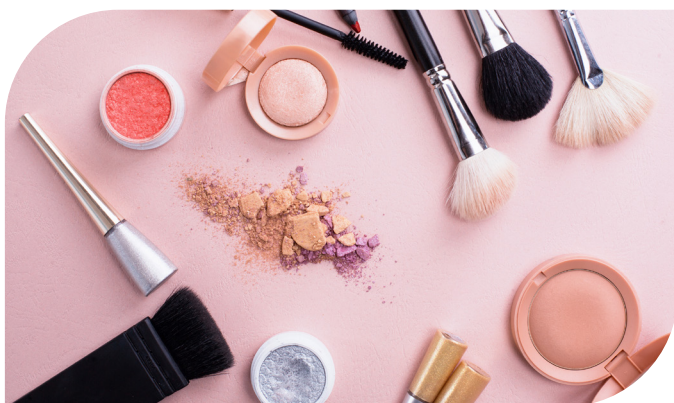
Spotlight

In this quarter, the spotlight is on our **Estée Lauder** and **National Grid**.

ESTÉE LAUDER

Estée Lauder

- A US listed global leader in skincare and beauty products
- Estée focuses exclusively on premium and prestige cosmetics and are truly omnichannel using online, speciality cosmetics stores, department stores, and travel retail – we all know the stores you have to walk through at the airport to get to the departure lounge
- The company has a very global presence which is weighted slightly more towards to the developed world but the China opportunity remains an exciting one as demand for their products continues to grow there
- A very wide ranging and high-quality stable of well-known brands including, Clinique, MAC, La Mer, and Bobbi Brown, along with their own name range
- Innovation is a key focus for Estée, whether that be innovation in products using the latest science and technology, or areas like packaging where they continually explore how to make their packaging ever more sustainable, using solutions like plant-derived plastics, whilst still retaining that high quality luxury product feel for consumers – in the prestige space it's a vital balance to strike



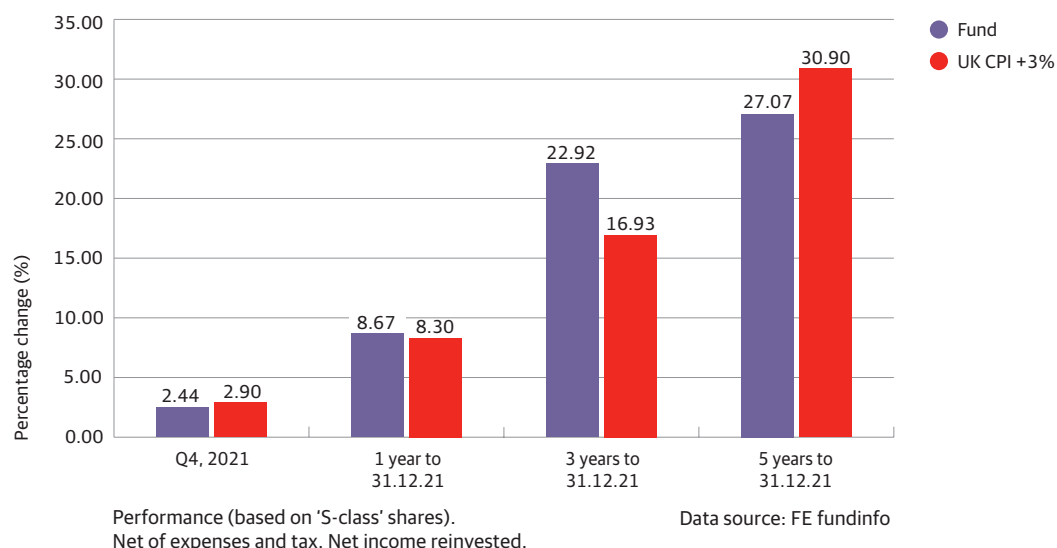
nationalgrid

National Grid

- National Grid owns and operates regulated energy transmission network in the England, and gas transmission across the whole UK
- National Grid also operate similar assets in the north east United States, predominantly New York and Massachusetts
- There is scope for higher growth from the US with regulators being more favourable and encouraging network companies to upgrade and strengthen aging infrastructure
- They are a key enabler of the energy transmission and are involved in a number of projects exploring renewable energy and storage



Fund performance



Discrete annual performance					
Year to:	End Dec 2017	End Dec 2018	End Dec 2019	End Dec 2020	End Dec 2021
Fund	+7.24%	-3.64%	+12.12%	+0.90%	+8.67%
UK CPI + 3%	+6.25%	+5.36%	+4.44%	+3.39%	+8.30%

Price performance based upon bid to bid prior to 21 January 2019 and single price (mid) thereafter. 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.

Our benchmarks are calculated on the rate of change of the CPI index, over different time periods (e.g. if we were calculating year to date figures in January 2021, we would look at the percentage change from December 2020 to the end of January 2021). So we take CPI to the current value, and add on 3%, prorated over a year (roughly 0.25% per month). If the CPI Index benchmark were to fall, more than the amount pro-rata, the benchmark year-to-date will be negative, even though inflation as reported by the media (calculated specifically as a 12M rate of change), remains positive.

Top performers (%)		Bottom performers (%)	
Holding	Performance	Holding	Performance
Accenture	29.61	Ashmore Emerging Markets Short Duration Fund	-14.00
Ferguson	28.07	AIA	-13.14
Estée Lauder	23.07	Discover Financial Services	-5.95
Cadence Design Systems	22.50	US Bancorp	-5.17
National Grid	21.75	Barings Emerging Markets Debt Fund	-4.99

Note: Top and bottom performers are taken from the list of all holdings of 0.25% and above of the portfolio. Performance and contribution data shown above is based on unhedged GBP capital returns.

Source: Rathbones

The top and bottom contributors to performance are listed above in the order of contribution. This quarter, whilst we can state absolute performance, we are unable to state the precise magnitude of contribution.

Asset allocation ranges

Liquidity	Equity-type risk	Diversifiers
5% to 40%	40% to 80%	0% to 40%

Asset allocation change and strategy

There were no significant asset allocation changes during the quarter.

Asset allocation split	30.09.21	31.12.21	% Change		12 month change	
Liquidity assets	20.34%	22.90%	2.56%	▲	0.08%	▲
Equity-type risk	76.03%	73.68%	-2.35%	▼	2.71%	▲
Diversifiers	3.63%	3.42%	-0.21%	▼	-2.79%	▼
	100.00%	100.00%				
Asset class split	30.09.21	31.12.21	% Change		12 month change	
Equities	59.31%	58.66%	-0.65%	▼	2.76%	▲
Index-linked bonds	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Conventional government bonds	9.45%	11.44%	1.99%	▲	-4.86%	▼
Corporate bonds	24.14%	22.14%	-2.00%	▼	8.57%	▲
Emerging market debt	3.85%	3.20%	-0.65%	▼	-0.68%	▼
Private equity	1.03%	1.02%	-0.01%	▼	0.11%	▲
Alternative investment strategies	1.44%	1.36%	-0.08%	▼	-1.17%	▼
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	0.00%	0.00%	0.00%	◀▶	-2.06%	▼
Cash	0.78%	2.18%	1.40%	▲	-2.67%	▼
	100.00%	100.00%				

For more information on our liquidity, equity-type risk and diversifiers (LED) risk framework, please consult our investor brochure.

Investment outlook

Energy prices are a big deal right now and will probably remain so for the rest of the year at least. We need to phase out carbon-heavy fuels as soon as possible, but the breakneck speed of the clean energy transition over the past few years has made energy markets more fragile the world over, and that has a knock-on effect on societies and economies. The pandemic-induced disruption to production and shipping, combined with many years of underinvestment in new oil and gas fields, has created a situation where energy is scarce and therefore expensive.

That all-important green source of base-load energy is yet to be developed, so it has fallen on natural gas to take the mantle from coal. While a much cleaner alternative, it's not clean enough for the world's climate change targets. And transport is still overwhelmingly powered by petrol and diesel. With little increase in the supply of this, that pressure has to release somewhere: the oil price, and so it creeps toward \$100 a barrel. Meanwhile, Russia is becoming yet more bellicose in Eastern Europe. Any flashpoint will likely further curtail the global energy supply, either because of sanctions on Russia and/or the nation withholding gas exports to the European Union.

High energy prices are effectively a tax on consumption, a squeeze on the spare cash for both households and businesses. And it's an insidiously compounding one as well. Because energy is required for virtually everything, so the cost of everything, from shirts and vegetables to washing machines and IT packages, starts to rise along with the price of filling up your car (with electricity or fuel). This squeeze will attract political attention. For many years, the move away from fossil fuels has been a narrative of "we must do this now". We are now entering an era where the narrative may change to "how are we going to pay for it?" It's crucial that policymakers plot a sensible course that ensures there isn't a backlash against cleaner energy because the masses can't bear the higher cost.

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Rathbones
Look forward

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