Rathbones
Look forward

Rathbone Income Fund

Monthly update February 2022

Last month, we argued that investors needed a Plan B as the world moved on from more than a decade of low rates, low inflation and high liquidity. This is now more important than ever, but recent events provide a stark reminder that we must be ready and willing to amend that Plan B as circumstances change.

It beggars belief that in the 21st century the world finds itself on the threshold of another major conflict on European soil. The First World War was thought at the time to be the war to end all wars; how very wrong that suggestion was. Of course, we all react with horror at Russia's aggression towards Ukraine and history will prove the ultimate judge of President Vladimir Putin. But it is important to disassociate from our own feelings of opprobrium and to try to understand his motivations so that we can gain some sort of perspective on where this takes us.

Geopolitical tides have turned

It now seems inevitable that the geopolitical tides are turning, with major ramifications for Europe and the wider world. The last few years have cemented the truth about the futility of trying to predict the future; indeed, we distrust anyone who has an investment stance established upon a high conviction view of what the future holds. However, we also recognise that it is incumbent upon us to have a strategy around which to frame our investment decisions and that we can communicate clearly to our investors.

From the outset, we must temper the optimism we expressed only recently about the prospect of a synchronised global post-pandemic economic recovery. Some data remain supportive, but the flattening yield curve hints at harder economic times ahead. With commodity prices in general and energy prices in particular going through the roof, there will be a brake on consumption as higher costs start to hit home. Fears that inflationary pressures will remain elevated for longer will be an inevitable drag on economic recovery.

So what changes have we made? We have increased our weighting in miners, with the introduction of **Glencore**. By so doing, we have diversified away from the heavy iron ore exposure of **Rio Tinto** and **BHP** and gained Glencore's broader trading expertise. Our exposure in the energy space is more nuanced. While the price of oil has soared, shares in **BP** and **Shell** have performed less well, reflecting the complications involved in their entanglement in the Ukraine maelstrom. Both companies will give up Russian assets, but the politics around security of energy supply makes this a highly complex industry in which to invest. The difficult capital allocation decisions they're making in response to demands for a lower carbon world have become a lot tougher.
However, the crucial point for us to focus on is the fact that there is every likelihood that the environmental, social and governance (ESG) narrative gets impacted by concerns over supply constraints within the fossil fuel space and broader energy security. Europe's (and especially Germany's) reliance on cheap Russian gas is likely to end but these are dynamics that have been established over many years of policy change and any volte-face will be a long and drawn-out process.

We will see a structural shift in the amount of money that European nations spend on their defence. Chancellor Olaf Scholz has already sanctioned €100 billion (£83.9bn) to modernise Germany's armed forces. Fundamentally, the industry is very attractive to investors: balance sheets are strong and robust cash generation enables progressive dividend policies. It is no surprise that shares in defence companies have been strong on the back of the conflict. ESG concerns are being re-framed, with companies highlighting their credentials: is it now expedient to view defence as a social good rather than a social harm? The structural shift in defence spending may be reflected in a structural change in the way investors view this industry.

Our constructive stance on financials was predicated upon controlled inflation, a normal yield curve and economic growth. All three are now in doubt. However, as share prices have rattled back, much greater risk is being priced in. We continue to highlight the balance sheet strength of our banks and life assurers and their ongoing potential to return cash to shareholders. Of course, these entities are economically sensitive and benefit from steepening yield curves so our investment rationale has changed. But in the interests of maintaining the correct balance of risks in the portfolio, and reflecting the positive fundamental strength of our businesses, we have maintained our positions throughout this volatile period.

Investing flexibly while maintaining balance

We manage an equity fund and so have not been immune from the volatility of the last few weeks. We absolutely acknowledge that there are more important things in life than financial markets. However, our job is to run the Rathbone Income Fund as well as we can for the benefit of our unitholders. We must, therefore, focus on this particular task while digesting and drawing investment conclusions from what is going on around us.

First, we are fortunate that we run a mandate that gives us tremendous flexibility — we haven't boxed ourselves into a corner by saying that we will not invest in very cyclical businesses, or price takers like the oils or 'old economy' stocks. We have the freedom to invest wherever we see opportunity and where we observe disciplined allocations of capital. Secondly, we have maintained a balanced portfolio, a practice which (when combined with our risk-based approach) is an advantage in these volatile markets. Finally, the Rathbone Income Fund as an investment proposition is supported by an attractive dividend yield and the prospect of real dividend growth. So, it's raison d'etre gains extra impetus when rates are low and inflation is high.

Long-term investors in the fund know all of this, but it serves us well to keep on banging this particular drum. Last month, we argued that investors needed a Plan B as the world moved on from more than a decade of low rates, low inflation and high liquidity. This is now more important than ever, but recent events provide a stark reminder that we must be ready and willing to amend that Plan B as circumstances change.

It goes without saying that the thoughts and prayers of all of us on the team go out to the millions of people affected by what is happening in Ukraine. Let us hope that somehow a resolution is found to end this unfolding tragedy before more lives are lost or irrevocably changed.

Recent Trading: As mentioned above, we created a new position in diversified natural resources company Glencore. We also added to **Games Workshop**. We trimmed **British American Tobacco**, **DCC** and **IMI**, and completed our exit from **Ferguson**.

Companies seen in the month: Diageo, **Micro Focus International**, **DCC**, **Dechra Pharmaceuticals**, Shell, **Novartis**, Rio Tinto and **WPP**.

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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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