Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Quarterly update June 2022

If everyone is predicting recession, is recession actually now priced into markets? Or is it complacent to automatically assume that economic weakness will herald a return to the playbook of the last decade, paying high prices for 'growth', because that's what you do when growth is scarce? We think it is wrong to trust that markets will return to some easily predicted version of the past. The world has changed, and markets have changed, so the challenges ahead are unique.

It is frustrating that, following a good start to the year, the second quarter was disappointing for our fund. In part, this was a function of a reversal of the 'value' rotation that had occurred previously; this shift from tail- to headwind was nevertheless exacerbated by some stock-specific issues, which we will explain later in this piece.

Performance review

Global markets were very weak during the second quarter. The war in Ukraine wages on, but from a market perspective investor gazes seem to have switched away from Eastern Europe toward the words and actions of the major central banks. With promises to defeat inflation, whatever it takes, the threat of a widespread recession is seen as the eminent market risk, and it is this shift in expectations that has so impacted the valuations of those businesses most exposed to economic cycles.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	-6.9%	-7.5%	-1.2%	6.0%	8.2%
IA UK Equity Income Sector	-5.5%	-5.6%	-0.3%	8.1%	11.8%
FTSE All-Share Index	-5.0%	-4.6%	1.6%	7.4%	17.8%

	30 Jun 21-30 Jun 22	30 Jun 20-30 Jun 21	30 Jun 19-30 Jun 20	30 Jun 18-30 Jun 19	30 Jun 17-30 Jun 18
Rathbone Income Fund	-1.2%	23.4%	-13.1%	0.9%	1.1%
IA UK Equity Income Sector	-0.3%	25.4%	-13.6%	-2.5%	6.0%
FTSE All-Share Index	1.6%	21.5%	-13.0%	0.6%	9.0%

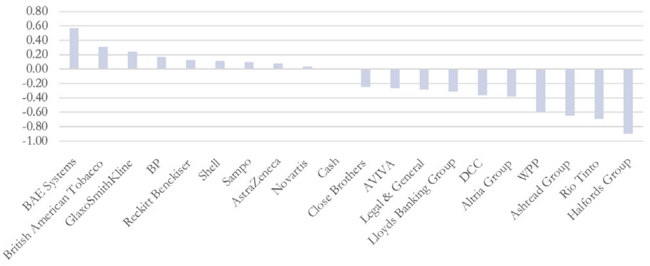
Source: FE Analytics; data to 30 June, I-class, mid price to mid price.

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

The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

While we maintain a balanced approach to portfolio construction, our fund has most certainly been tilted meaningfully towards those parts of the market that are cyclical. We own good businesses, but we are attracted by the value that we believe is inherent in these names. This has been the correct place to be for much of 2022, but it has been challenging over the last month or so. In the last quarter, our fund has retreated 6.9%, which compares poorly with a sector average of -5.5%, and the fall of 5.0% in the FTSE All-Share Index.

Q2 contributions



Source: StatPro; Rathbones

The style rotation is clearly shown by our major contributors to performance over the period. On the positive side of the equation, the biggest contributor was defence and aerospace engineer **BAE Systems**. As we have highlighted previously, BAE was operating very well prior to the tragic events in Ukraine; now, in an environment where governments are having to rethink defence budgets, the shares have seen a further re-rating, justified by this new structural tailwind. Elsewhere, defensive earners such as **British American Tobacco**, pharmaceutical giant **GlaxoSmithKline** and consumer products company **Reckitt Benckiser** have moved ahead.

It is interesting to note the performance of our large oil holdings, **Shell** and **BP**, which have held up well despite the heavy malaise afflicting other cyclical industries. Energy prices have remained high because, although demand may fall in the wake of economic slowdown, supply constraints continue to be the major influence on the market. The war in Ukraine continues to catalyse these supply constraints. However, a consequence of the drive to reduce the world's consumption of fossil fuels has been the deceleration of investment in development, production and refining assets. This deceleration has coincided with – despite the headlines and the summits – an *increase* in the global demand for fossil fuels. Furthermore, while high prices logically should reduce our insatiable demand for fuel, the clamour for inflation-busting government policy, such as fuel tax reductions easing the pressure on consumer pockets, goes against this grain. In an interview with the Financial Times, the CEO of US energy giant **Exxon Mobil** explained that he expected the oil price to continue to climb until it spurs renewed investment in output: "the cure to high prices is high prices," as he puts it. Policymakers face a conundrum, oil majors are likely to make very high profits, Shell and BP remain our largest positions.

We must address our biggest losers. The general reflection, notwithstanding the above, is that economic cyclicality has been punished – miners (**Rio Tinto**), industrials (**DCC, Ashtead**), media (**WPP**), and financials (**Lloyds, Legal & General, Aviva, Close Brothers**) were very weak in the quarter. In most cases, the view in the rear-view mirror is strong: results have been fine. Yet the issue is investor anxiety regarding what lies ahead. We have a more sanguine view than many, if only with respect to the margin of safety offered by current prices. More on this later.

Having been a star in the 15 months after the outbreak of the pandemic, **Halfords** shares have pulled steadily back, which belies the strength of its operation and financial health. The cycle and automotive retailer released very good results in June, marginally ahead of forecasts, but investors were spooked by a rebuild of inventory in the bike retail business. The company argues – convincingly in our opinion – that this was a correcting a very low stock position that hampered them when supply chains were constrained during the pandemic. Detractors feel that the timing is wrong ahead of a downturn. The shares are too cheap, but lack a catalyst.

Of greater concern is US tobacco company **Altria**. In June, the US Food & Drug Administration banned the sale of Juul e-cigarette products in the US, arguing teenager affection for their mint vapes is creating a gateway to smoking cigarettes. This has not been proven, and Altria are appealing, but the fact remains that a one-third share in the business bought for $12.8 billion (£10.8bn) has been written down to $1.6bn. Altria's dividend is very valuable – it's high and very well covered – but we don't like its business. The holding is being reviewed.

Outlook

Our first principle of portfolio construction is to balance risk across the portfolio. And although we do back our conviction in tilting our fund in whatever direction is appropriate, we are humble enough to recognise that we cannot predict the future. Our pragmatism reflects this obvious truth.

If everyone is forecasting recession, does this mean that recession is already priced in to share prices? The answer to this question will determine our fortunes in the weeks and months ahead. We continue to own a full suite of financial stocks, because we argue that many of these shares are already pricing in a bad recession, an outcome that we do not believe is certain. Furthermore, this is not 2008: these businesses are very well capitalised and should recover strongly with economic revival. We own commodity stocks because we think it very unwise to be underweight these industries when inflationary pressure exists. Extraordinarily (well, it depends on your view), we are looking at consumer-oriented companies, not because of what they are doing today, but because shares may bounce very hard when investors start looking beyond the inflation peak and wondering what is on the other side. For balance, we still want to own defensive businesses like our pharmaceuticals – we have recently added **AstraZeneca** – and structural winners like BAE Systems, but we are very aware of the price that we are paying for this 'insurance'. Value is its own insurance policy; valuation matters.

Recent Trading: We started to build a new position in AstraZeneca, partly funded by a small sale of Swiss pharma company **Roche**. We added to foundry engineering firm **Vesuvius** and continued to reduce **Jupiter Fund Management**.

Companies seen in June: paper-based packaging supplier **Smurfit Kappa** and Halfords.

Carl Stick
Fund Manager

Alan Dobbie
Fund Manager

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 what you originally invested.

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