Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update October 2022

Behold the fool saith, "Put not all thine eggs in the one basket" — which is but a manner of saying, "Scatter your money and your attention;" but the wise man saith, "Put all your eggs in the one basket and — WATCH THAT BASKET."

Pudd'nhead Wilson's Calendar, Mark Twain

In 1992 Jim Slater, founder of Slater Walter Securities back in the 1960s, published The Zulu Principle: Making Extraordinary Profits from Ordinary Shares.

His central premise was that with focus it did not take an overwhelming amount of time to become expert enough in any particular field to give yourself an edge over most other investors. Of course, there will always be many who are far more expert, but in terms of the general market, application can give you the edge if you are focused enough in your work. It may go against conventional wisdom, but his argument was to concentrate investment efforts into narrow areas of expertise.

Our approach to portfolio construction may differ slightly, in that we choose to be pragmatic and flexible. And we are a team, so can spread ourselves a bit more widely. However, we absolutely concur with the sentiment that just a little extra curiosity, whether that means subscribing to trade journals, or observing marketing and discounting strategies in supermarkets — basically just being nosey — can reap rewards. But more on this later.

Valuation matters

In a chapter entitled Earnings, Growth Rates and the PEG factor, Slater explained a very simple, self-evident concept: the ratio of the price that you pay for a stock to what it earns (the P/E multiple) in relation to the growth of those earnings. This created another formulation: the PEG ratio. So for example, a 100p share in a company generating 10p per share in earnings (so on a 10x P/E) and growing those earnings at 10% a year is on a PEG of 1, and therefore may be considered fair value. If the shares are priced at 6x earnings and growing at 10%, they may be too cheap because the earnings are undervalued (the PEG ratio will be 0.6). Likewise, if they're growing earnings at 16% and priced at just 10x earnings, the growth aspect is undervalued (the PEG ratio is 0.625). If the PEG is above 1, then the stock could be considered overvalued.

Now there are obvious limitations in this very simplistic approach, the clearest of which is that it ignores how indebted a business is. (This is why a more complicated PE calculation, EV/EBITDA, is in reality a more useful tool. Enterprise Value is the 'Price' in the formula, and is the market value of a company's debts and equity minus the cash it holds. Earnings Before Interest, Tax, Depreciation and Amortisation is the 'Earnings', and includes all the income that can be used to pay for a business's capital, regardless of whatever particular mix of debt and equity it may have.) However, the beauty of the PEG ratio is its simplicity.

Over the years since the 2008 global financial crisis and the implementation of overwhelming monetary stimulus in the form of quantitative easing and ultra-low interest rates, the prices that investors were willing to pay for high-growth and/or 'quality' earning streams became increasingly elevated. Consequently, PEG ratios expanded, and any anchorage around a notional fair value of 1 was relinquished because earnings growth traded at a premium when that growth was scarce. This is not to say that growth is now commonplace, but more that investors now need to look in different places. We can choose to accept this prevailing disconnect because the environment of the last 12 or 14 years is in total contrast to the monetary environment that existed through the sixties to the nineties that were Slater's heyday; but this does not deny the relationship that price should have to quality and growth of earnings. And this relationship is not infinitely elastic: it will revert to mean at some point. And because the relationship has become so strained over the past dozen years, when the elastic breaks share prices will react violently. This is what we have seen over the last 18 or so months.

What is even more fascinating is that it is not just expensive stocks that have lost their anchorage, so have dirt-cheap ones. When we start valuing high-growth businesses in terms of revenue growth rather than earnings growth, PEG ratios have no meaning. As we have commented many times over the last year, this willingness to re-write the rules of valuation was really beginning to worry us — we are income and 'value'-oriented investors after all, so maybe we were just frustrated at not being allowed a touch of the ball. But in economically sensitive and cyclical sectors like UK housebuilders, bargain-basement valuations are also inviting volatility. This again should not surprise, as future earnings are made more uncertain by a hostile mix of economic slowdown, increases in mortgage rates combined with a reduction in mortgage availability, and widespread consumer anxiety. With both the 'E' and the 'G' in the PEG ratio impossible to pin down, what's the right 'P'? The difference between paying 5x or 6x earnings represents a 20% difference in the share price before we even start to factor in the uncertainty.

Valuation matters, but these extraordinary times mean that the prices of both value and growth stocks are extremely volatile, as there is deteriorating visibility around the earnings piece of the equation, while growth forecasts are also being revised downward.

Results season

Bearing all this in mind, results season becomes increasingly important. There is little we can do about the market, but there is a lot we can do about the businesses in which we choose to place your capital.

All businesses are facing an array of challenges, and their ability to navigate these treacherous waters is a function of numerous factors. But they are all the factors that we tend to examine within our own risk-based 'Trinity of Risk' framework — the difference now is that the ramifications of a misstep are so much greater. We are wary that a blanket excuse of "supply chain issues" or "increasing cost pressures" is used to hide more deep-seated frailties. So in our meetings with companies, we are interrogating exactly where along the supply chains the stresses are occurring, and sadly the answer tends to be "everywhere". How easy is it to pass on costs? Is labour an issue? Is your product a must-have or a luxury? How is your balance sheet shaping up, and do you have any refinancing due? Are 'defensive' sectors, like consumer staples, truly defensive if customers are choosing to run down inventories? And if these questions just touch the surface of business and financial risks being faced, we also ask ourselves the question: is the share price compensating us for the risks that we are taking? Valuation matters.

Our experience this autumn has generally been an encouraging one, as shown by the performance of our fund over the last three months. Disappointments have tended to be idiosyncratic issues, like High Street lender **NatWest** surprising with a higher forecast for costs in 2023 and larger provisions for potential loan defaults because of the worse economic outlook for the UK, or housebuilder **Persimmon** on increasing its cladding provision. Unsurprisingly, investors are placing less weight on history and more emphasis on outlook statements, even if bland comments citing uncertain economic environments are not a surprise. On balance, our exposure to financials (life assurer **Legal & General**, Nordic insurer **Sampo** and wealth manager **Close Brothers** all had good numbers), industrials (North American construction equipment hire company **Ashtead** and fluid dynamics engineer **IMI** are the standouts) and importantly consumer discretionary names (retailer **Halfords** has yet to report, but its recovery from late-summer lows has been extraordinary) has supported our fund.

Portfolio management demands pragmatism. We tilt our portfolio within the disciplines of our mandate to take advantage of opportunities and mitigate risks, yet we are humble enough to recognise that we cannot imagine the many possible futures that are but an instant away. For this reason, we don't put all our eggs in one basket like Pudd'nhead Wilson. But there is a kernel of truth in Mark Twain's suggestion: you can easily spread your exposure and your attention too far. Individual businesses always spring their own surprises — that is the nature of idiosyncratic risk. Our job therefore, amplified during results season, is to try to understand these risks for the 40-odd companies we own. It's our job to remain curious, to ask questions, and to not accept conventional wisdom. While we have explained that for the moment it is harder to rely on valuation to provide a bullet proof margin of safety (at least in the short-term), we can at least push back by watching our own particular baskets of stocks as vigilantly as we can.

Recent Trading: We decided that the market mood was too weighted towards a very negative inflation consensus, so put into place a small shift in the portfolio towards shares that might play into any vision of an end to the rate cycle. To that end, we added to **Big Yellow Group**, **Dechra Pharmaceuticals**, **Relx** and our newly created position in **Experian**, and established a new holding in contract catering business **Compass Group**. We continued to add to Close Brothers and **B&M European Retail**, trades financed by the exit from **Anheuser-Busch InBev**, and some profit taking from Ashtead, **BP**, **Shell** and **Glencore**. Nothing dramatic, just a touch on the tiller.

Companies seen in October: Close Brothers and Big Yellow Group.

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 what you originally invested.

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