Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Strategic Bond Fund

Quarterly update December 2020

The 10-year gilt yield was roughly flat over the quarter, yet there was a bit of movement during the three months. Starting at 0.23%, it got as high as 0.43% in mid-November before retreating to 0.20% at 31 December.

Credit spreads — the extra return above government bond yields for taking on the risk of default — fell again over the quarter. The iTraxx European investment grade spread index started the period at 59 basis points, it closed on 31 December at 48bps.

	3 months	6 months	1 year	3 years	5 years
Rathbone Strategic Bond Fund	4.31%	6.91%	7.50%	12.91%	30.24%
IA Sterling Strategic Bond Sector	3.64%	5.53%	6.55%	13.53%	28.32%

	31 Dec 19-31 Dec 20	31 Dec 18-31 Dec 19	31 Dec 17-31 Dec 18	31 Dec 16-31 Dec 17	31 Dec 15-31 Dec 16
Rathbone Strategic Bond Fund	7.50%	6.47%	-1.36%	6.34%	8.48%
IA Sterling Strategic Bond Sector	6.55%	9.26%	-2.49%	5.31%	7.33%

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 returns.

Our fund did well in the closing quarter of 2020 because it was light on government bonds that are more sensitive to changes in interest rates, while holding more corporate debt which is more aligned with stock markets and investors' optimism about a 2021 recovery. We had a kicker from our holdings of 'legacy' tier one financial debt. Issued years ago under now-superseded regulatory rules, they aimed to ensure lenders and insurers had enough capital to avoid bankruptcy in times of stress. These bonds tend to pay high coupons and in many cases are now highly inefficient for their issuers. Because of this — and given today's extraordinarily low borrowing costs — many banks and insurers have been offering to buy back these bonds and replace them with new borrowing on more generous terms to bondholders.

For several years now we have been buying up a lot of these legacy bonds because we expected them to be bought back and replaced, as under new regulations they're expected to have equity conversion triggers (these ones don't have them). In October, the European Banking Authority announced that many would have to be replaced by the end of 2021, leading to a surge in demand as investors snapped them up in anticipation. That meant the price jumped, offering us capital gains. Three of our Lloyds bonds were converted into the **Lloyds Banking Group 2.707% Floating Rate 2035**.

A raft of highly viable inoculations were announced in November, helping drive stock markets and corporate bond markets higher. The announcement of Joe Biden as President-Elect was another boost, as many investors decided they liked the idea of a more experienced hand on the tiller. This whirlwind of news pushed the 10-year gilt yield to its quarterly high.

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.

The market reaction seemed disproportionate, so we took advantage of the spike in yields to get buying in areas that we have avoided or kept only small holdings in because we thought prices were too steep. Namely, longer-dated safer government or quasi-government bonds and high-quality corporate bonds that are more sensitive to changes in yields/interest rates ('higher duration'). So when yields spiked (prices fell) we bought the **UK Treasury 1¼% 2041** and **UK Treasury 4.75% 2030**.

Then, when the yield on these bonds fell back in December (prices rose), we sold some of them again. We used that cash to add to our riskier assets. Some of that went towards developing world debt, including the **Ashmore Emerging Market Short Duration**, **Barings Emerging Markets Debt Blended Total Return** and **Ninety One Emerging Markets Local Currency Debt** funds. And some went into higher-risk debt in the developed world through the **Muzinich Americayield**, **BNY Mellon Global Short Duration Short-Dated High Yield Fund** and the **Chenavari Toro Income Fund**, which invests in direct corporate loans and in bundled consumer credit, such as credit card debt.

We believe 2021 could be the year for emerging markets in particular. These nations have, in the main, managed to best shrug off the economic effects of the pandemic. Not only that, but for perhaps the first time ever, developing world central banks have been able to use the same stimulatory tools as developed nations without getting penalised by worried investors. Heading into 2020, emerging market central banks had much higher interest rates than developed, leaving them plenty of room for cutting rates. They have added to that with quantitative easing programmes, which have kept public and corporate borrowing costs sustainable. That should mitigate job losses and boost investment, which bodes well for these regions over the coming years. We will still be watching carefully to ensure this loose monetary environment isn't abused, however.

A very long engagement

Heading into 2021, COVID-19 is still with us. Time scales of recovery have been posed, blown through and re-posed. Now we have viable vaccines, we should be able to push back the virus and return to some normality. However, as always, the crucial question is 'when'.

Mutated strains have become more virulent even as inoculations begin around the world. It really is a race between the virus and health services. We're still optimistic about our ability to defeat the pandemic and move on with our lives. However, we are trying to stay grounded about how swiftly that may occur. Not only that, but this whole episode has shown just how vulnerable our societies (and our commerce) are to epidemics. Hopefully we will learn the lessons of 2020 and ensure we are better able to mitigate the next one that arises.

In the meantime, we're focusing hard on the cash flows and solvency of our investments. Bond investors are always looking at this stuff, because we can only ever lose. You know the total possible return you're getting up front when you buy a bond: the capital and the income payments. You can get some windfalls too, if interest rates move and someone else is willing to pay more than a bond's face value. But in the main we spend our time looking for things that could go wrong, where a company may not be able to repay its debts and how much we're likely to recoup if it does default.

As many countries, including the UK, fall back into lockdown, some businesses will struggle to generate the cash they need to pay their bills and service their debt. The intense fiscal pressure on companies has so far been seen mostly in the retail space and among energy prospectors. Many of these businesses were struggling to stay relevant even before the pandemic. However, apart from a few other exceptions, the massive disruption hasn't driven a commensurate rise in broad measures of company default. Much of this is due to extraordinary levels of support from governments and central banks. While it seems unlikely that this support will be removed anytime soon, the method of the government aid means that things may get harder for some. Interest-free loans will shift to interest-bearing, deferred taxes will finally fall due. You get the picture. So we're trying to think about how this may cause a shake-out, in time, and ensuring we're prepared well in advance.

Despite the gruelling year, we're actually happy with how 2020 went investment-wise. And we're very excited about the prospects for our holdings over the coming years.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

Stuart Chilvers
Assistant Fund Manager

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Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000
Fax 020 7399 0057

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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