Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Ethical 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 Crossover European high yield spread index started the period at 345 basis points, it finished three months later at 243bps.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	4.64%	7.76%	8.94%	18.54%	40.29%
IA UK Sterling Corporate Bond Sector	3.32%	4.92%	7.77%	15.38%	32.23%

	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 Ethical Bond Fund	8.94%	12.27%	-3.08%	10.54%	7.07%
IA UK Sterling Corporate Bond Sector	7.77%	9.49%	-2.22%	5.06%	9.08%

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 Issued years ago under now-superseded regulatory rules, they aimed to ensure lenders and insurers had enough capital to avoid bankruptcy in times of stress.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**. After exchange, this bond price jumped, so we reduced our new outsized position.

Another cheering official announcement came from Chancellor Rishi Sunak. After years of lobbying, pleading and cajoling, the UK will issue its first 'green gilts' next year to coincide with the COP26 climate conference in Glasgow. This will be a symbolic gesture at first — the amount will likely be paltry — but it's a welcome step in the right direction. Money raised by green bonds fund only low-carbon infrastructure projects. The idea behind them is that, once mature, they offer a separate, benchmark lending rate for green projects that should be lower than that for dirty projects, thereby encouraging sustainable investment.

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 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'). We don't invest in gilts because of the government's involvement in arms deals, instead we use sterling-denominated supranational (quasi-government) bonds as an ethical proxy. So when yields spiked (prices fell) we bought supranational **European Investment Bank 5.625% 2032** and **European Investment Bank 4.625% 2054**, senior housing association debt **Guinness Partnership 2% Senior Secured 2055** and **London & Quadrant Housing 2% 2038**, and Danish renewable energy giant **Orsted 4.875% Senior 2032**. Then, when the yield on these bonds fell back in December (prices rose), we sold some of them again.

We used that cash to buy floating rate bonds, whose prices are less sensitive to changes in interest rates/yields because their coupon payments track those changes. These included **Clydesdale Bank 4.3271% Floating Rate Senior 2024**, **TSB Banking Group SONIA Floating Rate 2024** and **Leeds Building Society Floating Rate Senior Secured 2025**.

We have taken this approach many times this year and we are likely to continue with it in 2021: we will carefully add to duration-heavy assets as yields rise and then sell them just as carefully when yields drop.

We did a lot of steady buying across our portfolio over the quarter, as money flowed in from new investors. Much of this cash went into buying more of the bonds that we already hold. Some examples include pensions insurer **Rothesay Life 3.375% Tier 3 2026**, Virgin Money bank holding company **CYBG 4.7% Floating Rate Senior 2026** and **Coventry Building Society 1% Senior 2025**. We also made some new investments, such as Spanish windfarm designer **Audax Renovables 4.2% 2027** and the UK operation of sustainable Dutch bank Triodos **(Triodos Bank UK 4% 2030)**.

We added some bonds that we think should continue to perform well due to greater flexible working and 5G opportunities that are set to bed in once the pandemic is over. These included the sterling-denominated **Verizon Communications 1.125% Senior 2028** and **Verizon Communications 1.875% 2038**, issued by the American telco giant. Also, with more people at home, we think the growth in home deliveries and the investment in distribution will continue. That's why we bought UK big-box retail property company dollar-bond **Prologis 1.25% Senior 2030**. It's also why we bought into the first green bond issued by a UK Real Estate Investment Trust (REIT): **Tritax Big Box REIT 1.5% Senior 2033**. Logistics warehouse company Tritax raised the £250 million from numerous investors to help pay for its pipeline of developments that should be built as best-in-class, sustainable, net-zero-carbon buildings.

In December, we sold **AMP Group Financial Services 6.875% 2022** because we were unhappy with governance of the Australian pension giant. The company had promoted a man to the top job despite knowing of prior inappropriate behaviour towards a colleague. The man has since resigned and returned to his old job within AMP. The chairman resigned as well, along with a fellow non-executive director, yet we believe this incident is evidence that the company has a culture we do not wish to associate with.

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. Many of our investments are helping improve the world, whether through greater development of green energy, by financing ethically minded businesses, or by providing good housing for those in need.

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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