Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update April 2022

If the last couple of years have taught us anything, it's how truly unpredictable is the world in which we live. As investors, there is just one thing that we can control and that is our calculation and assessment of the value of the assets that we choose to hold. Valuation is key.

The wild gyrations of markets grew wilder still in April. The evidence of the last few weeks suggests that the ramifications of generation-busting inflation are finally beginning to hit home. The future, as ever, is wholly uncertain. And economic and market outcomes depend on the aggregation of many huge considerations: the war in Ukraine; the pandemic, especially its resurgence in China; any post-pandemic economic recovery; the world economy's retreat from globalisation and the impact on supply chains; demographic shifts — none of us are getting any younger; government policies and central bank decisions. Who knows what might happen when all these dynamics collide? We reiterate: in the truly unpredictable world in which we live, there is just one thing that investors can control: our calculation and assessment of the value of the assets that we choose to hold on behalf of our unitholders. Valuation is the key.

Did we predict a 'value' resurgence?

In a previous missive, back in November, we had a good old moan (more in frustration than anything else), at a 'sell-side' sage's recent contention that "valuations do not matter". This view supported a bullish thesis promoting a long list of US-listed 'growth' and technology names. It is not for us to dispute the success of this call over (many) previous years even if we do feel tinges of envy at the rewards it has reaped. However, the over-riding investment case that underpins this thesis continues to depend on the identification of persistent revenue growth. And please note that such revenue growth does not necessarily translate into earnings growth or, indeed, even earnings. Nor is there any mention of the kind of 'earnings' multiple that might be appropriate for these growth and tech stocks, but this does not seem to matter in a world in which disinflation is key, money is free, and growth is scarce. Our frustration was fuelled by the lack of references to a world that was changing, even if the war in Ukraine and the inflation spike were unknowns when the bullish call was made. Were we observing a world different to everyone else? What were we missing?

Well, maybe we weren't missing anything after all. Back in May 2020, a press interview was headlined *"Rathbone Income duo eye risk of 'vicious' value resurgence."* At the time, we recoiled at that headline which we felt was far too vehement and definitive a prediction. But the key word in it was *'risk'*. We weren't predicting inflation, but instead highlighting that investors were failing even to countenance it as a possibility. And this was reflected in the values afforded to companies, industries and markets deemed to be part of the 'old world' — investors eschewed commodity plays, and financials were absolutely not de rigueur.

Hindsight is a wonderful thing, 20/20 vision and all that. We now include the headline in our investor presentations.

How may we illustrate this? In the two years since that article was published, the long-maligned FTSE All-Share Index is up 32%, while the share price of Amazon (a COVID play if ever there was one) is down by 7%. For balance, we should highlight that Microsoft's share price is up 43%, but the third of our cherry-picked 'COVID winners', Netflix, is down by a whopping 56%. This is not just a function of the big hit that technology has taken this year. All three pandemic 'winners' underperformed the UK market, and your fund, very substantially in the 12 months after that 2020 headline. No one, not even biased observers like ourselves, would have made that prediction. Think back to how you were probably thinking in May 2020. UK Equity Income was unlikely to be on your mind, yet it turned out to be a better place to be invested than the NASDAQ!

Valuations are important. Let us quote Kate Pettem, the senior analyst on our income team:

"I was once an analyst at a big stockbroker. That's why I can say with absolute certainty that you have to really understand their motivation. A sell-side analyst's job isn't what you imagine it to be. These analysts are not trying to become experts in their chosen industry of coverage and they are not trying to pick stocks that will outperform the market. Their job is to get fund managers to buy and sell shares, and to keep fund managers warmed up in case there is new issue activity.

Netflix is a case in point. Was COVID a game changer? Last summer, three-quarters of the analysts covering the shares thought it was a 'Buy' at $533 with targets of $620-$650, up just over 15-20%. That sort of upside doesn't scream, game changer to me, but the shares did peak at nearly $700 in November last year. By December, as the shares rolled over, how many of the 47 analysts covering the shares downgraded their ratings to 'Hold' or 'Sell'? Only one. The rest just increased their share price targets!

And now? The shares are $173; down 75%. Almost all those buyers in December at just shy of $700 now rate the shares a 'Hold' with a $300 target, +73% from the current price, which sounds like a 'Buy' to me. Confused? Me too."

Valuation does matter

For the Rathbone Income Fund, valuation matters. It's one of our three investment pillars. We spend a lot of time trying to figure out what's 'in' a share price so we can determine if there's an opportunity for us. It's not a case of trying to predict the future, it's a matter of trying to insure ourselves against as many possible futures as we can. It may not sound exciting, but it is what we believe investors in income funds require.

Back in May 2020, inflation was on the minds of very few investors. There were a couple of strategists who were arguing the case for an inflation resurgence, but they were very much outliers. These arguments motivated us to change the portfolio, not because of what we knew with any certainty, but because we recognised that there were outcomes that were being under-priced, under-appreciated and under-investigated.

Today, the future is even more uncertain. The reality is no one has any previous experience of the current environment: the exit from a global pandemic, the war in Ukraine and a return to real interest rates combine to make an extraordinary environment for investors. Inflation, and the interest rates required to combat it, reduce the price multiples at which people want to buy shares; in simple terms, share prices go down in concert with the present value of companies' future earnings.

Recent Trading: Notwithstanding the above, we made no changes in the fund during April. Nevertheless, we are minded to remain flexible in our portfolio management, while anchoring ourselves to a very disciplined valuation approach. So far in May, we have reduced exposure to certain names whose price risk we deem to be inappropriate, while adding to a selection of companies whose growth prospects are no longer priced in or whose cyclical risk is being over-stated. Flexibility opens up opportunities, but valuation is the discipline that underpins our decisions.

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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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