Rathbone Strategic Income Portfolio

Quarterly investment update, April to end June 2022

Rathbones
Look forward

Hot topics – 'Top-down' (market and macroeconomic)

Ebbing power. As Russia's war in Ukraine grinds on, the continued flow of gas to Europe gets ever more precarious. Supplies have already been shut off completely to five smaller nations, while six more (including Eurozone engine rooms France, Germany and Italy) have had their consignments

severely curtailed. Yet more cuts could be on the cards. Ironically, an exceptionally hot summer has led to unseasonably high energy demand because of people cranking up the air-conditioning. European countries – including the UK – have done well finding alternative energy import partners, yet completely reconfiguring your energy complex takes more than a few months. Continental gas prices have shot roughly 60% higher since the end of March. Put another way, the benchmark European gas price is now almost nine times the average price of the past decade. When you get down to brass tacks, energy is key for economic activity. You need people, sure, but without energy you have no technological uplift. Bluntly, it's the difference between you putting together your flatpack furniture with a screwdriver or doing it with a power drill. The extra cost of power – and don't be fooled, natural gas is the keystone of most European power grids, accounting for a quarter of all energy use – will make Europe's potent manufacturing sector less competitive and squeeze its people's wallets, hurting cafes, bars, restaurants and retailers. This is why we're worried about the potential for recession in Europe and the UK this year.

Fixed income foxtrot. Bonds are often thought of as the boring market, yet they have been absolutely wild so far this year. Hopes, dreams and despair have flowed through yields as investors flick from fear to optimism and on to different concerns in a restless foxtrot. This has been happening week to week and often day to day. The three broad scenarios swirling round are: the risk that inflation lingers higher and longer than anyone wants; that higher costs crimp the spending of households and businesses, causing a recession; and the gold-toothed rooster itself – that inflation fades quickly allowing central banks to slow their interest rate hikes. Ten-year government bond yields, on both sides of the Atlantic, have fallen back about 50 basis points or more from their mid-June peak after a series of worrying economic data. The yield drop was more pronounced in Europe and the UK, because of the recession risk we noted before. Even after the pullback in yields, we think investors are assuming too many rate hikes over the coming months. The global economy seems just too fragile for the phenomenal tightening that markets are implying. Because

of this, we think bond yields are finally starting to look attractive again. The inverse relationship between bond and stock markets is starting to reassert itself, which makes them much more helpful for portfolio diversification.

Earning respect. As for stock markets, the upcoming earnings season will be more revealing than ever. With the wider

economy a whodunnit and nerves running high about how central banks will proceed, investors are eager to hear how companies are feeling. The probability of recession has risen significantly so far this year, and cost pressures for businesses are high because of rampant inflation… yet earnings forecasts haven't dipped at all. Consensus profit estimates from analysts are pretty high, given the circumstances, yet it seems like investors themselves are expecting disappointments. Outlooks will be watched closely for signs of impending disaster (even small, cautious asides tend to cause punchy falls these days). We think the reported results will differ markedly company by company, as will the commentary around what the future may bring. It will no doubt be another volatile period, one that we hope will throw up some opportunities to take profits and add to quality companies at a discount.

Portfolio activity

Key purchases/additions	Key sales/trims
Co-operative Group 11% Subordinated 2025 (new purchase)	iShares Core FTSE 100 ETF (sale)
UK Treasury 4 ¼% 2027 (addition)	Ashmore Emerging Markets Short Duration Fund (sale)
HSBC Capital Funding 5.844% Variable Perpetual-2031 (addition)	Shell (trim)
SSE 8.375% 2028 (addition)	National Grid (trim)
Barings Emerging Markets Debt Blended Total Return Fund (addition)	

Source: Rathbones

We took advantage of large falls in the price of bonds to buy several deeply discounted bonds that we felt were overexaggerating the chances of default for some solid companies. We added to our five-year gilts as yields rose by purchasing the **UK Treasury 4¼% 2027**. We also bought credit, including supermarket **Co-operative Group 11% Subordinated 2025**, insurer **Saga 5.5% Senior 2026**, energy giant **SSE 8.375% 2028**, lender **HSBC Capital Funding 5.844% Variable Perpetual-2031** and UK pub company **Punch Finance 6.125% Senior 2026** bonds, along with the **Invesco US High Yield Fallen Angels ETF**.

We added a lot of corporate debt as spreads widened, across a range of short and medium-term maturities and different credit qualities. This included the **SSE 8.375% 2028**, **HSBC 5.844% Variable Perpetual-2031**, **Heathrow Funding 7.125% 2024** and **Just Group 7% Subordinated 2031**.

We switched our developing world bond exposure from the **Ashmore Emerging Markets Short Duration Fund** to the **Barings Emerging Markets Debt Blended Total Return Fund**. The Barings fund is more flexible, with the ability to buy local currency bonds, actively manage duration, and take long and short positions in the fund. We also reduced our exposure to British stocks over the quarter by selling the **iShares Core FTSE 100 ETF**.

We frequently use options and structured products to build protection into our portfolio. Options are tradable contracts with investment banks that give us the right to 'buy' (calls) or 'sell' (puts) at a certain value of an index which has the effect of limiting our exposure to market fluctuations. Structured products work in a similar way, except they are more like contracts that pay out gains in set situations and lose money in others. When stock market volatility is high, the value of these sorts of assets increases, making it more expensive to buy more of them. Because of the recent elevated volatility, we thought a straight replacement of our recently matured vanilla **S&P 500 put option** was too pricey. We still wanted the protection, however, and we felt a 'put spread' was a cost-effective option. This is cheaper yet only protects us if markets drop between 5% and 25%. Given how far markets have already fallen, we felt this was a reasonable risk to take.

Spotlight

In this quarter, the spotlight is on our **Discover Financial Services** and **Home Depot**.

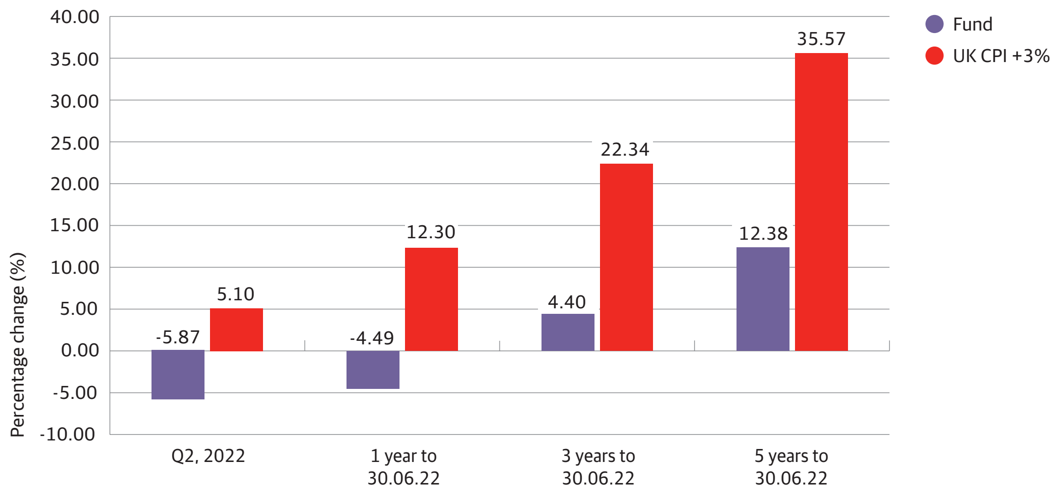
Discover Financial Services

- Loans, credit cards and payment services business (owns Diners Club International) – one of the largest credit card companies in the US and aims to be the top card in their customer's wallet
- Typical customer has a good credit score, above average income, and is a property owner – they actively target high quality customers rather than sub-prime, and approach which we believe offers more resilience during economic downturns
- Customer service is a key focus for the business – mostly online with highly rated apps, people answering phones rather than machines, innovative, and a well-recognised brand
- Average customer has been with them for around 12 years – service focus helps foster loyalty
- Focuses on customer experience, innovation, and employee satisfaction has led to numerous awards and leaves the business well positioned to continue to benefit from the strength of the US consumer

Home Depot

- The US home improvement business that services both retail and trade (Pro) – they are the world's largest home improvement retailer and the second largest retailer in the US
- Much time, effort, and money has been spent on strategic projects to improve the customer experience in both retail and trade channels – this work is vital in securing Home Depot's position in the face of competition from physical and ecommerce competitors
- In their "Pro" channel, which accounts for around half of sales, the company has vastly improved its capabilities around loyalty programmes and personalised service, a drive which has allowed them to focus on more planned purchases rather than unplanned, which had previously been where they were used most in the "Pro" channel
- Where Home Depot's customer focus in retail can be seen the best in via their app which not only allows you to look for products, but when in store can be used to scan barcodes for more product information, has a geo-location feature which will tell you exactly where a product is for those quick purchases when you want to be in and out, and has an augmented realty (AR) function so customers can see what those new taps would look like on their sink
- For Home Depot, the customer is king and this focus on making the shopping experience more efficient, more personalised, and more seamless is why we believe they can continue to be a leader for many years to come

Fund performance



Performance (based on 'S-class' shares).
Net of expenses and tax. Net income reinvested.

Data source: FE fundinfo

Discrete annual performance

Year to:	End Jun 2018	End Jun 2019	End Jun 2020	End Jun 2021	End Jun 2022
Fund	+2.69%	+4.82%	-2.95%	+12.62%	-4.49%
UK CPI +3%	+5.49%	+5.04%	+3.56%	+5.19%	+12.30%

Price performance based upon bid to bid prior to 21 January 2019 and single price (mid) thereafter. 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 your original investment.

Our benchmarks are calculated on the rate of change of the CPI index, over different time periods (e.g. if we were calculating year to date figures in January 2021, we would look at the percentage change from December 2020 to the end of January 2021). So we take CPI to the current value, and add on 3%, prorated over a year (roughly 0.25% per month). If the CPI Index benchmark were to fall, more than the amount pro-rata, the benchmark year-to-date will be negative, even though inflation as reported by the media (calculated specifically as a 12M rate of change), remains positive.

Top performers (%)

Holding	Performance	Contribution
AIA	+13.10	+0.09
Total	+12.91	+0.16
Coca Cola	+10.77	+0.11
WEC Energy	+10.08	+0.11
Amgen	+9.94	+0.09

Bottom performers (%)

Holding	Performance	Contribution
Amazon	-29.36	-0.19
Ashtead	-28.81	-0.21
HG Capital Trust	-24.01	-0.25
ASML	-23.31	-0.15
Siemens	-20.49	-0.11

Note: Top and bottom performers are taken from the list of all holdings of 0.25% and above of the portfolio.
Performance and contribution data shown above is based on unhedged GBP capital returns.

Source: Rathbones

As the second quarter of 2022 proceeded, we began to see a little less of the commodity-centric and value-based performance from markets that was characteristic of the first quarter of the year. Instead that environment gave way to a broader risk-off sentiment that began to impact all risk assets as investors seemingly began to move to price in the increased risk of recession. Some of our protective assets within the Diversifiers component of the fund helped during the quarter, with the **US rates volatility note** again benefitting from additional volatility in US rates and making a meaningful positive contribution to fund level returns. Our **Nasdaq put option** which expired in late April also provided support in the early part of the quarter and expired slightly in the money (index price below the strike on the put option).

Again, our holdings in **Shell**, **BP**, and **Total** contributed positively along with our **commodity ETF** exposure, but to a far lesser degree than in the first quarter. We also had some support from more defensive names such as **WEC Energy**, **GSK**, and **Coca Cola**.

Fund performance (continued)

Given the falls in equity markets it is of course no surprise that equities overall were the largest performance detractor. US equities were again the largest detractor, but it was Japanese equities which fell the most during the period after a particularly weak quarter for Japanese equities as a whole. Weakness from the likes of **Amazon**, **Alphabet**, and **Aptiv** also drove some meaningful negative contributions. After a steady start to the year, we also saw a negative contribution from **HG Capital**, a Private Equity investment trust focused predominantly on the technology space in the US and Europe. As the weakness in public equity markets began to bleed across into private markets during the quarter, we saw a number of names in this space experience meaningful falls and have somewhat of a catch up with what we have seen from public equity markets so far in 2022.

Asset allocation ranges

Liquidity	Equity-type risk	Diversifiers
5% to 40%	40% to 80%	0% to 40%

Asset allocation change and strategy

We cut our UK equity exposure, using the proceeds to increase our allocation to high yield bonds and UK and overseas government bonds.

Asset allocation split	31.03.22	30.06.22	% Change	12 month change
Liquid assets	22.19%	26.42%	4.23%	6.04%
Equity-type risk	74.32%	69.94%	-4.38%	-5.18%
Diversifiers	3.49%	3.64%	0.15%	-0.86%
	100.00%	100.00%		

Asset class split	31.03.22	30.06.22	% Change	12 month change
Equities	59.95%	52.38%	-7.57%	-7.60%
Index-linked bonds	0.00%	0.00%	0.00%	0.00%
Conventional government bonds	11.65%	12.49%	0.84%	2.90%
Corporate bonds	21.59%	25.02%	3.43%	3.14%
Emerging market debt	2.87%	2.74%	-0.13%	-1.37%
Private equity	1.06%	0.81%	-0.25%	-0.14%
Alternative investment strategies	1.34%	1.61%	0.27%	-0.79%
Property	0.00%	0.00%	0.00%	0.00%
Commodities	0.00%	0.00%	0.00%	0.00%
Cash	1.54%	4.95%	3.41%	3.86%
	100.00%	100.00%		

For more information on our liquidity, equity-type risk and diversifiers (LED) risk framework, please consult our investor brochure.

Investment outlook

Weak sentiment surveys – from households through to businesses and investors – have combined with disappointing retail sales and Purchasing Managers' Index (PMI) readings to renew worries about a global slowdown. The cost of living has skyrocketed all over the world, pinching many people's spending power. Meanwhile rapid rises in the cost of labour and raw materials have tripped up more than a few companies reporting earnings.

Still, these concerns clash with the sugar rush from reopening, driven by pent-up savings and boredom. At least for now, to paraphrase Cyndi Lauper, many people still seem to want to have fun. Flights are full again, and restaurants and pubs seem to be doing alright. But the question is how quickly people may rein in spending as the summer of high prices rolls on. Wages are rising though, which could offset some of the effects and support spending.

We're feeling better about the prospects for the US, rather than Europe and the UK, where the Ukraine war and upended energy markets are having a greater impact. This year has been a painful one for holders of US companies, yet we remain comfortable with our exposure to these businesses and have added steadily to them throughout the quarter's drawdowns.

Meanwhile, it's bye bye for Boris Johnson after one scandal too many. The Prime Minister's widespread popularity with voters gave him more lives than a pack of cats, yet the final straw was two crushing by-election defeats: one in the 'Red Wall' that he had three years ago delivered to his party and the other in a supposedly safe seat won by roughly 20,000 votes in each of the past three elections. Like clockwork another booze-fuelled scandal appeared for the government, giving 50 ministers and appointees the excuse to resign. Johnson finally decided to go himself, sparking another monkey knife fight for the leader of the Conservatives and the keys to Number 10.

The effect of Johnson's resignation on the UK market and sterling shouldn't be overstated. Given the government's poor polling and the recent by-election defeats, together with the cost-of-living crisis, the Conservatives are highly unlikely to hold a general election until they absolutely have to – likely in January 2025 because of The Dissolution and Calling of Parliament Act. So this will simply be a case of swapping one Conservative leader for another.

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Rathbones
Look forward

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