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Rathbones
Look forward

Rathbone Income Fund

Monthly update July 2022

Conviction is a quality that is generally rated very highly. We may not agree with an opinion, but we can still recognise — and even applaud — the conviction with which it is held. Conversely, a more balanced view that weighs up pros and cons, hedges various bets or (heaven forbid!) even sits on the fence, often seems less enticing. At worst, it smacks of a lack of commitment. Suffice to say, we disagree… maybe.

What if conviction turns out to be stultifying, a stasis, a failure to recognise that the world has moved on? We're all at risk of falling into this hole. Look at any investment that's performed badly and the investor will come out with an argument as to why they will ultimately be vindicated and the market is dead wrong. The problem with conviction is that, over time, it rusts. What was once a carefully researched argument can easily get whittled away to a few bullet points and soundbites to be trotted out on demand at client meetings or in interviews. The pitch is well-honed, but the argument is stuck in place, taking no notice of the passing time. Conviction becomes the polished repetition of a persuasive narrative that, if you're not careful, becomes increasingly detached from reality. Businesses change. Good and bad decisions are made. Competitive environments evolve and regulators and governments have a tendency to wade in. You know: life and events get in the way of the story.

Now, we're not suggesting that fund managers *never* change their views. Of course they do. However, we recognise (and we are just as guilty on this front as anyone else) that it's all too easy to get carried away with a great narrative and fail to spot the frailties within a particular argument that may emerge over time.

Pragmatism doesn't seem quite so exciting. Balancing risk across a portfolio is a sensible investment strategy, but it can be hard to classify a fund that favours such an approach. Is it 'value' or 'growth' oriented? Does it tilt towards large or mid-caps? Does it dismiss heavy industry in favour of asset-light business models, like technology or media?

But pragmatism — an intention to continually measure portfolio risks, combined with a willingness to employ maximum flexibility when choosing investments — does not dull conviction. Instead, it can prove a very powerful creative force. It encourages you to keep thinking of alternative paths or to revisit ideas that they may once have been cast aside.

Pariah or cash machine?

Of all the British banks that epitomised the industry's calamitous fall from grace during the Global Financial Crisis, **Royal Bank of Scotland** (RBS) was possibly the most infamous. We owned it back then (its rapidly growing dividend was the draw). But when the crisis hit, RBS's aggressive acquisition of ABN Amro as part of a consortium aggravated the bank's financial frailty and the shares came crashing down. We got out well before the bottom, but owning RBS really hurt. Could we ever go back?

Early in 2020, RBS began to be rebrand as NatWest. We bought the shares in May 2020, at the height of the pandemic panic. We did so primarily because we felt that the world simply had no concept of any inflation at all entering the financial system, and that holding banks was a way to meld attractive value with an inflation hedge. We took some convincing of the argument: our RBS scars ran deep. But we also recognised that the UK banking sector now had much more stable foundations after 10 years of tighter regulation.

In late July, **NatWest** rewarded investors with an outstanding set of interim results. Although there are clearly worries about the future health of the UK economy, loan impairments remain low and RBS's profits are high because the full increase in base rates is not being passed through to savers. The real standouts in NatWest's trading statement were its upgraded guidance on future revenues and earnings, and its substantial return of cash to shareholders. There is huge potential for banks to generate cash over the short to medium term, irrespective of darkening economic clouds. This is because, after years of most banks consistently destroying value, they are now creating value once again. What has changed? Valuations within the sector remain low: NatWest trades at 0.9x its tangible net asset value (i.e. its assets less its debts with derivatives, goodwill, intellectual property and other accounting values stripped out). Meanwhile, it has upgraded its forecast return on tangible equity to 14%-16% from its previous "comfortably above 10%". As a simplistic rule of thumb, a 10% return might justify a share price equal to the tangible net asset value, so its upgraded guidance offers a substantial margin of safety. And then, of course, there's its dividend and special dividend on top, representing an 8% return on a 250p share price.

NatWest is a high conviction hold in our fund. But we got there by being prepared to be contrarian two years ago and asking, "What if inflation returns?" Our decision to buy the shares was driven as much by a desire to balance risk across our overall portfolio as by a wholehearted belief in the business. The latter came along later.

But (and there's always a but) our confidence in the shares must be tempered by the fact that banks are massively complex businesses. NatWest is a very different beast to the RBS of yesteryear, but that must not fuel complacency. Of course, we should let our winners run when appropriate, but our job as fund managers is to hold back on any congratulatory backslapping and to keep alert to any potential changes in the reality undermining the narrative. Getting too comfortable is dangerous; pragmatic portfolio management is creative.

Recent trading: Our major trade this month was exiting **GlaxoSmithKline** ahead of the spin-off of its consumer health business as **Haleon** and reinvesting the proceeds into **AstraZeneca**. We also sold a small residual position in **Jupiter Asset Management**. We trimmed distribution business **DCC**, and created two new holdings: global credit and marketing services business **Experian** and discount retailer **B&M European Value Retail**.

Companies seen in the month: Haleon, **BAE Systems**, and **Reckitt Benckiser**.

Carl Stick
Fund Manager

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Fund Manager

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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