Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update August 2022

The UK stock market marches to a different beat to many other markets. Over recent years this has too often been viewed as a negative. This year, with a new macroeconomic backdrop, the benefit of having exposure to UK stocks as part of a diversified portfolio is very clear.

We are not unbiased commentators on the attractions of the UK Equity Income sector — it is our business to bang the drum for what we do, the fund that we run, and our relevance in the investment world. But this business has been challenging over the last few years. In conversation, there has been the persistent refrain that the UK economy and its politics are broken, just one argument among many against investing in the sector that doesn't offer the high-growth, high-tech attractions of other markets. While we may not agree, we do understand the motivations, and recognise the frailties in the UK market that led to many years of underperformance. We get it.

But… the UK market has a been a lucrative place to invest over the last two and a half years and has been particularly resilient in 2022. The FTSE 100 is a real bright spot globally. We must remember, the UK market is not the same as the UK economy, or the political scene. Cheap valuations, poor sentiment and a rapidly changing global economic environment have all helped the blue-chip UK index. As has a strengthening dollar, which has increased the sterling value of the roughly 80% of revenues earned outside of the UK. Energy and mining stocks have supported returns, with rising commodity prices feeding through to increased profitability, dividends and share repurchases. Banks, for many years deemed almost un-investable, have also flexed balance sheet strength that was built up in the decade or so since the global financial crisis. We have been rewarded with strong absolute performance, and a second year of robust dividend recovery. We will give more detail on this in our quarterly report next month, but we do intend to post another meaningful increase, which will go a good way to offsetting inflationary pressures.

If markets are changing — if new inflation and interest rate expectations are beginning to be baked in for the longer term (a big if, we admit) — investors must start thinking differently. We believe that eyes will begin to open further to the opportunities available in the UK market, as a function of both the value on offer (important if rates rise and the present value of future profits comes down) and the industries that dominate the FTSE 100. We have certainly prospered in 2022 by maintaining our exposure to the UK mining, energy and banking sectors, in terms of both share price performance and total returns. Put another way, not owning these shares would have had a hugely detrimental effect on portfolio returns, such has been the divergent impact these sectors have had on performance. Contrary to some opinions at the start of the year, you had to own these businesses.

An unusual paradox

However, we are challenged by an unusual paradox, in that the areas that we deem worthy of our attention right now seem to be split into two categories: cheap 'growth' and cheap 'cyclicals'. This reflects the uncertainties that still prevail.

Within our cheap growth bucket, we have this year bought a holding in specialist retailer **Games Workshop**, manufacturer and purveyor of miniature wargame figures, with brands such as Warhammer, admittedly a niche interest, but a hugely loyal and increasingly international customer base. We have latterly added to **Dechra Pharmaceuticals**, the veterinary business that has been a mainstay of our fund for 20 years, which is further expanding into the US with two acquisitions made in the summer. Both of these businesses represent unique growth opportunities that have been de-rated since the start of the year to levels that make them attractive to income investors.

On the other hand, cheap cyclicality offers up a different opportunity set. Here we are looking beyond the headline sectors of the main index to great businesses that are exposed to economic cycles, but are important and differentiated enough to give us comfort as the strains begin to show in global economies. This is the opportunity when markets eventually recover, especially if too much gloom is currently priced in. So, in this area we have been encouraged to add to businesses as diverse as paper and packaging company **Smurfit Kappa**, **Ashtead Group**, the equipment hire business focused predominantly on the US market, and **Vesuvius**. Vesuvius is a ceramics business whose products are used in the steel industry — mission-critical technology that is crucial in managing the flow of molten metal. This is heavy industry, and very capital intensive, so at risk to economic slowdown. However, Vesuvius has continued to operate very well in its particular niche this year, and, in our opinion, market expectations around the broader industry are so negative that there's plenty of room for upside surprise. Vesuvius is still only a small position for us, but it is a valuable diversifier in our portfolio, and exemplifies the opportunity to do something different in the UK market.

Valuation matters

Ari Wallach is an American 'futurist', founder of an enterprise called Longpath, and currently doing the podcast circuit, unsurprisingly promoting a book. According to Wikipedia, Longpath is an "initiative fostering long-term thinking and behaviour in the individual, organisational, and societal realm." Wallach's general theme is that we need to have a much longer view of time when considering our behaviour, being informed by the past, but thinking way beyond the present when making decisions or actions. For example, how different would politics be if the protagonists and voters were motivated beyond the next election cycle? How different would commerce be if CEOs were not distracted by the next quarter's numbers, and really focused on long-term strategy, impervious to short-term market reaction? Wallach argues for the understanding of considerations with ramifications tens, hundreds, even thousands of years down the road.

His message is one of compounding returns. The actions you take today influence what happens tomorrow, and the next day, and the next. It's a bit like chaos theory – or put it another way, a smile and a good morning can have a domino effect through the day, and who knows what good that does. Trillions of daily interactions and decisions, all compounding on each other, create an infinity of possible futures, yet we have a tendency to try to predict the future, even if all we can really do is have the softest of hands on the tiller. As investors we read research reports entitled 'the future of energy', 'the future of agriculture', 'the future of tech', etc, etc, as if we can predict the future of anything. Rather, **the** future is just one outcome of an infinite number.

We press this point all the time, but humility in the face of this reality is the reason why valuation matters. The more expensive the price of a share in a business, the more weight you are placing on a limited number of very specific futures. Couched behind arguments like, 'it's only revenue growth that matters,' or, 'that's the growth algorithm,' is a reliance on many things going right over many years. But what if the world contrives against this future? What if we don't know what lurks around the corner? COVID-19? War? A vaccine? A price cap on energy? Regulation, or a helping hand? But the lower the price risk, the cheaper the stock in relation to the quality of the business, the greater the number of possible futures that may benefit your investment. This is a way of understanding what a margin of safety means, and we believe it always needs to be at the core of any investment strategy, irrespective of style or asset class. Valuation matters.

Recent Trading: We have trimmed **Rio Tinto** and have added to **B&M European Retail** and Vesuvius.

Companies seen in the month: IMI.

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