Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Income Fund

Quarterly update September 2023

Quiet summers now seem to be a thing of the past. The lazy holiday weeks at the end of July and the beginning of August of yesteryear are now dominated by wave upon wave of companies reporting their mid-year results. The view in the rear-view mirror has proved broadly positive: it's the outlook that's more troublesome. This is hardly a surprise. Fifteen years after central banks were forced to intervene to prop up financial markets following the collapse of Lehman Brothers, they are still dominating financial headlines. The fight against inflation, the shape of the yield curve, the risk of a policy mistake, the likelihood of a recession, levels of employment and wages are the many pressing challenges confronting the UK, Europe and the US, and indeed further afield. No wonder so few companies are willing to admit unequivocal confidence in the future.

Performance review

In the second quarter, we managed to outperform a weak market. The tables were turned last quarter as we lagged a market that recovered through the summer. The net result is that relative performance across all time periods is very tight, but we remain satisfied with the absolute numbers we've achieved during a period of intense political and economic volatility. Indeed, the UK market has performed very well over the last three years — an outcome that we continue to trumpet with enthusiasm, but a message still ignored by many.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	1.6%	0.6%	14.0%	39.8%	18.3%
IA UK Equity Income Sector	2.4%	0.6%	13.6%	38.0%	14.0%
FTSE All-Share Index	1.9%	1.4%	13.8%	39.8%	19.7%

	30 Sep 22-30 Sep 23	30 Sep 21-30 Sep 22	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19
Rathbone Income Fund	14.0%	-5.3%	29.4%	-17.5%	2.5%
IA UK Equity Income Sector	13.6%	-8.5%	32.7%	-17.2%	-0.2%
FTSE All-Share Index	13.8%	-4.0%	27.9%	-16.6%	2.7%

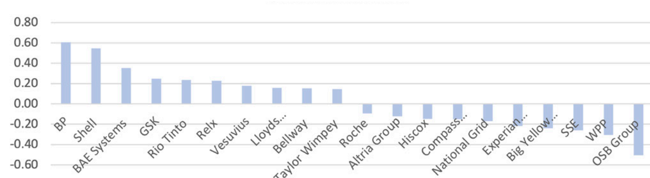
Source: FE Analytics; data to 30 September, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future returns.

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.

We've gotten used to the ebbs and flows of the market, and, as ever, we are motivated more by the long-term health of our businesses rather than any short-term fluctuations in market sentiment, a discipline that's crucial when uncertainties are heightened. Many of the share price movements we see in any quarter are as much about exogenous macro events as company specifics, and we must be careful not to exaggerate any self-congratulation or self-criticism as a consequence. But results season is important, if only to refocus our minds on the key strategies being employed and how managements are dealing with the dynamic challenges they face. We fall back on our key disciplines, and our business, financial and price 'trinity of risk' (which we explain more fully here).

Q3 stock contributions



Source: StatPro; Rathbones

The two largest contributors to performance are **BP** and **Shell**. The shares performed well last quarter and they're large positions within the fund. We never try to predict the future: we just have a view which we humbly accept may well be wrong. That said, we expect the oil price, while fluctuating on account of the economic cycles at play, to remain stubbornly high. We attribute this view to three principal factors: geopolitical risk; price discipline by key suppliers such as OPEC; and a reduction in capital expenditure on the back of the net-zero agenda, implying structural supply constraints trumping any deterioration in demand. The price of oil jumped in the quarter (from a low at the start of July of $74.65 a barrel, Brent peaked at $96.55, just before the period-end), a leap which was reflected in the shares of the oil majors. And this benefited our fund.

But the story is much more complex than this. We think the shares are cheap, they pay good dividends, and they're an important part of the index, so we own big positions. However, our fundamental analysis is less straightforward. Our analysis of business risk centres on how management allocates 'our' capital. And the arguments surrounding investment in renewables versus fossil fuels have become hugely more complicated in this world of flip-flopping government policy and the heightened importance of energy security. We remain constructive on the sector and are appreciative of the performance generated in the last three months, but we also understand the difficulties in getting this one right.

BAE Systems affords us another set of challenges. This is a good business that has been run very well over the last few years, with a laser focus on operational efficiency and cash management. They have been good stewards of our capital. The tragic war in Ukraine has reminded nation states about the importance of their own security, implying they'll spend more on defence in future. This substantial tailwind has propelled BAE Systems' shares forward over the last couple of years. They recently announced the acquisition of Ball Aerospace, an American manufacturer of spacecraft, components and instruments for national defence, civil space and commercial space applications, in a deal worth $5.6bn. Strategically, the deal makes sense and it reflects management confidence in the future. But it's a big acquisition, which will take up substantial management time as well as money, and they did pay a full price. BAE Systems' shares have done well, suggesting the market is not concerned by these challenges, but we are just a little bit. We've slightly trimmed our position.

Elsewhere on the positive side of the equation, pharmaceutical group **GSK** has continued to trickle out good news (we've discussed our advocacy of the healthcare sector in previous letters). It is also interesting to note the positive contribution from two of our housebuilders, **Bellway** and **Taylor Wimpey**. Despite the general feeling of unease around the UK housing market as mortgage costs have been rising, the shares have held up well. Indeed, both are up strongly year-to-date, easily beating the FTSE All Share index. This suggests investors are beginning to look beyond peak rates, and perhaps also hoping the industry will get more political help given upcoming elections.

Among the laggards, **OSB Group** highlights the ever-present possibility of a nasty surprise. OSB provides lending to the professional buy-to-let market. In brief, they calculate the worth of a mortgage based upon the term of the fixed rate and the length of time they expect customers to stay on the standard variable rate before refixing. The rapid rise in rates has meant that more customers have refixed earlier than they might otherwise have done, impacting the profits they traditionally make on any delay. In hindsight, they might have spotted that this sudden change might happen earlier, but that is easy to say now. Fortunately, OSB has ample capital and has generated enough earnings to continue to pay a dividend while also buying back shares. The dip in OSB's profitability is frustrating and provides a salutary reminder of our repeated affirmation that valuation matters, especially if things go awry. There are after all many 'unknown unknowns' out there.

WPP's shares have performed badly in 2023, a drift lower exacerbated by disappointing interim results. This media conglomerate benefits from robust economic strength and business confidence feeding into healthy advertising and marketing spend, and the shares had recovered well from last year's lows into the new year. However, growth in the US was impacted by lower spending from technology clients and some delays in technology-related projects. It has warned that things probably won't improve in the second half of the year. The shares are cheap in our opinion but are likely to remain so for a little while, which is informing our position sizing.

Elsewhere, our big utility holdings **SSE** and **National Grid** were impacted by the lessening positive sentiment around net zero. Nevertheless, they remain core holdings, as do the other shares that have trailed during the quarter.

Outlook

October is an anxious month for investors (for some, the scars of 19 October 1987, AKA Black Monday, run deep). So it's concerning that investor confidence is beginning to wane. Now, the extent to which that confidence is justified is certainly up for debate – the S&P 500 has been driven higher by a diminishing coterie of high-tech giants, the 'Magnificent Seven', while the remainder of the market has lagged. It's inevitable that investors have crowded into these names, just trying to protect relative performance, and valuations tend to matter less when you *have* to own a stock, whatever the cost. However, this doesn't belie the fact that the S&P 500 is an expensive stock market.

The paradoxes now at play heighten the risks ahead. The assumption is that the Federal Reserve engineers a soft landing for the US economy, but that does not negate the possibility of a recession. Yet US earnings estimates for the next 12 months remain close to record highs. It's quite a leap of faith to expect earnings to keep growing in a recession. If optimistic forecasts fail to materialise, we could have a caustic mix of lowered numbers combined with lower ratings – which makes sense if growth is less. Inflationary pressures do seem to be dissipating, and yet the bond market is being pummelled, especially ten-year US Treasuries, a sure sign that the fixed income market is pricing in a recession. It's unusual to see equity and bond markets at such variance – either bond yields need to fall to justify equity valuations, or equities need to fall to reflect what the bond market is saying.

Is the UK different? No, to the extent that where the US goes, the rest of the world tends to follow. However, with UK valuations so low, we do have more than a fighting chance of outperformance because of where were starting from. We may assume a recession is coming but hold out hope that the British version is mild. A shambolic political environment augurs greater volatility ahead of a general election, but the flipside is we may have reached peak rates. What happens when we crest that particular hill? The lagged effect of all the tightening over the last 18 months or so remains to be seen, but we repeat, lowly valuations do provide a modicum of protection. It's better starting from this low in the value scale if things get gnarly.

Our positioning reflects our caution. There's value in commodity stocks, but they're economically very sensitive – we prefer the oil majors to the miners but are underweight both. Financials are also cheap, but the bond markets worry us, and we are happy to have lightened the load. Fingers crossed that the UK consumer gets through all this, so we have been warming up a few specific retail names – cut-price retailer **B&M** is our favoured play now – and we're hoping that our housebuilders continue to improve in 2024. We have been adding to our staffers – early in the year **Page Group**, more recently **Hays** – and we have been adding to online trading platform **IG Group** and computer services provider **Computacenter**. If these are aggressive moves, we have also been playing defence, adding to our healthcare exposure, again as detailed in previous letters, and increasing our exposure to **Unilever**, all 'defensive' areas with greater earnings security and visibility. We recognise that major uncertainties lie ahead and therefore want to balance our bets between more 'cyclical' and more 'defensive' stocks.

One final word on dividends

We should mention that at the end of this quarter we went 'ex-' our final distribution. We hope to pay an estimated 28.83p per unit (Institutional, Inc.), an increase of 6.8% on the same period last year. This would also lead to a total distribution for the year of 43.83p, an increase of 4.8%. Our ambition is to give a real pay rise every year; this year we are marginally short, but we hope that the increase will be seen as evidence of a suitably conservative approach to capital preservation and growth in a particularly challenging environment. We explain here why we believe that the investment case for UK equity income, given its potential to increase income payments meaningfully over the medium to long term, is as strong as ever.

Carl Stick
Fund Manager

Alan Dobbie
Fund Manager

Rathbone Income Fund

If you require further clarification on this commentary, then please contact your adviser or Rathbones at the contact details below.

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.

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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