Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Update September 2018

I was dreamin' when I wrote this, forgive me if it goes astray,
But when I woke up this mornin', could've sworn it was judgment day,
The sky was all purple, there were people runnin' everywhere,
Tryin' to run from the destruction, you know I didn't even care,
Say say two thousand zero zero party over, oops, out of time,
So tonight I'm gonna party like it's nineteen ninety-nine.
Prince, 1999

Only time will tell whether 2018 or 2019 – or neither – will prove to be pivotal years in market history.

Perhaps we worry too much; indeed, many say the equity steam train will continue to career further down the tracks. On the other hand, our gut feel is that, despite resilience in the US domestic economy delivered by tax breaks and increased share buy backs that are supporting asset prices, the drag of higher tariffs, louder whispers of slowdown in China and the inevitable repercussion of limited corporate investment over many years, will come back to bite. It’s the timing that is unknowable.

Our remit is to grow income, generate good total returns and preserve income over the cycle, through investment in equities. This is constant regardless of market conditions. With this in mind, our caution was premature at the start of 2017, but looks more valid in 2018. Let’s just hope that the world’s not preparing for an almighty collective hangover.

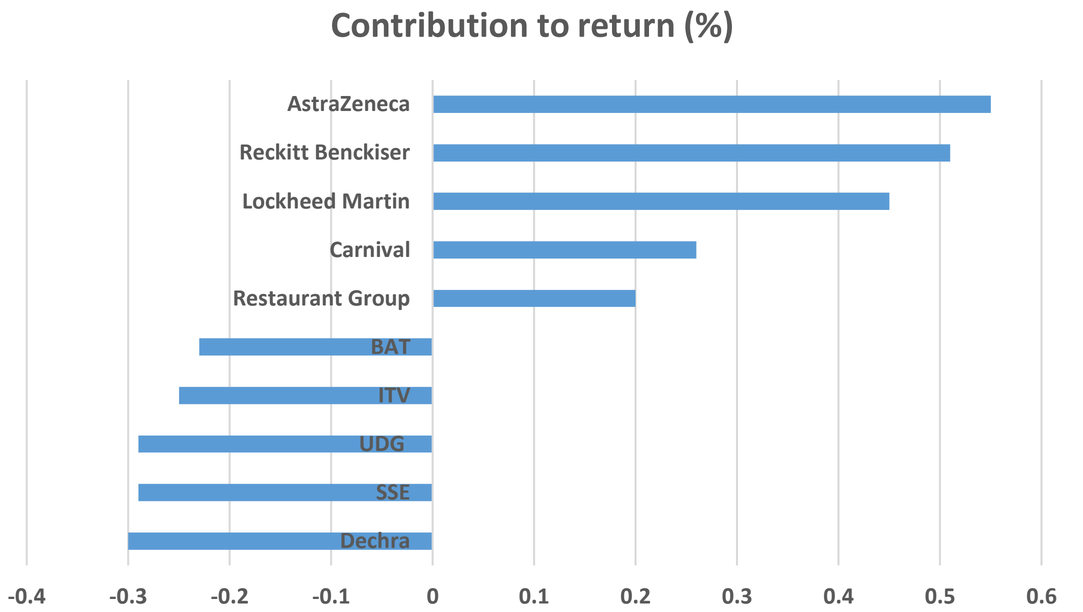
Performance review

	3mths	6mths	YTD	1yr	3yrs	5yrs
Rathbone Income Fund	0.22%	7.96%	1.38%	2.53%	24.82%	45.62%
IA UK. Equity Income sector	-1.31%	6.91%	0.38%	3.43%	27.42%	41.95%
FTSE All Share index	-0.82%	8.31%	0.86%	5.87%	38.45%	43.5%

We have described this year’s performance so far somewhat simplistically as a repeating cycle of three steps forward, two steps back. Although our fund has generally made progress when animal instincts have been roused among investors and risk-on bets have worked, we have lagged in relative terms, having eschewed unwarranted exposure to momentum and growth. On the other hand, when anxiety has increased and risk-off has been the theme of the day, our sense is that comparative numbers have been better. The net result, in markets where the general level of confidence has diminished as the year has progressed, is that we have started to make relative gains. If the current trend continues, we would hope to manifest further positive comparison as the year closes out.

Third-quarter review

The third quarter provided evidence that we made some good decisions earlier in the year. Two of the dullest performers were **Dechra Pharmaceuticals** and **UDG Healthcare**, businesses of which we are long-term fans, but which are much more growth oriented. Earlier this year, we felt their share prices had run too far – price risk was excessive. Sometimes investor exuberance leaves no margin for error, so we heavily pruned our positions. Both companies disappointed lofty expectations this summer, and their shares beat hasty retreats. We are now well-placed to rebuild our holdings, if we so choose. Some days even quality businesses go on sale.

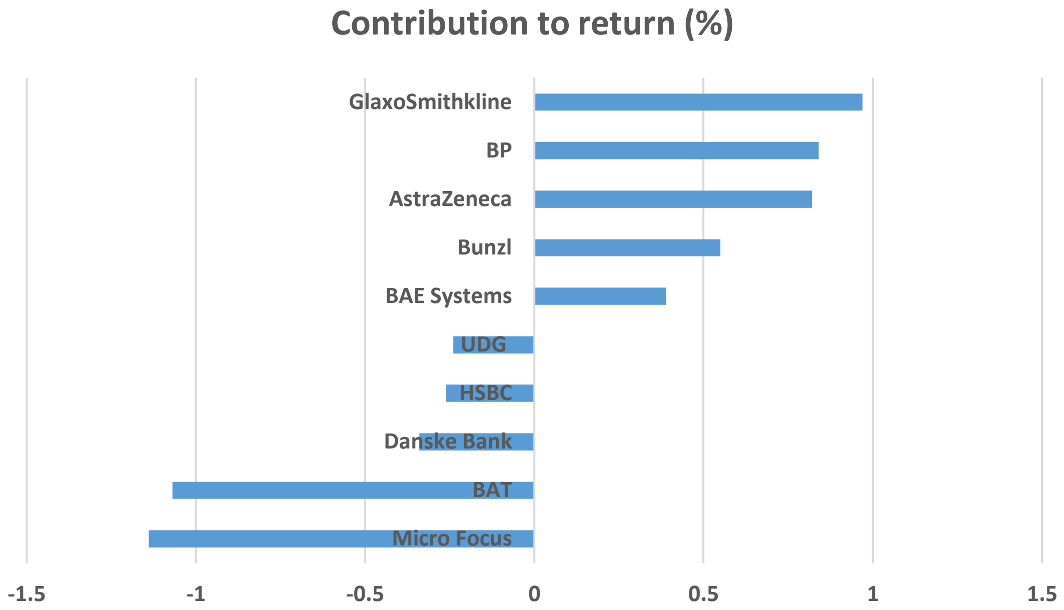


Source: StatPro, Rathbones; data: 3 months to 30 September

Other laggards included **SSE**, **ITV** and **British American Tobacco**. On the positive side of the balance sheet, as defensive earnings became more attractive and risk became less so, we saw strength in **AstraZeneca**, **Reckitt Benckiser** and **Lockheed Martin**. We are also enthused by the recovery in **Restaurant Group**, sparked by a more confident strategic tone that accompanied the company's numbers over the summer. A second good decision for us was to add to Restaurant Group in 2018 as a value and recovery play. Recent news has encouraged us.

Nine-month review

Some of the FTSE's household names were the principal contributors to our strong relative performance year to date. We remain conscious of valuations, so we have latterly trimmed our **BP** and AstraZeneca shares, but it is these giants of the fund that have generated much of our returns. On the negative side, **Danske Bank** has been embroiled in a money laundering scandal. Much of this is old news, but the clamour is loud. Arguably, the shares are cheap; however, as the headlines began to build, we sold our shares before incurring too much damage.



Source: StatPro, Rathbones; data: 9 months to 30 September

Micro Focus International is an improving story. We reviewed the company in our February and March letters following its profit-warning in the spring. Although its valuation looked undemanding, the business risk had changed. Since then, the business, and therefore the investment case, has stabilised, and the shares have made slow, but steady progress. We are now more comfortable with the story – yes, this might be the false comfort of a rising share price – but we believe better news flow and further meetings with the company supports our patient view. Having trimmed in the immediate aftermath of the warning, recently we have been occasional buyers of the stock as the balance of risk has improved.

British American Tobacco

British American Tobacco has been a poor performer for more than a year. The appeal of Juul, a high-nicotine vaping product made by an American company with no tobacco heritage, has proven to be so strong in the US that it has not only stormed the vaping market, but it has also eaten into the traditional cigarette market. British American Tobacco's profit forecasts have fallen as a result, aggravated by poor currency translation and a product recall of their Vuse and Vype e-cigarette power units.

In some respects the attraction of tobacco companies is that they should be able to raise prices faster than volumes decline. This had been amply reflected in valuations a few years ago: the shares had moved from a discount in 2009 to a market premium by 2016. At this stage, expectations for cash profit growth are more modest than they were and the valuation is at a bigger discount to the market than it was in 2009. Given that this remains a very cash-generative business, we believe the sell-off in the shares has been overdone.

Outlook

We are beginning to resemble a damaged piece of vinyl, repeating the same line over again. But that's simply because we've been consistent in our messaging.

We believe that we are positioned to benefit, in relative terms, if there is a correction in equity markets. We argue that the pre-existing conditions of high asset prices, low interest rates and low volatility, won't continue and, indeed, change is already afoot. We are not in the business of making predictions, but we do believe in clarity. So, to repeat from previous letters, we are favouring businesses with predictable, sustainable and visible earnings streams. We are biased towards late cycle and recessionary industrial trends, which explains our weightings in oil and gas, pharmaceuticals, consumer staples, and utility-style businesses. We are looking for value, which has drawn us back into mid-cap, consumer-oriented UK names, despite Brexit's noise and uncertainty. Global investors hate this area right now, so value does abound, but we have to be wary of heightened business risk. Finally, we have a short shopping list of growth stocks that may prove very attractive if equity markets do correct. We won't buy them all – maybe two or three – but if they go on sale, we can pick and choose.

Is this 1999 or 2007 all over again? We shall see. The past few years have been a great party for investors, but our remit is straightforward: grow our dividends and, crucially, preserve capital. Sometimes that means leaving the party a little early and enjoying your records at home rather than going another round.

Carl Stick
Fund Manager

Carl Stick is manager of the Rathbone Income Fund. This is a financial promotion relating to the Rathbone Income Fund. Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in the context of the constitution of the fund and in no way reflects an investment recommendation. The information contained in this note is for use by investment advisers and journalists and must not be circulated to private clients or to the general public. Source performance data, Financial Express, bid to bid, net income re-invested.

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