

Rathbone Income Fund

Update December 2018

“It’s always better to leave the party early.”

Bill Watterson, cartoonist

Imagine an old-fashioned hour glass, with grains of sand running from top to bottom. The grains slowly form a mound in the lower half of the instrument, and as the mass slowly grows, periodically, randomly, a grain will fall that will cause a more abrupt reaction. It triggers an avalanche, with one side giving way. It is impossible to predict the timing and quantum of this move from stability to collapse, but occur it always does.

And so it is with financial markets. Through much of 2018 prices generally moved higher; however, we have known for many months that conditions have become more difficult for investors across multiple asset classes, as evidenced by increased volatility as the year drew to a close. History will decide whether the catalyst for this change in investor sentiment was the threat of a global trade war, a pairing of normalising interest policy and a reversal in the growth of central bank balance sheets (quantitative easing becoming quantitative tightening), a collapse in oil prices, greater perceived risk in bond markets, anxiety around an inverted US yield curve, or any combination of the above.

We also do not yet know whether we are on the cusp of a major retracement in markets. Different commentators have different views, but the “buy the dips” call does seem to be losing its erstwhile confidence, and we remain very cautious. On the positive side – and there is one – if 2019 does herald a more meaningful correction in prices, it means that the opportunity to buy high-quality assets, and by that we mean high-quality income streams, will become much greater. Let’s see ...

Performance Review

The Rathbone Income Fund was not immune to the draught experienced in the final quarter, but our defensive positioning did provide a degree of protection. Over 12 months, the fund gave up 8.55% in value, but while this is disappointing in absolute terms, it does compare favourably with our peers and the wider market. In 2018, the IA Equity Income sector averaged a loss of 10.6%, while the FTSE All-Share Index fell 9.5%.

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	-9.79	-9.59	-8.55	7.26	25.25
IA UK Equity Income Sector	-10.87	-12.06	-10.57	8.38	18.73
FTSE All Share Index	-10.25	-10.98	-9.47	19.54	22.13

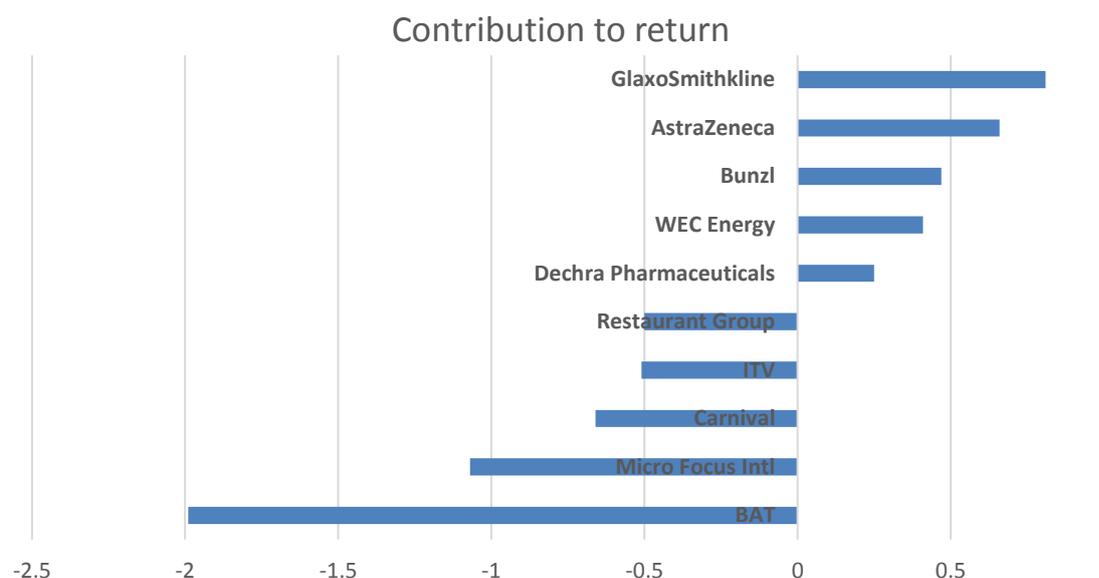
Source: FE Analytics

While loathe to draw too many broad brush conclusions, a brief summary would be that our conservative positioning held us back as markets pushed forward in the latter quarter of 2017 and

into the start of last year, but then as sentiment changed, so did our relative fortunes. You can see this in even sharper divergence in performance over the last six months.

Performance Attribution

Our positioning was consistent throughout 2018, with a preference for companies offering predictable and sustainable earnings – and, therefore, dividend – streams (consumer staples, showing our willingness to pay up for quality); a bias towards late cycle through to recessionary names (consumer staples again, pharmaceuticals, oil and shifting towards utility-style stocks); as well as meaningful exposure to the value end of the market (typically evidenced by businesses exposed to the UK economy). This approach proved moderately, if not outstandingly, successful.



A busy year for GlaxoSmithKline

Two of our largest portfolio positions, the pharmaceutical giants **GlaxoSmithKline** (GSK) and **AstraZeneca**, were the dominant contributors to performance, with the former being the best-performing share in the portfolio. Indeed, following a tough 2017, GSK recovered well as investors warmed to the strategy being established by new chief executive Emma Walmsley. Her approach has been two-pronged. On the pharmaceutical side, growth in vaccines and HIV product sets is being bolstered by increased investment in oncology. The recent acquisition of US biotech Tesaro for \$5bn is an expensive transaction, in our opinion, but it reveals an intention to commit capital to high-growth, if competitive, areas of the oncology sector. The other side of the coin is consumer health. In March, GSK walked away from bidding for Pfizer's consumer health business; \$20bn was way too rich. Later that month it paid \$13bn to buy out Novartis from a consumer health joint venture, taking full control. As a denouement to a busy year, in December GSK agreed to combine this business with the Pfizer consumer health enterprise, creating a much larger joint venture that GSK controls. All without paying the aforementioned premium. In all three instances, we support the company's lower-risk approach to M&A. The deal makes GSK a clear number one in consumer health and provides a great platform for future bolt-on deals. As far as breaking the company up is concerned, for the moment we are happy that the company is taking the right actions to improve the quality of the group. But we will take some convincing of the need to split, other than to improve the bottom lines of investment bankers!

Otherwise, we reduced our exposure to AstraZeneca on valuation grounds as the year progressed. Global distributor **Bunzl**'s share price enjoyed a strong recovery following an analyst-induced "Amazon scare" bout of weakness in the early spring. Bunzl is a fine example of our predictable and sustainable earnings cohort of stocks. **WEC Energy**, our US utility business, also performed well; the share price ignored rate rise concerns and was driven ahead by strong operating results. Finally, **Dechra Pharmaceuticals** moved higher in the first half of the year. We took profits, so were relaxed when the shares gave up ground in the summer.

The negative influences are less thematic, more stock specific. **Restaurant Group** was a poster child for our value exposure: a recovery play generating cash that financed a high dividend payout combined with a sensible balance sheet ... and then it announced a rights issue and debt raising to buy Wagamama. We detailed our reaction to this in last month's letter. Suffice to say, management succeeded in causing both upset (the share price reaction on rights plus increased leverage at this stage in cycle meant a bad result for existing shareholders) and excitement (Wagamama is a growth business and an exciting franchise that could transform a tiring portfolio).

ITV was weak throughout the year as the slowing advertising cycle weighed on sentiment. **Carnival** disappointed on trading towards the end of the year, but we remain sanguine about the company's long-term value, pinned as it is on an oligopolistic market structure. **Micro Focus** warned at the very start of 2018, but has improved steadily since the lows of the spring, so we are slowly being rewarded for our patience.

British American Tobacco is a tougher problem.

British American Tobacco (BAT) has been moving lower since reaching an all-time high in May 2017.

The tobacco industry was beset by regulatory noise last year, with the loudest clamour the suggestion from the US Food & Drug Administration that it might consider a ban on menthol cigarettes, a market BAT is particularly exposed to. Secondly, next-generation products such as e-cigarettes, vaping and "heat not burn" are gaining a stronger grip on the marketplace. The complexity of the tobacco market means it is very difficult to conclude the potential share gains that may be achieved by these new products. Indeed, the more successful they are the more likely regulators will examine them more closely. However, there is evidence that the sales deterioration in traditional tobacco products is accelerating, approaching a point where old business models may not work.

An attraction for us has always been the strength of BAT's cash flow and balance sheet. At the moment, excess cash is going towards the balance sheet, but gearing is coming down only slowly because so much cash is being used for the dividend. There is not much cash lying around to pay down the debt. Net debt, at about 3.9x ebitda at year end, remains stubbornly, but not necessarily inappropriately, high.

The shares have been very weak. On the other hand, we believe the overarching market trend of the past 18 months has been to afford excessive valuations to the promise of future growth, while simultaneously devaluing the present value of future cash flows of industries in decline or change. Now, BAT has of course had its own issues, and in hindsight the deployment of capital to acquire the Reynolds brands may appear to have been ill-timed. But our assessment needs to focus on

what value the shares offer now, and whether there is enough of a margin of safety baked into the shares at the current level.

All three of our tobacco holdings (**Imperial Brands** and **Altria** make up the triumvirate) are cheap. Our analysis is that the market is pricing in too much bad news for them, and the shares will look very attractive if this sentiment changes. On the other hand, share prices in 2018 have clearly reflected investor concerns, and we would be foolish not to seriously review our conviction.

Outlook – reminding ourselves of some simple resolutions

As a team we do not try and predict the future, because we will get it wrong.

Therefore we do not position the fund to benefit from a high-conviction opinion about what 2019 has in store. Rather, we hope to be roughly right rather than precisely wrong.

We focus on the expectations of our unitholders. Thus we must be sensible and conservative stewards of your capital (“winning without losing”), while providing you with a real increase in distribution (“a pay-rise every year”).

We do this by attempting to balance risk across the portfolio in order to insure ourselves against as many possible futures as we can.

We are maintaining, and perhaps increasing, our defensive bias as we move into the new year. Tactically, we wish to reassess those companies and industry sectors that are currently offering abnormally high yields. Do they represent outstanding value in what could be a very difficult market or is the market telling us that they are value traps? Rephrasing the question, are these dividends for real or are they likely to be cut? Within these industries, are there disparities in value that we can exploit? For example, within the broad consumer staples space, there are big mismatches in valuations and expectations between, say, **Unilever** and **Reckitt Benckiser**, or between those two and tobacco stocks. **HSBC** yields more than 6%, as do the life assurers and many utility and telecom stocks, along with smaller domestic plays such as **ITV**, the housebuilders, **Halfords**, and so on.

A few letters back I pondered whether this market felt like the end of the tech bubble in 1999. Back then the successful playbook was to buy safe, defensive yield. The risk is that these yields are sometimes illusory. The potential reward is a successful switch into assets offering tangible returns at a time when investors turn distinctly more risk averse. As the new year begins, this asset allocation combined with considered stock selection seems a sensible way to put this playbook back into action.

Recent trading: December was another quiet month for trades. We were opportunistic profit-takers in **Lockheed Martin** and **Unilever**, and created a small holding in UK housebuilder **Bellway**.

Companies seen in December: Greene King.



Carl Stick
Fund Manager



Alan Dobbie
Co-Manager

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.