Rathbone Unit Trust Management
Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Income Fund

Update February 2019

On Monday 9 March 2009, the benchmark US S&P 500 Index closed at 676.53, the lowest level in over 10 years. Equity investors had been battered by the global financial crisis, yet that day proved to be the inflection point, the start of one of the longest bull markets in history. Now, a decade on, it is appropriate to write about change.

This is not yet another prediction of impending doom, something we've become used to hearing *ad nauseam*. Instead, this is a letter about brands and what they mean; it is about avoiding complacency and the dangers of getting too comfortable with easy narratives that serve the past better than they do the future.

Plus ça change, plus c'est la même chose.
The more things change, the more they are the same.

Jean-Baptiste Alphonse Kerr, Journalist
January 1849

In some ways, the world has changed dramatically since stocks started their decade-long rebound. The geopolitical landscape has been transformed. The UK and Europe are somewhat hamstrung, both politically and economically; the US and China continue to remodel their own spheres of influence; and Russia and North Korea are flexing their geopolitical muscles. Globalisation of trade and liberalisation of politics have now given way to protectionism and populism.

What we regard as cutting-edge business practice has altered. The last decade was all about efficiencies, stripping out costs – corporate austerity, if you will. All zero-based budgeting and marginal gains. Yet these motifs/signals of corporate excellence are losing their lustre. These themes are less about investing in the future and more about using cheap money, easy debt, to amplify returns and send capital back to shareholders. This trend no longer seems sustainable.

On a more positive tack, sustainability issues are increasingly front and centre. One-time presidential candidate Al Gore's film *An Inconvenient Truth*, released in 2006, caused not-insubstantial ripples, but it didn't engineer real corporate change. David Attenborough and *Blue Planet II* seems to be resonating far more widely, and behaviour, both of people and the companies they support, is changing. Ideas to make supply chains less wasteful and more efficient, like the circular economy championed by the Ellen MacArthur Foundation, will further cement this change. We will undoubtedly keep circling back to this theme in the future, given how fundamental we believe it is. Now, though, I wish to take one step back and think about what this all means for brands, their value, and how we as consumers choose to champion them.

The Kraft Heinz narrative

In October 2012, Kraft Foods spun off its low-margin grocery business. The jettisoned division kept the old parent's name, while the higher-growth business was rechristened Mondelez International (which also held the brands acquired in its (in)famous purchase of Cadbury's). In 2013, the private equity machine that is 3G Capital combined with the equally renowned Berkshire

Hathaway to purchase HJ Heinz Co. for $27.4bn in cash. In 2015, the joint venture bought Kraft Food Group for $55.4bn, totting up a combined $82.8bn. By 2016, Kraft Heinz Corporation (KHC) was the largest US food manufacturer, with a market capitalisation of $93bn. That was a lofty price for a combination of low-margin and mature, albeit well-loved, brands.

The rationale behind the merger was stripping massive costs out of the two entities through business efficiencies. This led to the establishment of the church of zero-based budgeting (ZBB), a process championed by 3G. Each year, each line of expenditure has to be justified anew under ZBB. In this way, all unnecessary costs are eliminated and department managers' ability to create fiefdoms is dramatically curtailed. Another technique for cutting costs is using their clout as a large supplier in "trade promotion optimisation", which is basically paying less for shelf space in the supermarket. In the short term, the food manufacturer has the competitive advantage because the retailer has to stock Heinz ketchup and Kraft mac'n'cheese – customers would be shocked if those brands simply weren't there one day. Or at least, that is how it used to pan out.

The competitive balance is changing. Jorge Paulo Lemann, the billionaire Brazilian businessman who co-founded 3G Capital, gave an unusually frank interview to Forbes magazine in 2018. He made this brutal self-assessment:

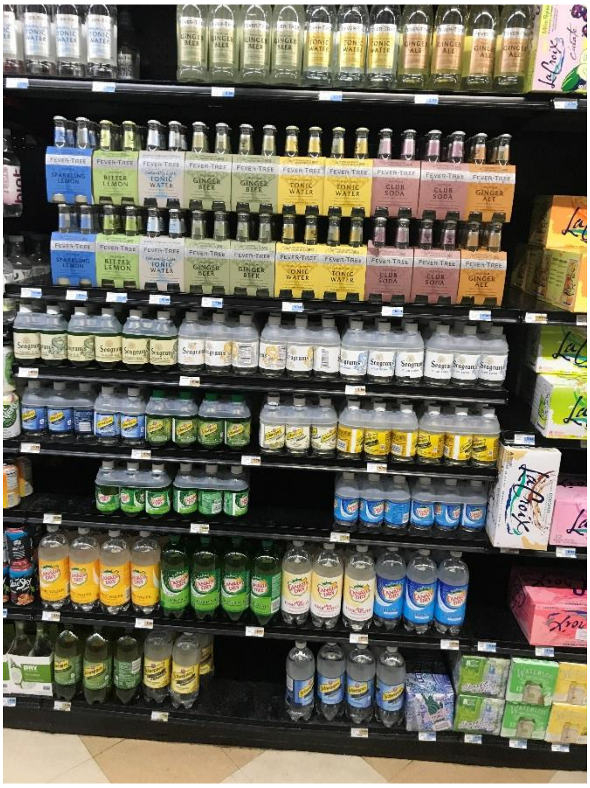
> "*I'm a terrified dinosaur.*
> *I've been living in this cosy world of old brands and big volumes…*
> *We bought brands that we thought could last forever.*
> *You could just focus on being very efficient…all of a sudden we are being disrupted.*"

A change in behaviour

Planograms – a floorplan of a store marking out where different products will be sold – is one example of how food makers work with grocers to ensure that their products sell as best they can. A good planogram that drives higher sales is good for both the retailer and the producer. But it also means there is a lot of competition from suppliers to get their products in the best spots at the best prices. Food makers pay the retailer to give them a big display at the end of an aisle; unit sales go up, which benefits the supplier, and the retailer can opt to use the fee from the producer to pass on a discount to the consumer or take the benefit themselves through an increase in margins. KHC eventually managed to pull off the reverse trick, through the toxic combination of trade spend optimisation (paying less for shelf space, not more) and making products that consumers were actually growing weary of. The result? Retailers no longer had the incentive to promote these brands as customers were starting to question their value.

Recently, Kraft reversed course. Now it will inject substantial sums into its brands through increased marketing and product innovation. However, I wonder whether this ship has already sailed. Kraft needs to hold back the tide on multiple fronts: a general distrust of big food companies, healthier eating trends, and sustainability concerns around supply chains, packaging, buying local, etc.

Our shopping habits reveal a changing attitude toward brands. On the one hand, many of the brands that resonate today are young, niche, and do successfully navigate the difficult waters between the retailer and the consumer. Take Fever-Tree, a business that successfully nurtured its brand – it's only real asset – disrupting long-standing giant Schweppes in the process.



Fevertree's superior shelf positioning, at eye-line, supplants older, less vibrant brands, in an American supermarket.

Interestingly, Fever-Tree has trodden the more traditional route by buying useful shelf "real-estate" to boost sales, though arguably we are less brand-driven these days. It has been a long, slow burn, but the German discounters, Aldi and Lidl, have subverted our relationship to brands. (I urge you to read the deep dive into Aldi on the Guardian newspaper website). Although they have been around for decades, it is in the last one that they have truly changed the face of the UK retail market. We used to be a nation of shoppers divided into supermarket clans we were introduced to by our parents. This emotional attachment used to be a fundamental part of the UK retail game. Discounters were a shameful thing, a last resort.

Things are very different now. Now, it's cool to swipe a bargain and get one over the mainstream supermarkets down the road that are charging over the odds. Increasingly, middle class people are likely to get an Ocado delivery from Waitrose (soon to be M&S) in the morning and pop down to Aldi in the afternoon to rummage round the middle aisle deep-discount specials.

This is having a profound impact on brands. At one point, before it changed tack, a Tesco Superstore might have stocked 90,000 different items. In the parlance, these items are called "stock keeping units" or SKUs for short. Was there just too much choice? By comparison, Aldi stocks about 1,800 SKUs. Its model is based on stocking large amounts of a limited number of goods at very low prices. Why pay for branding, marketing, frills? Ketchup is ketchup, after all. Amazon exacerbates this trend: are Duracell batteries really better than Amazon's own brand? Are we turning into a society that distrusts brands? If so, we're unlikely to pay a premium for them.

There is a new retail website in the US, called brandless.com. It offers limited SKUs across six categories: food, home, beauty & personal care, stationery, baby and pets. Its website expounds the virtues of quality, value, doing the right thing and getting better things for fewer dollars. As implied by the domain name, there are no brands on brandless.com. You want peanut butter, you get a jar of peanut butter with peanut butter stamped on the side. I have absolutely no idea whether this will go on to radically change the way we shop, but the very fact that it exists shows this shift away from the old branded world is real.

Change impacts the entire value chain

- Some brands will retain their value – the big drinks companies will certainly hope so – but high margins on everyday items could be competed away
- Despite decades of advertising and category dominance, some brands will go the way of the dinosaurs
- New brands will resonate, but in the modern world, relevance may prove more fleeting, and therefore less lucrative: bigger is not necessarily better
- The relationship between brand owners and retailers is changing, as are the traditional routes to the consumer
- Brand owners need to manage fundamental disruptions to their supply chains as companies look to reduce their reliance on plastic, water and energy. For example, in the case of bottled water, do we need packaging at all? Why not dispense your favourite branded spa water from a wholesale-sized container into your own multi-use water bottle?
- Therefore, we as investors must continually re-evaluate how much we are willing to pay for the owners of these brands, just as companies themselves need to judge carefully how much they pay to acquire or develop them
- In simpler times, we may even choose to eschew branded goods altogether

A lot happens in 10 years. Technological development has been exponential. Geopolitical change has been no less fundamental. Humankind has progressed (arguably), our habits have changed, the way we communicate, work and go about our business has evolved. Our relationship to things has moved on. The fact that this seems so very clear at a time when one of the longest bull markets in history is at a crossroads should have a profound impact on the investment decisions that we make and the prices that we are willing to pay for consumer companies. The investment play-book that has been very successful since the darker days of March 2009 had its foundations in globalisation and the hegemony of brands. This edition seems inappropriate now. The difficulty is that the correct play-book for the next 10 years has not yet been written.

Recent Trading: Activity was light this month, a reflection perhaps of the commencement of a results season that has been generally benign for us. We sold our position in **Lockheed Martin**. We first bought shares in this US defence giant during the teeth of the financial crisis, when the shares were very cheap indeed. However, our view now is that there are more attractive businesses, at better valuations, for us to own. We also took further profits from **Relx**, on the news that the University of California cancelled its scientific journal contract and published a strongly worded letter announcing this decision. The shares remain fully valued, but investor perception of the business risk is greater.

Companies seen this month: Royal Dutch Shell, Rio Tinto, Bunzl, Kingspan, Hiscox, and **Dechra Pharmaceuticals**.

Carl Stick
Fund Manager

Alan Dobbie
Fund 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.

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000
Fax 020 7399 0057

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