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Rathbone Strategic Bond Fund

Product brochure

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Rathbone Strategic Bond Fund

Combining a wealth of strategic thinking, two proven investment processes and managers in one fund, accessible to all.

Our investment offering is always driven by our investment expertise not by marketing. The Rathbone Strategic Bond Fund is no exception. It is a logical extension of our fixed income offerings, the highly-regarded Rathbone Ethical Bond Fund and the latest addition to the suite, the Rathbone High Quality Bond Fund. The fund exploits our considerable in-house expertise to offer investors diversification across the full spectrum of fixed income assets.

“Rathbone Strategic Bond Fund will target a lower annualised volatility than the median level of its peer group (namely, the IA Sterling Strategic Bond sector) over a three year rolling period. Furthermore, it will target low correlation to global equity markets (the MSCI World index is considered a suitable representative of global equity markets for this purpose).”

Bryn Jones, Fund Manager and Head of Fixed Income

Investment objective and process

High level definition of the product

- Quality investment-grade bonds
- Average risk.

The process has various layers to achieve superior results:

- Theme based investment-idea generation (macro, sector, regional, supply, regulation, interest rates)
- Credit analysis – the four C's PLUS model
- Valuation – relative value
- Evaluation of risk.



Investment strategy

1. Macroeconomics - interest rate risk

The major risk a bond fund will face is a change in monetary policy and thus interest rates. Any change of interest rates has an inverse impact on the price of a bond. The sensitivity of a particular bond to changes in interest rates is known as its *modified duration*.

If the manager expects a general rise in interest rates, it is likely he will structure the portfolio so that the average modified duration is less than that of the FTSE Actuaries All-Stocks Gilt index. In this way, the manager will hope to limit any fall in prices. The manager may also invest a proportion of the fund in *floating rate securities*. These instruments have a rate of interest which changes with base rates.

If interest rates are expected to fall, then the manager may structure the portfolio with an average modified duration that is more than that of FTSE Actuaries All-Stocks Gilt index. The manager believes this should lead to an out-performance in terms of price during falling interest rates.

2. Asset allocation

The overall credit quality of the fund will be the weighted average of the credit rating of each security within the fund. The manager will choose a portfolio that will reduce the overall credit risk of the fund during periods when the economy is expected to contract. During these times, it is likely that individual issuers will face downgrades to their credit rating to reflect the deteriorating trading environment in which they are operating. When the manager expects the economy to be expanding, he will seek, through the selection of securities, to optimise the potential of credit upgrades.

3. Selection of individual securities

Decisions are made using a top-down meets bottom-up approach. In-depth analysis of the current macro environment provides a view on the likely direction of future economic growth, inflation, and interest rates. This helps the selection of the overall *maturity, duration* and *credit quality* of the fund.

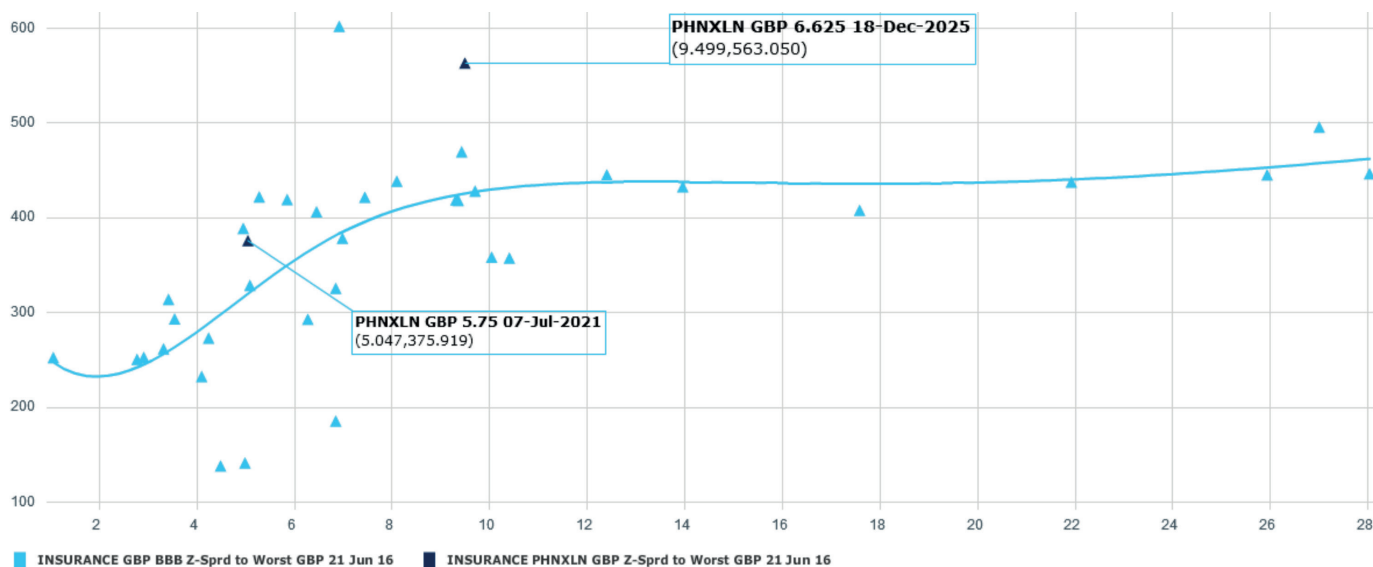
We then examine each individual issuer using the four C's approach to credit analysis.

1. **Character:** An assessment is made of a company's management quality and their ability to meet their own and the market's expectations. The extra policing provided by the ethical research team in Bristol is particularly useful here.
2. **Capacity:** The ability of an issuer to repay its debts. In-depth analysis of the cashflow in a business is key to this part of the overall approach.
3. **Collateral:** The quality of the assets of any company is of paramount importance. Tangible assets can always be sold, whereas in-tangibles cannot. 'Real' assets are good sources of cashflow during good and bad times.
4. **Covenants:** These are the terms and conditions detailed in the bond prospectus that govern the way the management may operate the business. At times, they can restrict managements' options. A covenant default can often be the first warning sign of impending trouble. Covenants play an important role in minimising investor risk when lending to corporates.

Depending on credit quality (indicated by the rating), there are limits for each individual issuer in terms of the size of the holding as a percentage of the whole fund.

4. Valuation – an example

Phoenix Group



Source: Barclays Capital Live Curve

Valuation model

Name	Cpn	Maturity	Yield	Duration	YC score	Rating	Rank	6m Vol	1y Vol	6m R/A yield	1y R/A yield
TSB Banking Group Plc	5.75	06/05/2021	6.38	2.22	2.31	BBB3	T2	2.01	1.80	3.18	3.54
Paragon Banking Group Plc	6	28/08/2024	4.79	4.65	1.88	BBB2	SENR	3.59	3.58	1.33	1.34
Cybg Plc	3.125	22/06/2024	4.63	5.36	1.68	BBB2	SENR	3.61	3.35	1.28	1.38
Phoenix Group Holdings	6.625	18/12/2025	5.82	5.61	1.68	BBB2	SUB	3.03	3.05	1.92	1.91
Lloyds Bank plc	13	22/01/2029	6.34	7.16	1.67	BB1	T1	2.25	1.97	2.82	3.22
Places for People Fin	4.25	15/12/2023	3.71	4.38	1.61	A2	SENR	1.00	0.98	3.71	3.79
Investec Plc	4.5	05/05/2022	3.06	2.99	0.85	BBB1	SENR	1.45	1.68	2.10	1.82
AXA	6.686	06/07/2026	4.77	5.59	0.71	BBB2	JSUB	2.55	2.72	1.87	1.75
Skipton Building Society	1.75	30/06/2022	2.95	3.30	0.68	BBB1	SENR	1.74	1.88	1.69	1.57

Source: Bloomberg and Rathbones, as at 21.01.2019

YC score

A valuation measure based on the excess yield a bond provides relative to a Rathbones fair value yield curve model. Fair value yield curves are determined by bonds with similar characteristics – i.e. credit rating, subordination and currency.

Risk adjusted yield

This measure calculates how much yield a bond provides per unit of risk. By looking at daily pricing data for a bond, we calculate standard deviations (risk) over 6 months, 1 year and 3 year time horizons. We then divide a bond's current yield by its risk to provide a measure similar to a Sharpe ratio for each bond.

Broad definition

The Rathbone Strategic Bond Fund combines investments in direct bonds and bond funds. It uses the strong investment process that is used to manage bonds for Rathbone Unit Trust Management and the robust Rathbone fund selection process.

“Post a 20-year run of strong performance in bonds, it is increasingly difficult for advisers to navigate the bond market, and to achieve capital growth and sustainable income for their clients over the longer term.”

Solution: Rathbone Strategic Bond Fund

What are we targeting?

The fund aims to achieve a total return comprising a regular above-average income coupled with medium to long-term capital growth.

The fund does not target a specific nominal yield as the fund is run to maximise total return at an acceptable level of risk. In any event, even in extreme circumstances, we would not expect the fund yield to fall below that available on the FTSE Actuaries Government Securities UK Gilts sub-5 year index. Under normal circumstances investors should expect a yield well above the level of the minimum yield target set out above. **However, the yield is driven by our asset allocation and will fluctuate over time.**

What are we offering?

The base portfolio the Rathbone Strategic Bond Fund will typically be invested 50% in direct bonds and 50% invested in funds. Initially, the asset allocation is driven by the output from Rathbone Strategic Asset Allocation process.

1. Once asset allocation views have been generated, the whole fixed income universe is examined to find the best investment opportunities.
2. 50% of the portfolio will typically be invested in mainly Sterling-denominated government bonds and investment grade corporate debt.
3. These direct-bond exposures will soften the impact of fees levied by third party funds, reducing the fund's overall Ongoing Charges Figure (OCF) compared to the 'fund of funds' universe.
4. The remainder will be invested in funds focused on specialist areas such as high yield and emerging market debt, distressed debt and credit alternatives on a best-of-breed basis.
5. The exposure to funds will ensure a greater level of diversification than a single strategy investment would otherwise be able to achieve. To manage risk and volatility within the fund, up to 20% can be invested in 'off-benchmark' assets such as qualifying alternative fixed income funds and qualifying structured products.
6. Flexible asset allocation around the 'base' portfolio (*see page 4, What is the investment philosophy?*) in order to be able to manage the risk/return profile of the fund as economic and market conditions change.

Client suitability?

Investors should have a medium-risk appetite, seeking to achieve a long-term total return, generated from a mixture of capital growth and income. Investors will be exposed to the full spectrum of fixed income assets from lower risk assets such as government bonds and high grade corporate bonds, through to riskier investments such as emerging market debt and high yield bonds. They may, therefore, expect some short-term volatility in the value of their investments. As a result, investors should be able to commit money to these investments for five years or more if necessary, especially if there has been an extreme market event.

Fixed income investments have become an increasingly important part of retail and private client portfolios. This fund is for clients seeking:

1. Access to bond markets where they are precluded from investing because many individual issue sizes for bonds are above £100,000 per issue.
2. Access to the full range of fixed income investments and to the strategic asset allocation skills required to manage their exposures – providing true diversification of fixed income holdings that would ordinarily only be open to the largest private client portfolios.

Product suitability?

1. Pension plans for members with medium risk tolerance.
2. Self Invested Personal Pensions (SIPPs) in drawdown, particularly early years.
3. Charities and trusts – investment fiduciaries.
4. ISAs; small pension funds.
5. Those near to annuity purchase who may have income requirements but not with a large enough investment to buy a bond (which could have a high minimum).
6. Part of a core investment for medium risk clients.

“Demand is stronger than ever for funds that can apply robust strategic asset allocation expertise to the full spectrum of fixed income securities.”

Solution: Rathbone Strategic Bond Fund

“Whilst a number of other strategic bond funds have come to the market in recent years, we are differentiated by our ability to invest directly in bonds and funds, harnessing the considerable experience across Rathbones.”

Solution: Rathbone Strategic Bond Fund

What is the investment philosophy?

Our processes used for the selection of direct bonds and for funds selection have been combined. Fund selection is managed using the Rathbone fund selection process. The direct-bond selection is managed using the Rathbone Unit Trust Management bond selection process. The fund, therefore, provides levels of diversification to a wide range of fixed income asset classes.

From this, we have developed core strategy ('base' portfolio) targets for bond and fund selection.

Direct bond selection

	minimum (%)	maximum (%)
12.5% UK Index Linked (Government bonds)	2.5	22.5
12.5% UK Gilts (Government bonds)	2.5	22.5
25% UK Corporate Bonds (Investment grade credit)	15.0	35.0

Fund selection

	minimum (%)	maximum (%)
15% Emerging Market Sovereign Bonds	0.0	25.0
15% Global High Yield Bonds	5.0	25.0
10% Global Corporate Bonds (Investment grade credit)	0.0	20.0
10% Global Government Bonds (ex. UK)	0.0	20.0
0% Distressed Debt (US)	0.0	10.0

Once the asset allocation of the fund has been agreed, we act on the views using the two investment processes. For more on this, please see our investment principles and process brochure.

What are the essential differences between this fund and our competitors?

1. Whilst a number of other strategic bond funds have come to the market in recent years, very few have the bond experience and the ability to overlay macro and fund selection and the expertise of Rathbones – this fund is structured to be managed effectively across economic and market cycles with true diversification.
 2. Much wider investment scope to invest in funds managed by outside specialists.
 3. The fund is a client-led offering, rather than marketing or fashion-led.
 4. Rathbones has ability to access lower fees on funds, as one of the largest fund buyers in the country.
 5. Considerable expertise within Rathbones but chiefly:
 - i. Lead manager, Bryn Jones, began his career in 1999 and has a wealth of investment experience of direct-bond investing.
 - ii. Fund Manager, Noelle Cazalis, works closely with Bryn Jones to support the fund. Noelle joined Rathbones in 2011 and has been involved with the team since the fund's launch.
- III. Fixed Income Research Analyst, Stuart Chilvers joined Rathbones in September 2017. Providing in-depth coverage on sovereign and corporate bonds for the team. He also runs a proprietary valuation model, used to help identify opportunities for Rathbone Ethical Bond Fund and Rathbone Strategic Bond Fund.

What will the fund aim to do?

1. The fund will aim to take advantage of the full range of bonds including government bonds, corporate bonds, high yield, emerging market bonds and distressed debt. This list may also include qualifying alternative fixed income funds and other structured products which can be employed to reduce risk and boost returns.
2. The fund aims to bring a wide range of bond investing to all suitable investors who would not necessarily have access to the essential strategic asset allocation and fund selection expertise required today.
3. The fund will maintain a wide range of investment powers – to maximise the potential for strong risk-adjusted returns.
4. The fund will offer true diversification through exposure to both funds and direct bonds.
5. The fund will target a lower annualised volatility than the median level of its peer group (namely, the IA Sterling Strategic Bond sector) over a three year rolling period. Furthermore, it will target low correlation to global equity markets (the MSCI World index is considered a suitable representative of global equity markets for this purpose).

What will the fund not aim to do?

1. The fund won't chase short-term performance.
2. The fund won't allow fees (where funds are involved) to dictate portfolio construction.
3. The fund won't buy other Rathbones funds.
4. The fund yield will not remain constant – it is determined by asset allocation and will fluctuate as we seek to maximise total returns.

“Most strategic bond funds only invest directly in bonds and investors must, therefore, remain convinced that the investment manager has real strength in all areas of the market.”

Solution: Rathbone Strategic Bond Fund

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Rathbones
Look forward