Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update August 2020

For all the complexity of investment, we would argue that it all comes down to one fundamental skill: the sensible allocation of capital. For a fund manager, that means buying the right asset at the right price and, conversely, knowing when to sell; for company management teams, it's achieving the right blend of organic, internal investment and inorganic, external acquisitive expenditure. Companies must decide when and how much to invest in their own business and — importantly — when to pull the plug. It may be that a project is not generating the predicted return, or that it would be better off in someone else's hands. Alternatively, when investment opportunities are scarce, both inside and outside the business, returning capital to shareholders by purchasing your own shares may be the best option. And all along, managers must ensure that the correct sources of funding are used to finance these decisions, whether cash, debt, or shares. In the end, the name of the game for both fund and business managers is to ensure sustainable and consistent returns on the money invested, and knowing which of many metaphorical levers to pull and buttons to press.

Case study — big oil and the energy transition

This year has been an *annus horribilis* for the oil industry and, by consequence, the many funds and people that rely on the sector for the dividends they pay. But the inconvenient truth is that the industry's capital has been poorly allocated for many years, a circumstance evidenced by the second-quarter releases of both **Royal Dutch Shell** (Shell) and **BP**. (To be transparent, we own both companies in our fund.)

Shell made a loss of $18 billion in the second quarter of 2020, a huge number that arose largely from the impairment of its assets. In its statement, Shell management assume lower oil prices in the medium and longer term, in response to the pandemic, and they also reflected upon structural changes to fundamental global supply and demand dynamics. A lot of money Shell invested is not going to generate the returns that were predicted when those investment decisions were made. As a result, the assets created or bought need to be devalued on the balance sheet, hence the eye-watering loss.

But the issues pre-date COVID-19. Some of the write-downs relate to assets acquired when Shell bought BG, and specifically renewable and gas operations in Australia. Indeed, these values started to be reassessed back in 2015, with a $4bn diminution of value. On the earnings call, Shell explained that many of these investment decisions were made over a decade ago when the outlooks for supply and demand, and the pricing environment for both oil and gas, were markedly different. In hindsight, Shell — a business with over 100 years' experience of drilling oil out of the ground — made poor capital allocation decisions.

The rap sheets against BP and many other participants in the sector reflect similar missteps. Most major listed oil and gas companies have slashed their payouts. Some, like US shale pioneer Chesapeake Energy, have gone bust — Chesapeake filed for Chapter 11 bankruptcy in June this year.

In all fairness, the environment has been very harsh. In March this year, just as the world was awakening to the reality of a global pandemic, Saudi Arabia and Russia launched a price war and ramped up production. The oil price plummeted, as did company profits. However, a further consequence is that planned transitions towards zero-carbon business models, anticipated predominantly by European oil majors, have been dramatically brought forward. COVID-19 has got us thinking about the world in new ways, and the decimation of profits has catapulted many oil companies to be a lot more radical in terms of how they move ahead.

Contrasting market reactions to Shell and BP's results, released just days apart, revealed the extent to which investors were persuaded by their respective strategies towards zero-carbon goals. The fact that Shell failed to convince investors showed the weakness of its balance sheet; its ambition to be a net-zero emissions business by 2050 or sooner is hampered by capital constraints. In recent years we calculate that the $23bn a year that they have invested has only been enough to stand still; the current plan to reduce expenditure down to $20bn, albeit reflecting the recessionary environment, is not sustainable if the company wishes to grow, and especially if it wants to accelerate, like many of its peers, towards a greener, more holistic energy model. The decision to cut the dividend was correct, considering the calls on Shell's cash, but it does need the oil price to recover to generate the earnings needed to invest for the future.

Maybe it was just the confidence with which the message was proposed, or the scope that took the market by surprise, but BP announced such a big leap into the unknown that the industry may be compelled to react and follow. The board endorsed a new financial framework, sanctioning a considerable increase in BP's investment in clean energy. The intention is to move **"earlier, faster and further"**. The world is a different place on account of COVID-19, and within a decade BP expects to be a very different company.

BP's vision and enthusiasm are enthralling, and they emphasise the company's pedigree. It has announced an aggressive strategy and timetable. Our primary gripe, nevertheless, is down to capital allocation, which may seem ironic, even paradoxical, considering we are income fund managers. In order, their priorities are as follows:

1. **Resilient dividend**
2. **Strong balance sheet**
3. **Investing at scale in the energy transition**
4. **Investing to maximise value in resilient hydrocarbons (i.e. necessary cash flow from core, legacy business)**
5. **Buyback commitment.**

Counterintuitively, we would prefer the dividend to be the secondary outcome of sensible investment decisions, rather than the number-one priority. Also, behind these priorities is the harsh truth that cash is hard to come by, and this all needs to be financed by a combination of earnings (determined by capricious, volatile commodity prices), divestments, balance sheet management, all the same puzzles that Shell needs to solve. BP has perhaps just said it better, with more confidence, and with a modicum more financial security.

"Golf is the closest game to the game we call life. You get bad breaks from good shots; you get good breaks from bad shots – but you have to play the ball where it lies."

Bobby Jones

The energy sector is a fascinating conundrum for income investors. We have been through the pain of dramatic dividend cuts, but we deal in today not yesterday. With a dividend yield of 11%, Shell was not a good investment; now it has cut its dividend by two-thirds, it may have more shots to play. If the oil price recovers – market players act logically rather than emotionally, the global economy recovers – then maybe Shell can move more quickly. BP has had to halve its dividend, but it has more clubs in the bag, and a more imaginative game plan.

As we said at the beginning, it all comes down to the capital you have and how you allocate it. Paying the right price for assets, making the sensible investment decisions, and getting lucky on the returns that you get back from these choices. Yes, there is a lot of luck involved. The energy complex is suffering today on account of investment decisions made one or two decades ago. This industry is now making plans out to 2030, 2050 and beyond, in sectors where, notwithstanding the rhetoric, they are still learning the ropes and developing the expertise. We own BP and Shell because we think that the shares are cheap, that the dividends are more sustainable after the cuts, and that they need to be part of the solution to our energy needs. However, no matter how exciting the future may sound, they face huge challenges investing our money, and generating safe, predictable returns.

Recent trading: August evidenced a focus on a further lean towards value, and a diversification into newer names. To this end, we reduced **Roche**, **GlaxoSmithKline**, **Reckitt Benckiser** and **Rio Tinto**, and created a new holding in **Novartis**. We added to **Jupiter Fund Management** and continued to increase our holding in **NatWest Group**, funding these deals by trimming **Legal & General**, **Aviva** and **Lloyds Banking Group**.

Companies seen (virtually) this month: Legal & General.

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 managers, 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 may go down as well as up and you may not get back your original investment. Performance data is sourced from Financial Express, mid to mid, net income re-invested.

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