Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update February 2023

"No man ever steps in the same river twice, for it's not the same river and it's not the same man."

– Heraclitus

The businesses whose shares you buy, and the prices that you choose to pay, are never static. One of the most dangerous things you can do as an investor is to get too comfortable with an easy narrative. Trust us, we all do it, to milk the hard work needed to uncover an investment idea, to distil this idea into a short series of easily digestible bullet points to include in updates and pitches. The process of anchoring a story to these reductive points invites complacency.

We inevitably focus on the big changes that are stark and loud – COVID-19, the war in Ukraine, inflation, financial crises. However, it is the smaller, more continuous changes that demand harder work, and greater scrutiny. Little changes that are happening all the time, in individual divisions of individual companies, in the industries and the geographies in which they operate.

Thinking about our Trinity of Risk discipline, we recognise that business and financial risks are in constant flux, and we must guard against any overconfidence and complacency that disregards this basic truth. Of course, the third leg of this trinity is price. As we have said and written so many times over the years, the price that you pay for an investment is the biggest determinant of the return on that investment. Thus, every day, it's not just the business that changes, but the price risk does as well. Valuations matter.

Our view of the status quo is challenged every results season, when we are forced to confront the spaces between what we think a company is all about, what the company is compelled to tell us through regulatory requirements, what they choose to emphasise in their narrative, those themes upon which analysts decide to focus, and what other investors think the company is all about, measured in real time and pounds and pence on the stock market. On results day, not only is the river flowing hard, but there are multiple places on the bank from which to observe and opine.

Different views from the bank, or what's in the price?

Bunzl is a very good business. Through about 150 subsidiary companies, it manages the distribution of a wide range of 'goods not for resale' for customers across a range of industries. These are things like napkins, hangers, hard hats, and toilet rolls. Bunzl buys in bulk, taking only about a 6% mark-up all-in, so it can provide a cost-effective service for its customers, small and large. It spends excess cash making tuck-in acquisitions when it can and distributing a dividend that is well-covered by cash profits.

It's always right to hold investments in quality companies, companies like Bunzl, right? Wrong! We love a quality compounder (which steadily grows its earnings each year), but how can it outperform when everyone understands how the business works and has baked into the valuation all the profit growth there is likely to be?

We think the market doesn't understand just how much Bunzl has benefited from inflation. Organic sales growth in a normal non-COVID year tends to be 0% to +4%. In its full year results, it revealed 12% growth in its base business. But what about 2023 or 2024? If inflation in the things Bunzl distributes stops rising or, horrors, begins to fall, it will have to pass those lower prices on to their customers. We don't think the City is adequately pricing in that risk, so we've sold our holding.

Sometimes the river floods

Our view of UK financials has been bullish, and we have been rewarded for our optimism. Our banks are well capitalised and have benefited from the widening margin between interest received from loans and interest paid on deposits. Furthermore, because a large portion of the deposits banks take in is systematically invested into government bonds, as older, near-zero-yielding bonds mature, the banks are reinvesting these funds into today's much-higher-yielding bonds. Through time, this should be the engine of profit growth for the banks. Higher rewards allow the banks to return more capital to owners in the form of dividends and buybacks. As an example of this, **Lloyds**, which has a market cap of £32.4 billion, announced a £2 billion buyback paired with a total full-year dividend of £1.6 billion. The total capital return of £3.6 billion equates to over 11% of the company's value.

Now that's all fine and dandy, but the global financial system has been plunged once more into panic with the collapse of Silicon Valley Bank (SVB), a regional bank based in California. Those of us around at the time of the Global Financial Crisis (GFC) know full well how broader systemic crises can begin.

Our initial reaction is to regard this as a unique situation which the US authorities will be able to quarantine very quickly. The 16th largest bank in the US, SVB provided financial services to technology businesses around the globe. However, while few people seem to be quibbling with the quality of its client base, eyebrows have been raised about its balance sheet. SVB relied upon the deposits of a very concentrated number of venture capitalists, high-tech companies and start-ups, rather than sticky retail money, and it had very little recourse to wholesale funding (loans from large institutional finance companies) to diversify its liabilities. With deposits ramping up over the last few years, arguably because of the immense tech boom through COVID, SVB's loan growth couldn't keep up, so it bought longer-dated government treasury bonds to boost returns. However, with interest rates going up in the last year, two things happened: corporate clients took their (short-duration) money away in search of better returns elsewhere, while the value of the (longer-duration) bonds fell. They hadn't matched their assets (the bonds) to their liabilities (the deposits). So when 25% of its deposits were withdrawn in one day, SVB had to crystallise the losses on their treasuries to honour the withdrawals.

There are numerous reasons for multiple alarm bells to be ringing. We all remember from our experiences of 2008 how foolish it is to dismiss such an incidence as unique, somehow ring-fenced from our own interests, and to be blindsided as to any further contagion within global markets. The share price volatility beyond the limited purview of US regional banks reminds us of this reality. We must also be alert to the ripple effects further afield, whether funds taking losses, or business failures within the technology space. It can be these aftershocks that augur broader systemic collapses.

By way of an aside, the CEO of Sweden's biggest pension fund, Alecta, is having to explain a $2bn bet on the three niche US banks caught up in SVB's collapse (Signature Bank, First Republic Bank and SVB). The fund is so big that the losses won't have a material impact on their solvency ratios, but you get our point.

But do UK institutions offer a safer view from the bank?

Despite performing very well over the last couple of years, sentiment towards our UK banks has been fragile (**NatWest**, Lloyds and **OSB** have outperformed; **Barclays** is up but marginally behind the index; **Close Brothers** is down). SVB will dent confidence further. In the future there may well be a persistent nagging drumbeat of concern about increased regulation. And yet, we suggest that the greater regulatory burden under which the UK and European banks have been operating since the GFC will prove to be a competitive advantage post-SVB – who do you trust with your money?

What is perhaps harder to surmise is where this leaves interest rate cycles and the outlook for inflation. Markets seem to be alighting on the view that global rate rises will now be put on hold, as shown by the dramatic moves in shorter-term bond yields, and that stability in the financial system probably demands a pause. Homeowners and businesses may breathe sighs of relief, but inflation could begin to increase once more. Stricter lending criteria may dampen investment, the high-tech industries may come under greater stress, and anxieties about a stalling US economy could grow.

But is the UK in a better place? We don't know yet. Taking a step back, we remind ourselves that economic data have been incrementally more positive. It was only a small beat, but UK GDP rose 0.3% in January, following a 0.5% decline in December, and ahead of the 0.1% forecast. This raises hopes that the UK will avoid a deep recession. Economic pressures are impacting the jobs market, but this means that wage growth is slowing, which reduces the pressure on the Bank of England to raise rates. For the banks in which we invest, while there is always the trade off between rates, the shape of the bond yield curve and the strength of the economy, what isn't in doubt is the fact that a better economy is a good thing.

The Trinity of Risk

Every day is unique. We should learn the lessons of the past, but must understand that the challenges of today will be different. Our job – not just over the coming weeks, but every day we run your fund – is to look at our portfolio and ask if it is appropriate for the world in which we live and work. With the discipline of our investment process, we forge an understanding of business risk, of financial risk, and of price risk. If the collapse of SVB teaches us anything, it is the self-evident importance of this trinity. But crucially for UK Equity Income investors, it may instruct us as to the specific opportunities that may well be arising at this moment in time.

Recent Trading: February proved to be a busy month. Wanting to increase the cyclicality of the portfolio, we sold Bunzl and reduced academic journals and analytics business **Relx**, and added to existing positions in three industrial names, engineer **IMI**, foundry production supplier **Vesuvius** and packaging giant **Smurfit Kappa**. We trimmed oil major **BP** and UK retailer **Halfords**, and switched some funds from housebuilder **Bellway** into rival **Redrow**.

Companies seen in February: drinks business **Diageo**, BP, miner **Rio Tinto**, pharmaceutical firm **Novartis**, **British American Tobacco**, advertising conglomerate **WPP** and business equipment supplier **Takkt**.

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Any views and opinions are those of the investment manager, 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 and the income from them may go down as well as up and you may not get back what you originally invested.

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