Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone High Quality Bond Fund

Quarterly update March 2021

The first quarter saw big moves in government bond markets. The yield on US 10-year Treasuries (which rises as prices fall) shot up from 0.92% at the start of the year to reach 1.74% by quarter-end. And the yield on 10-year gilts surged from 0.20% to 0.85%.

Credit markets were less tumultuous, though credit spreads – the extra return above government bond yields for taking on the risk of default – did widen marginally. The iTraxx European investment grade index started January at 48 basis points and ended the quarter at 52 bps.

	3 months	6 months	1 year	31 Mar 19-31 Mar 20	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	-1.43%	-0.25%	4.23%	-0.69%	4.95%
Bank of England Base Rate + 0.5%	0.15%	0.30%	0.60%	1.23%	2.29%

These figures refer to past performance, which isn't a reliable indicator of future returns.

Source: FE Analytics; data to 31 March, I-class, mid price to mid price; performance is a combination of I-class units and S-class units where I-class was unavailable (I-class launched 23 July 2019).

The value of your investments and the income from them may go down as well as up, and you could get back less than you invested.

Big bond moves ahead of the 'great reopening'

Three months ago, much of the developed world was firmly in the grip of COVID-19. Fast forward to today and several of the world's biggest economies are making decisive moves to open up again as the vaccine rollout has gathered momentum. By mid-April, more than 900 million vaccine doses had been administered world-wide. Notwithstanding the emergence of alarming new COVID mutations and new lockdowns in parts of Europe, the UK is gearing up for a 'great reopening'.

As all this has been happening, economists have been ratcheting up their growth and inflation forecasts. By early February, these had begun to suggest that pent-up demand, fuelled by the sizeable savings that many have accumulated during lockdowns, could lead to a red-hot recovery. Bond yields have been climbing as optimism has been growing about an economic rebound – alongside expectations that reflation (a recovery in prices as economies get back to full throttle) would soon follow.

In early February, bond investors began anticipating that reflation would morph into full-blown inflation and concluded that this would drive big central banks to hike interest rates sooner than they'd previously expected. (Higher rates can tame rising prices because they make it more expensive to borrow and, therefore, curb propensity to spend.) This drove a scramble to sell government bonds, whose value would decline if rates went up.

Bond investors have been shoving their carts well ahead of their horses. Central banks have repeatedly insisted that they're not going to raise rates anytime soon. US Federal Reserve chair Jay Powell has stressed that the central bank will keep rates at rock-bottom levels until it sees firm evidence that inflation and employment have settled at its longer-term targets.

The government bond market selloff had begun to ease by quarter-end. Indeed, the 10-year US Treasury yield was back to 1.57% by mid-April. But the intense selling pressure at the longer end of government bond markets (which is most sensitive to changes in yields/interest rates) has ensured that the yield curve has steepened significantly. That's to say, the yields on longer-dated bonds have risen relative to those on shorter-dated bonds. We see this as no bad thing: a steeper yield curve often signals that the economy is recovering or expanding.

We took advantage of this steepening by selling some of our shorter-term debt and investing that money in longer-dated bonds that offer greater yields. The largest of these sales were the **Korea Development Bank 1.75% Senior 2022**, **Barclays Bank 2.375% Floating Rate Senior 2023** and **London Stock Exchange Group 4.75% 2021**. We replaced them with new issues from US finance giant **Athene Global Funding 1.875% 2028** and **London Stock Exchange Group 1.88% 2030**, and life assurer **New York Life Global Funding 0.75% 2028**. We have increased our modified duration from 2.9 years at the beginning of the year to 4.1 years – the highest level since we launched the fund. However, we are also benefiting from greater income, which is part of the reason we are comfortable making this change. Also, while our duration is higher than it has been, it is still much lower than a typical corporate bond fund.

Keeping calm and carrying on...

We have stuck to several longer-term themes that have proved rewarding for us over the last year.

We continued to sell our highly rated floating rate notes, because their yields are unappealing. These included the **Leeds Building Society Floating Rate Senior Secured 2025**, **Coventry Building Society Floating Rate Senior Secured 2025** and **TSB Banking Group SONIA Floating Rate 2024**. These bonds did a good job protecting our capital throughout the rough trading patches in the past year or so, but we feel fixed-rate bonds are more compelling today.

We still see value in senior parts of banks' capital structure, so that's where we have made many purchases during the quarter. Lenders' credit ratings have been stable and their bonds still offer higher credit spreads than equivalent issues in other industries. We bought the newly issued **Leeds Building Society 1.86% 2027**, **HSBC Bank 1.75% 2027** and French bank **BPCE 1.17% Senior 2025**, as well as a few others in the secondary market. We also added to our duration while making these trades, by purchasing the **Nationwide Building Society 1.03% Floating Rate 2031** and Dutch lender **ING Groep 1.45% Green 2028**.

When we could, we bought dollar-denominated bonds. The cost of hedging dollar-denominated investments back to sterling has dropped dramatically. Because US treasury yields are markedly higher than gilt yields, US credit investments can offer much more attractive yields than their UK counterparts. Pricy currency hedging costs used to wipe out much of this yield boost. But it's got much cheaper for sterling investors like ourselves to hedge out the currency risks associated with dollar bonds, so we added significantly to our US dollar exposure, hedged back to sterling, over the quarter. This also allows us to buy bonds issued by some very high-quality companies which don't tend to offer much sterling debt. These included Swiss insurer **Zurich Finance 3% 2051-2031 (it has a call date)** and smartphone titan **Apple 1.2% 2028 and 1.65% 2031**.

Finally, we have exited our holdings of Heathrow Airport. In March we sold the last bond we held, **Heathrow Funding 5.225% 2025**, after the UK's vaccination success led to a rally in pandemic-affected industries. Before the virus struck, this bond was rated A-; after the fallout, its average is now BBB+. The bond has performed well despite the setback, so it isn't offering as much yield as we would expect for the higher risk. So we used the improving credit picture to sell and reinvest in bonds offering similar yields but with higher credit ratings.

When markets turn very volatile, as they did in February, it's easy to get panicked. We don't join short-term selling (or buying) stampedes just because that's what lots of other people are doing. We tune out market noise and instead stay focused on opportunities that we believe will benefit our fund's long-term return and income potential.

Noelle Cazalis
Fund Manager

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

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

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