

Rathbone Income Fund

Update July 2018



Fear and loathing in the income space

I began working on the Rathbone Income Fund, as an analyst, twenty years ago. I joined Rathbone Unit Trust Management in the summer of 1998 from the private client side of the business. Back then, investor enthusiasm towards UK domestic names was certainly cool; the white heat of the market was concentrated on the technology, media and telecommunication (TMT) sectors. We were all enthralled by the amazing possibilities that the future held.

Two decades later, the world is indeed transformed. Our phones are super-computers; we demand immediate fulfilment from our internet retail transactions; and we stream video and music onto our TV screens across multiple platforms and providers. However, making money from investing in these industries has been far from straightforward. Apple (now the first \$1 trillion business by market capitalisation) is one of a few outstanding winners, but there have been innumerable losers. Many businesses have crashed and burned over the years, destroying mountains of investors' money in the process. This is nothing new – every thriving industry and technology has built itself up on its failures as well as its successes. Conversely, many of the old-economy businesses for whom the funeral bells were being pre-emptively tolled decades ago have actually moved on and thrived. History is all about change, evolution, revolution and re-birth.

It is now the summer of 2018. Facebook, Apple, Amazon, Netflix and Alphabet (Google), the FAANG stocks, have had an overwhelming impact on potential investor rewards. Total return for these stocks in the 12 months to the end of June was 35.2%, versus the S&P 500's 14.0% gain. In the first six months of this year, the 1.8% achieved by the S&P disintegrates to a loss of 0.7% if the aforementioned FAANGs are removed from the calculation. The FAANG stocks now make up 11% of the S&P 500. This is symptomatic of a wider phenomenon whereby market strength is being generated by an increasingly narrow leadership of stocks, a distortion in global markets that is further magnified by the strength of the dollar. Our fear is that future global returns from equity investment are being eroded by this exuberance, and that narrow leadership and stretched valuations will have dire consequences.

The UK is at the other end of the exuberance spectrum. The titans of the FTSE 100 still attract plenty of support, but they are plays on the global rather than the domestic economy. However, the domestic, predominantly old-economy plays – those companies that ply their trade within these shores and are a representation of UK plc – are very much out of favour. If investor sentiment was cool towards such swathes of the market in 1998, it is achieving pockets of ice age dormancy in 2018. Bank of America Merrill Lynch's monthly poll of fund managers shows the UK has consistently been the market most loathed by global investors for months. The principal fears are

understandable: Brexit and the threat of a Jeremy Corbyn-led government. Irrespective of value, why take the risk?

Risk of a policy mistake

We can see plenty of value in the UK market, but when we see little immediate catalyst for change, we do wonder how patient we should be. Indeed, if anything the mood has darkened in recent weeks.

Let's review the most recent pronouncement from Mark Carney, chair of the Bank of England's Monetary Policy Committee (MPC). Base rates will rise 25 basis points to 0.75%. The initial market and media response was muted and measured, unsurprising perhaps as the news was widely predicted. On the day, foreign exchange markets were largely unchanged. There was some good news: a rebound in second-quarter economic activity, following a period when the abnormally cold weather kept us indoors, reflected a normalising of economic behaviour rather than a great leap forwards, but still informed a decision to raise rates.

As a standalone decision, this does little to change our current weightings in UK domestic entities. Our positioning already takes into account the risk of an error in policy, and our general view is that the low valuations attributed to many of our UK names – especially those consumer-facing businesses – offer us adequate compensation for the very visible risk of the combination of tightening monetary policy and Brexit uncertainty. We estimate that approximately 14% of our portfolio is directly exposed to the domestic UK economy.

Industry	Companies	Combined portfolio exposure (UK revs)
Leisure	Greene King; Restaurant Group	3.7%
Financial incl. Property	Lloyds; Big Yellow; Hansteen; Jupiter	3.3%
Retail	Halfords; Headlam	2.9%
Media	ITV; DMGT	2.3%
Housebuilding	Berkeley	1.6%
TOTAL		13.8%

Methodology: When vast majority of revenues generated in UK, 100% of portfolio weight; when only partial UK exposure (e.g. ITV), portfolio weight reflects pro rata UK revs (in ITV's case 73% x 2.1%). Global businesses have been excluded.

Data as at 31 July 2018.

However, some quite serious clouds have formed on the horizon over the past few weeks. The MPC's rate decision and forecast are premised on a smooth Brexit, and while this might have always been an optimistic assumption, the thunder in the distance is the growing possibility of a no-deal Brexit.

The IMF has already predicted that UK GDP would relinquish 4% of future growth over the next five to 10 years if we switched over to WTO rules, given the necessary tariffs and barriers that would be incurred.

The Bank of England has suggested that rates of migration are already lower than initially recognised as the UK becomes a less attractive place to live and work; a no-deal scenario

exacerbates this trend. The labour market is already tight, potentially fuelling wage inflation, as input costs rise concurrently because of a weaker pound. Inflation combined with a stalling economy (stagflation) is a clear possible future.

Where does the MPC turn if this comes to pass because of a no-deal Brexit? (Or do we assume that all bets are already off?) The additional wriggle room afforded by the latest 25bp rise will seem inadequate if the economy lurches downward once more.

The UK currently exudes uncertainty from every pore. However, it is all too easy to focus on the worst that can happen. We have to deal with the situation as it is, and arguably valuations reflect all of the above.

The risk of a no-deal Brexit has been raised, but for all the political posturing around “no-deal is better than a bad deal”, our base case presumption must be that a practical resolution is achieved. Full employment and manageable wage growth may offset the effect of the rate rise on mortgage costs where they most hurt: on personal consumption. Weaker sterling means our goods and services are more attractive in terms of price. There may be some more fertile uplands in the economic landscape, only they are difficult to perceive at the moment. A much needed improvement in productivity growth, which has been deteriorating for much of the recent past, would be a further fillip to our economic prospects. This should therefore be a clear political priority. While any optimistic scenario is still unlikely to persuade overseas investors to jump back in, it may at the very least belie the basement valuations that are being attributed to stocks.

It is also necessary to make one final point regarding currency. At the moment a bet against sterling seems the obvious call. We have been here before. In the summer after the Brexit vote, sterling weakened, sterling earnings were less valuable, and businesses gaining dollar profits saw their share prices soar. What if the opposite happens? What if a deal is signed and the sterling bears take fright? There could be a whiplash reaction.

We have benefited from our dollar earners, but we should never put all our chips on one call. We are comfortable hedging our bets in the UK value pot.

Current positioning

We have been consistent in our message throughout 2018, and we make no bones about repeating this message again this month. **There has been an extended period of low rates, high asset prices and low volatility, and we do not believe that this scenario will be maintained indefinitely.**

We continue to favour businesses where we believe earnings growth is predictable and sustainable. We are willing to pay a higher price for this security, hence our core positions in consumer names like Unilever and Reckitt Benckiser, tobacco stocks, and core compounders like Bunzl, DCC and Relx.

Late cycle moving into recessionary phase of the economic cycle – this informs our positioning in the consumer staples cited above, as well as oil, pharmaceutical and utility positions. These stocks may also thrive if the yield curve inverts.

Interest rate sensitivity – we have a diversified exposure to financial stocks, which may benefit from increases in short-term rates. However, we fear policy mistakes, and bond proxies have been

sold down too far, especially those utilities with index-linked revenue streams attached to regulated assets. We are very much hedging our bets.

Value is very much out of favour and in some cases for good reason, as expounded upon above. However, when Armageddon is priced in, one piece of good news can change the view. We will continue to buy value when the risk is appropriate, especially when we view the dividend stream to be secure.

Finally, we have **a shopping list of more growth-oriented businesses**, not to buy now, but to examine if there is a correction in markets.

We must conclude by emphasising that our fund continues to behave just as we might expect. When investors are confident and equity markets are robust generally we make hay, but we tend to lag on the more exuberant days. On the other hand, when nervousness returns and the risk-off trade predominates we do seem to fare better in relative terms. In our opinion the fund is reacting according to type, reflecting its bias toward capital preservation.

Above all, we maintain a balance of risk across the portfolio. The world is always changing, and it is often the hardest times that actually throw up the greatest opportunities. Investing money at the moment is not easy, but as fortunes ebb and flow, we must have confidence that we can grasp these opportunities. And we must also recognise that the best ideas can be found in the places that are the least obvious.

After all, history is all about change, evolution, revolution and re-birth.

Recent trades: July was a very quiet month, and there are no significant trades to report, other than general portfolio management.

Companies seen this month: **Greene King, Berkeley Group, Micro Focus International and Jardine Lloyd Thompson.**

Carl Stick

Fund Manager

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