

Rathbone Income Fund

Monthly update May 2022

It goes without saying that dividends are a vital component of the return that income funds achieve for investors. It's often argued that dividend policies instil discipline in businesses to generate a sustainable and predictable flow of cash profits, cash returns that give investors a little bit of 'jam' today. The counter-argument claims that if companies have wonderful opportunities to invest cash back into their businesses, why give it back to those shareholders who funded their capital in the first place in the hope of more jam tomorrow? When does dividend policy stop being a sign of financial discipline and become a tail that wags the dog?

Dividends should be an outcome, not a driver, of company strategy. We herald our own focus on "giving investors a pay-rise every year", but it's important that we don't allow this focus to trump the discipline that steers our investment process. Our primary concern is to assess the cash returns that a company makes on the capital it invests in its business. This capital is the fruit of a company's investment decisions; when successful, it engineers the compounding of returns that makes equity investment so very compelling.

Case Study 1: The Scottish energy linchpin

Utility business **SSE** is unique in that it is the only ever-present stock in your fund since Carl Stick took over the fund management reins in 2000. At a very early meeting with the company, the management explained how dividends, and most importantly real growth in those dividends, were central not only to SSE's investment proposition, but also to how it ran its business overall. For years this was very attractive, particularly in the early noughties between the bursting of the technology bubble and the Global Financial Crisis (GFC). UK utility companies then represented a 'sweet spot' of value and predictability. However, for much of the time thereafter, SSE has found itself in a bit of a bind. After the GFC it had three hungry mouths to feed. It needed to: reduce debt (because investors were much more worried about leveraged balance sheets); pay an increasing dividend; and invest in its business, directing funds towards renewable assets and its network business (the jewel in its crown). Inevitably, satisfying one risked malnourishing another.

But SSE has managed to evolve and today it's a different beast. Its dividend will be reduced in a year or so and its balance sheet is stronger – albeit compared to history since it's still a utility business after all. The point is it can prioritise allocating capital towards renewable energy and network projects that look so attractive in a world where security of supply and the green energy transition are crucial. As income investors, we welcomed this dividend reduction considering the growth opportunities that lay ahead. The price of the shares, which reflect the company's relative 'safe-haven' status, means that we've marginally reduced our position nevertheless. But we continue to believe that SSE represents a compelling long-term story.

Case Study 2: Engineering efficiency

A cash-generative business can spend its profits paying us handsomely or buying back shares, but if its balance sheet is already in decent shape, wouldn't it be better to spend the money on sensibly growing profits? We bought into industrial group **IMI** more than a year ago when we were hunting for undervalued cyclical businesses and have added some shares during the recent market sell-off. The stock is not a high yielder, but we like how it allocates its capital. Since we invested in IMI, it has increased research and development spending, bought into a business that complements its specialist actuators for medical equipment (they are tiny things!) and, most recently, bought a business that tucks neatly into its factory automation portfolio. With labour scarce and increasingly expensive, we believe factory automation is a theme with real legs.

Predicting the future

None of us has ever experienced a market environment quite like the one we're in, no matter how long we've been working in our industry. Never before have we seen such accommodating (and experimental) monetary and fiscal policy for so long. We are emerging, we hope, from a global pandemic. A war is raging in Eastern Europe. Decades of globalising supply chains and increasing economic inter-dependence have halted abruptly, and these trends are reversing. The current spike in inflation is almost unprecedented. We can only try to estimate how economies and markets will react as these great forces resolve themselves. We have no perfect reference points.

We do know that inflation lowers the price that investors are willing to pay for assets and that higher interest rates dampen investment and, therefore, growth. Markets have de-rated – the S&P 500 index is down by 21% year to date. But earnings expectations have yet to retrace and if this happens, it could herald further market falls. This is why we focus so intently on valuations: we want to avoid the double whammy of de-ratings and earnings disappointments. This market differs from the crash that followed the bursting of the tech bubble back in 2001. However, 20 years ago, we responded to that crash by doing two things. We tried to be realistic about what businesses might earn, but, more importantly, we focused even more sharply on the valuations of these businesses. Owning a business that you've bought at the right price is the best insurance policy when markets fall. Conversely, owning expensive assets gives you nowhere to hide if things go awry. We cannot predict the future, but we can learn from the lessons of the past.

When portfolios go up in value, who needs dividends? Just take profits from your gains, they say. But when valuations fall, it's harder to lock in losses to fund your cash needs! When interest rates are low, it seems to make sense to own long-duration assets. But when inflation and rates are rising, a bird in the hand suddenly seems a lot more attractive – dividends, and the capital discipline required to produce, sustain and grow them, are what make income funds so attractive in this environment. Bear markets are scary, but they're part and parcel of most investing journeys. To be blunt, they tend to be a good place to start, or to invest more because – as we have already said – the price you pay for an asset matters a lot to its overall return. We also know that you only know in hindsight when the market has hit its bottom. If you're not invested at that point, you really will miss out on the upside.

Recent trading: May was a busy month, in which we re-balanced several positions in the portfolio. We added to **Ashtead Group, Big Yellow Group, Close Brothers, Dechra Pharmaceuticals, Games Workshop, IMI and Smurfit Kappa.** We reduced positions in **Jupiter Fund Management, National Grid** and **SSE.** We also created a new holding in materials technology company **Vesuvius.**

Companies seen in May: Jupiter Fund Management, **DCC,** Vesuvius, Big Yellow Group, and SSE.



Carl Stick
Fund Manager



Alan Dobbie
Fund Manager



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