Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update July 2021

Once upon a time, August was a month of relaxation. Do you remember summer holidays when the sun was always shining? (Well, it didn't shine quite every day.) When the football season was still a few weeks away. And when markets took a breather, reviving only when the big hitters got back to work in September.

These days, things are different. For one, it has rained an awful lot. For another, the first week of August was a bumper one for companies reporting their first-half numbers. No apologies for the plot spoiler, but the dividend story has been great this year, a happier sequel to the horror that was 2020. So much so that we must wonder whether, for the first time in several years, **dividend income is becoming a greater factor in total returns**.

The dividend comeback

Last year was characterised by uncertainty, especially its first half. It would be an overstatement to claim this uncertainty has dissipated in 2021: it hasn't. Yet the macro backdrop has certainly changed. Delta variants notwithstanding, the economies of most developed nations have started to reopen. Increased optimism has whetted investor appetite for more cyclical industries and 'value' has put up more of a fight against 'growth'. If we feared deflation early in the pandemic, inflationary pressures have become the hotter topic this year. Increased confidence is further evidenced by the level of M&A activity this year, with UK plc a key target. The world has moved on and narratives have changed.

Twelve months ago, **BP** and **Royal Dutch Shell** were reeling. The pandemic-driven massive drop in demand, combined with huge disunity among oil-producing nations, smashed the price of crude and with it the profits of the energy giants. The industry was also hit by the ESG hygiene factor. Environmental, Social and Governance investment has been rapidly gaining traction, and — as you would expect — most of its adherents tend to take a dim view of oil majors. Many investors eschewed the sector altogether, while others failed to be convinced by big oil's net-zero strategies and its ability to prove that it could execute them successfully.

A year on, while many challenges remain, the mood music has a stronger beat. The rebound in profits was expected, as we all could see the recovery in oil prices. What surprised investors in BP and Shell was their emphasis on dividend growth. Remember, BP had previously signalled a static dividend, with more cash returned through share repurchases, in a scheme worth $500 million in the second quarter of this year. Those buybacks have now been ramped up to $1.4 billion for the coming quarter. BP announced:

"Reflecting the underlying performance of the business, and ***improving outlook*** *for the environment,* ***confidence in our balance sheet*** *and commencement of the share buyback programme, the board has announced an increase in the second quarter dividend of 4% to 5.46 cents per ordinary share." Source: BP Q2 results, 3 August 2021 (our emphases).*

This was just the start. Shell went even further, announcing a 38% increase in its dividend and a $2bn repurchase scheme for the rest of 2021.

Great news for income funds, great news for many British pensioners who hold these businesses in their schemes. But one big caveat remains. Generating loads of cash is one thing, but investing it wisely is another. The big puzzle is: how much money should be given to shareholders today at the expense of investment that could generate greater profits tomorrow? Investing in energy transition is a gamble as it involves the substitution of once-reliable fossil fuel cash flows with less predictable green energy returns. However, for the moment, let us recognise the industry's recovery from the dismal days of 2020 and the cash benefit of its dividends.

Super-dividends

The mining sector has thrown up very different challenges. It was expected to deliver bumper profits and it didn't disappoint. **Rio Tinto** generated huge profits, principally due to extraordinary iron ore prices. In normal circumstances, miners would spend this level of cash on expansionary capex and M&A. They might reduce debt, but their balance sheets have grown so strong in the years following the global financial crisis that, in essence, they've got nothing to spend their cash on. This means that their payment ratios to investors are very high. Last year, Rio paid an interim dividend of 155c/share. This year, the interim payment is 376c, an increase of 143%. In addition, it is paying a special dividend of 185c, aggregating to a total eye-watering rise of 262%. This is 75% of its total earnings, which was actually on the low side of some predictions, because there is still some investment to be made.

Our conundrum is that this level of profitability and payout is unlikely to be repeated even if supply and demand imbalances are maintained. Of course, we will actively seek to manage any future drop-off in dividend income. **For now, let's take this for what it is: a very welcome bonus year**.

Financial strength

The UK banks represent an altogether different opportunity set. Like the miners, they're not the same beasts as those laid low during the global financial crisis. Despite their balance sheet strength, the regulator pressurised them to stop paying dividends last summer. This year, shareholders are finally getting their reward. Profitability has improved across the board as provisions for potential bad loans have been released. Mortgage providers like **Lloyds Banking Group** have benefited from the strong housing market. Banks with greater high-margin credit card exposure have prospered through greater consumption and fewer defaults; the payment industry offers exposure to economic recovery. All four of our banks, Lloyds, **NatWest**, **Close Brothers** and newly introduced **Barclays**, pay what we regard as healthy and sustainable dividends. Economic growth will determine the extent of their future strength. (Barclays and NatWest have been confident enough to embark upon share buybacks too.)

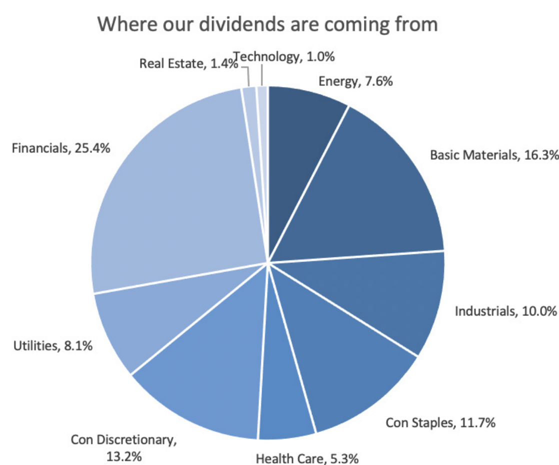
It's not just these three big sectors that are commanding all the limelight. Another new addition to the portfolio, recruitment business **PageGroup**, affords economic leverage in a varied way through the vibrant employment market. Its board is sufficiently confident in the excess cash it's generating to have reinstated its interim dividend, up 9% from 2019, and also to declare a special dividend. **And it's paid back £3.4m of furlough money**. We are mindful that staffing agencies have a reputation for over-distribution. But this is a sure sign of confidence that we don't believe the market is fully valuing.

Outlook

A recent study by an analyst at UBS suggested that US businesses, especially technology names, might start returning more cash to shareholders. Payout ratios may increase and dividend growth may start to exceed earnings growth. Under such a scenario, dividends and dividend growth could start to play a greater role in generating shareholder returns.

The US technology sector is not really our bag. But this concept of dividends playing a greater role most certainly is. Dividend income is the tangible return you get from owning shares. This rule has been neglected for some time now. This summer may be when it starts to regain some of its former eminence. This is important for us, as managers of the Rathbone Income Fund, since the majority of our outperformance (our alpha) has historically been generated by our ability to capture dividends and dividend growth and reinvest this dividend flow back into the fund (securing the steady compounding effect). But the dividend comeback re-emphasises a critical dilemma: every pound we receive is one pound less that the payers can reinvest in their own businesses. We are forever seeking a happy medium!

That said, the positive news flow is clearly a good thing. We cannot predict the exact impact of the dividend comeback, but as things stand, it looks as if we're going to regain nearly all the ground our distribution lost last year. This is, quite frankly, astonishing! Our attention is now moving towards next year as we try to understand what our dividend profile might look like in 2022.



Source: Rathbones; estimated for fund year 2021/22

We stress that these are our estimates and they'll likely change. But we are predicting dividend growth next year, though it's expected to fall back to our 'normal' range. We're reaping the benefit of this year's 'bonus' payments, but expecting enough growth going into next year, all else being equal, to lay a good foundation for our next 'pay-rise', without any overwhelming reliance on one industry. **If the dividend continues its comeback, it's going to be a more important constituent of your total returns**.

Recent trading: All our trading was done late in the month. We trimmed some of our larger positions, including some **BHP** and **Rio Tinto**, for dividend planning, as well as **Relx**, **Bunzl**, **Lloyds**, **British American Tobacco** and **Ashtead**. Following the month end, much of the proceeds were reinvested, first into **BAE Systems** (another company to post super numbers) and to create the new **Barclays** position.

Companies seen in July: **Micro Focus**, **Reckitt Benckiser**, **Smurfit Kappa**, **Altria** and **Jupiter Asset Management**, amid an early deluge of results calls.

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