Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Income Fund

Monthly update August 2021

Apparently, statistics show that September is historically a very difficult month for investors, although the data is skewed by the impact of massive extraneous events: 9/11, the Global Financial Crisis, taper tantrums and credit crises (hat tip to David Amato at Citi). As we write our note in this inauspicious month, there is an overwhelming vibe of uncertainty and trepidation.

The narrative of the last 18 months centred upon inflation — whether it would prove transitory or more secular in character, and if it should instruct rotation into more cyclical assets — has evolved into something altogether more complex. This evolution is occurring just as we are all coming to terms with new realities, trying to work out what living with COVID will really be like, not just in the limited focus of financial markets, but for the world as a whole.

Labour costs are unequally distributed

This is not the letter (and we are not the writers) to dive head-first into an intricate discussion of the link between wage growth and inflation. However, we should make a few observations. It is obvious to all that there are major fractures in employment markets, especially in the UK and the US. These must be reset and this will take time. In the UK, job vacancies have shot past 1 million for the first time ever, with a quarter of that supply coming in August alone. Firms are desperate to hire. But the supply of workers is low, with unemployment at 4.6%. Is this a basic supply/demand imbalance, or a mismatch in skills, or in expectations? We don't know, but we are seeing the impact of this, particularly in the leisure sector, in logistics and in healthcare. Tesco is offering £1,000 in signing-on bonuses to lorry drivers — the supermarkets don't like empty shelves; Costa Coffee is giving staff a 5% pay rise as it looks to recruit 2,000 workers; Wagamama is struggling to recruit chefs. The National Farmers' Union is reporting "anxiety off the scale", as a lack of seasonal workers risks leaving crops unharvested and rotting in the fields. The pattern is being repeated in the US, where labour market shortages seem to be getting worse, and job openings are increasing (even if August data are notoriously unreliable and volatile).

Supply chains are squeezed. Ikea is short of mattresses and JD Wetherspoon is running out of beer — even toast is off its breakfast menu. European power and carbon prices are surging to record highs as costs rise on the back of global energy demand and a supply crunch in the gas market. There is even a global shortage of the vials that health services, including our NHS, use for blood tests.

Now this is not intended to be an exercise in dramatic scaremongering or political finger-pointing, just a recognition that there is an accumulation of signals of which we need to be aware. Now, we may surmise all we like about the causes of these signals — the COVID-19 pandemic, political forces instigating a retreat from globalisation to more nationalistic, autarkic policies, the impact of Brexit on UK trade and labour markets, and so on. Whatever the conclusion, there are big changes taking place in labour markets and supply chains that are going to take a long time to wash through, and we must be very cognisant of the impact on business.

When economic forces are clashing so strongly that it becomes difficult to fathom with any degree of certainty a clear trend in the market, as now seems the case, it just makes it easier for us to focus on companies themselves. The area where we believe we can make informed decisions for your benefit. We have been doing close forensic work on individual companies to evaluate the impact of supply chain constraints, staff shortages and wage pressures. We've been trying to understand how easily resultant costs are passed on to their customers, and then on to consumers. We've also been trying to figure out how that will be reflected in our companies' costs, as higher prices will ultimately put pressure on wage demands. Also, each business will be impacted differently depending on the availability of the skills it requires and its ability to automate and adapt labour needs. All our businesses operate in this massively complex system that we blithely refer to as the global economy, so we should jolly well do the work on a company level.

Man's best friend

We recently met with **Dechra Pharmaceuticals**. We have mentioned Dechra many times before in these letters, unsurprisingly since we have owned the shares for almost 20 years. This is arguably the greatest investment we have ever made. A veterinary pharmaceuticals business, it dominates niche markets where giant pharma rarely ventures, thereby generating healthy margins and cash profits. Its core 'companion animal' market is growing strongly, and it is taking market share in every market in which it operates. Although management have eschewed M&A during the pandemic, a rock-solid balance sheet affords Dechra substantial ammunition when it is once again able to go out and kick the tyres on potential purchases (cultural fit is extraordinarily important to Dechra). Underlying earnings growth of 29% allowed Dechra to comfortably increase its dividend by 18%. A great business, but this is not a cheap stock; we are always playing this balance between quality and price. Dechra's shares did indeed drift on the day of its latest results, always a hazard when there is price risk on the table. However, this is a business that is executing well, and can negotiate the hurdles that face global businesses. Having made substantial changes to its supply chain over the last few years, it is not as yet experiencing the problems seen elsewhere and it seems to have the pricing power to pass on costs.

The argument for UK Equity Income is strengthening despite the travails that we have detailed. Fully 85% of high yield US debt is trading at negative real yields. To get a real return, investors in US corporate debt need to venture into the murky depths of weak single-B credit or below. That's a lot of risk for not much return. US equity markets are trading at the highest price-earnings multiples since the dot.com boom. That asset prices are so high seems to run counter to the stresses impacting global economies. There is a lot of money being staked on the expectation that central banks will continue to do whatever it takes, which means baulking at the first sign of market weakness.

But what if that central bank action doesn't happen? The UK market still trades at a big discount to other major markets. Yes, it is commodity heavy and there's a lot of old economy stuff that is out of fashion right now (even though they tend to be critical to most people's daily lives). Is it cheap enough to present sufficient margins of safety? Maybe. But look at the value and look at the yield and reflect on that US high yield debt making real losses. We are not strictly comparing apples with apples here, but this does seem anomalous.

Yes, there are risks, but we believe they are worth taking. At the end of August, our fund yielded 3.4%, but that is before any healthy rise that occurs this year on the back of the strong resurgence in dividends from UK plc. This income return, and the potential compounding effect of these dividends being reinvested back into the fund, alongside the disparity in value at a time when assets are generally overpriced, are arguments that we must keep on making.

Recent Trading: Most of our trading straddled the month end. In August we sold our small position in high street baker **Greggs**. We also began to exit from housebuilder **Berkeley Group** prior to reallocating those funds elsewhere in the housebuilding industry early in September. We also added to oil major **BP**, lender **Barclays** and defence and aerospace contractor **BAE Systems**.

Companies seen in the month: consumer brands conglomerate **Reckitt Benckiser**.

Carl Stick
Fund Manager

Alan Dobbie
Fund Manager

This is a financial promotion relating to a particular fund. 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 your original investment.

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

Authorised and regulated by the Financial Conduct Authority

A member of the Investment Association

A member of the Rathbone Group. Registered No. 02376568

7481.09.21