**Rathbone Unit Trust Management**

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Rathbones
Look forward

# Rathbone Income Fund

## Quarterly update December 2020

Twelve months ago, we began our annual review with the phrase, "By any measure, 2019 was an extraordinary year." We need a new bigger measure.

Twenty-twenty redefined 'extraordinary', and 2021 is already having a go. Any review of 2020 cannot satisfactorily reflect the global ramifications of the COVID-19 pandemic, and this investment review even less so. The fact that financial markets generally ended the year in ebullient form conceals the social, political and economic upheavals for which the year will be remembered. Reviews, by definition, look backwards; the challenge now is to make some sort of sense as to what 2021 may bring. A salutary lesson to heed is to expect the unexpected, and to invest on this basis.

| | 3 months | 6 months | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| **Rathbone Income Fund** | 13.0% | 9.3% | -10.6% | -3.0% | 13.7% |
| IA UK Equity Income Sector | 15.6% | 11.9% | -10.7% | -4.1% | 16.2% |
| FTSE All-Share Index | 12.6% | 9.3% | -9.8% | -2.7% | 28.5% |

| | 31 Dec 19-31 Dec 20 | 31 Dec 18-31 Dec 19 | 31 Dec 17-31 Dec 18 | 31 Dec 16-31 Dec 17 | 31 Dec 15-31 Dec 16 |
|---|---|---|---|---|---|
| **Rathbone Income Fund** | -10.6% | 18.6% | -8.6% | 8.2% | 8.4% |
| IA UK Equity Income Sector | -10.7% | 20.1% | -10.5% | 11.3% | 8.8% |
| FTSE All-Share Index | -9.8% | 19.2% | -9.5% | 13.1% | 16.8% |

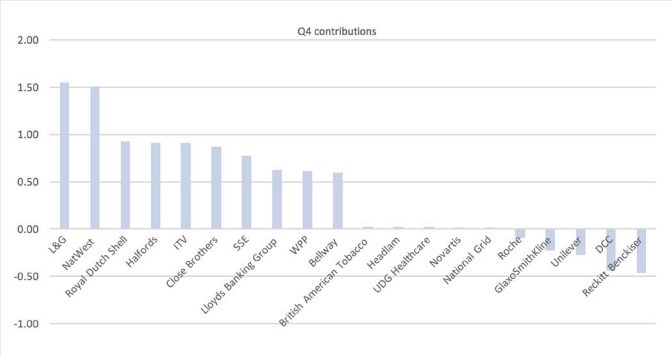
Source: FE Analytics; data to 31 December, I-class, mid price to mid price.

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

**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.**

Over the year, our fund performed in line with the IA UK Equity Income sector and marginally behind the FTSE All-Share Index. Over the last quarter, we lagged the sector, but moved ahead of the market. We had hoped that a benign Brexit denouement would have been a positive fillip for the fund, and indeed it was at first, but gains were trimmed in the final few days of the year, which, in purely cosmetic terms, was a disappointment.

### Three-month performance




Source: StatPro; Rathbones.

After several false starts during the year, a more concerted rotation into more cyclical sectors and shares described as 'value' ramped up during the fourth quarter. Some of the catalysts for this shift had been around for preceding months: concern about market valuations, especially in technology, and more growth-oriented sectors; greater volume of analysis arguing for inflation to start coming through into the system; weakness in the US dollar; and investors finding income harder to come by. The fourth quarter also included the drama of the US election, and the news that several vaccines were viable which acted as a counterpoint to the resurgence of the virus as the days got shorter and colder. For UK investors, and especially those with an interest in the UK economy, there was, at last, the signing of the UK-EU trade agreement. The extent to which these events impacted the markets is not easily quantified, but the rotation theme, into value, is evidenced by our individual stock contributions above.

Financials and energy stocks recovered strongly during the quarter. In financials, our strongest performers included **NatWest** (a holding steadily established since May), **Legal & General, Close Brothers**, and **Lloyds Banking Group**. Admittedly, this does reflect a recovery from deep share price falls earlier in the year. However, the market is warming to the fact that balance sheet strength offers not just the possibility of a robust defence against a stalling economy, but also the flexibility to invest in business opportunities and distribute cash once the current crisis abates. Exposure to a rebounding UK economy, post-Brexit and COVID, combined with cheap shares and actual or potential dividend flow, has created an attractive mix.

A recovering oil price, established upon a more orderly market instigated by greater discipline from OPEC, bolstered the energy space. Secondly, **Royal Dutch Shell** was able to return to profitability in Q3, after the huge asset write-downs of earlier in the year. This was eminently predictable, but the market liked the 'optics', and it bolstered confidence in the company's – and the wider sector's – ability to pay dividends, albeit rebased. Elsewhere, **ITV** and **WPP**'s resurgence epitomised a more optimistic prognosis for the media sector backed up by better-than-expected advertising numbers.

The other side to the value rotation was a reassessment of 'defensive quality' and 'growth' stocks. Since May we have steadily reduced our exposures to **Reckitt Benckiser** (by 50%), and **Unilever** (by 30%), arguing that too much emphasis was being placed on COVID 'beneficiaries' and not enough scrutiny afforded to their inadequacies. Having peaked at the start of October, shares in both businesses have reversed meaningfully versus the FTSE All-Share.

This rotation also impacted other core defensive positions, including **GlaxoSmithKline** and **Roche** in the pharmaceutical sector, and **British American Tobacco** (BAT). These businesses have substantial dollar earnings exposure, so the dramatic weakening of the greenback has hurt the sterling value of much of their income. We regularly review our exposure to these companies, but all three businesses act as counterbalances to our more aggressive 'cyclical' holdings. Glaxo, Roche and BAT are also not as highly rated, in our opinion, versus some of the consumer staples names we also hold. Finally, **DCC**, the global distributor of petrochemical, technology and pharmaceutical products, has also lagged. What was deemed a virtue back in the spring, during the height of the panic, is now an encumbrance: cash on the balance sheet generates no return, and as market confidence improved, some investors grew impatient with DCC's conservative approach to deploying these funds. We are happy for it to be patient. Of greater concern is the fact that, in our opinion, the company has been a little late in arguing for its Environmental, Social and Governance (ESG) credentials, which is important considering its exposure to the wider energy complex.

### Full-year review

We do not intend to go into much detail regarding full-year stock contributions; suffice to say this has been covered extensively in previous quarterly reviews, and the data are heavily weighted to the market reversal in March 2020. On a 12-month basis, the biggest drags on our performance were the consumer-oriented stocks, **Carnival** and **Restaurant Group**, that we sold back in the spring, and our energy and financial positions, many of which we have already commented on in this review. The bigger volte-face we have seen since the spring has been in the positive moves, where Reckitt Benckiser and **Bunzl** have been superseded by **Rio Tinto**, NatWest (bought in the summer) and **Halfords**, a stock we saved from giving the chop, and which has rewarded us with an astonishing rise from its March lows.

## Outlook

The coming year presents many clear and present challenges. The disciplined roll-out of vaccines worldwide will take many months, and it will take many more for the world to return to a semblance of normality, a normality that will be different to what we knew. The US needs to move on from the Trump years, but, as shown by the storming of the Capitol Building in early January, there are severe hurdles to overcome. And profound changes must be made. In the UK, there is a new future to negotiate outside of the European Union, and great economic problems to solve. And globally, issues of climate change, and the challenges of inequality, as exemplified by the Black Lives Matter movement, and other human causes, are there to be resolved. The year 2021 is indeed likely to be extraordinary.

However, we must look forward with optimism. If these challenges are overcome, and humankind does generally get things right in the end, things will get better. In the shorter term, the uncertainty of Brexit is behind us, and the roll-out of three vaccines has begun. British businesses have struggled, but many have survived, and evolved, and there should be a bounce back as all the pent-up consumer demand comes on stream. Companies will change, as our behaviours change; they will also be taking greater heed of ESG matters, we believe. Not just because of high profile advocates and activists such as Sir David Attenborough or Greta Thunberg, but because regulators are telling them to, and investors are asking them to. The US political upheaval tells us that people are angry and frustrated, so we need to be mindful that stakeholder rather than shareholder returns may become more important. Regulators are certainly pushing this agenda. As investors, we cannot stand still. We must look ahead, even if we cannot rightly tell what is around the corner.

We are nervous about market levels and are minded to maintain our focus on value; this focus gives us a margin of safety for precisely the reasons stated above. This is no time to be too aggressive on price, we believe. We are more bullish on the UK, which may sound absurd considering the current lockdown and the inevitability of a double-dip recession. However, markets are forward looking, and the UK businesses in which we invest are survivors and have balance sheets that should see them through more short-term disruption. Importantly, relative to others, the UK market is very, very cheap; there is a lot of bad news baked in. As evidence, observe the recovery that occurred in the final quarter once investors started to look through the present troubles toward the future. We will maintain our bias towards cyclical stocks, such as miners, and we are increasingly constructive about the energy sector. We are confident that there needs to be a broader response to the world's energy requirements, and the fossil fuel giants must be engaged in the conversation. Meanwhile, financials offer exposure to any steepening in the yield curve, as well as economic exposure and dividends.

Finally, we want to re-emphasise the attraction of equity income. If investors are looking for income, where else can they go? Cash earns no return, the bond markets are expensive, and property funds are less easily traded. We agree that total return is paramount, but income is a constituent of that return. At the year end, our dividend yield was 3.9%, and our objective remains real growth in this income. Right now, despite the uncertainty, we think there is a robust argument for the UK, for a more appropriate exposure to value-oriented and cyclical shares, and for equity income as a recently neglected asset class.

**Recent trading:** In a quiet month for trading, we trimmed **AB-InBev**, Roche, **Imperial Brands** and **Smurfit Kappa**, using the funds to add to **Aviva**, **Persimmon** and Lloyds Banking Group.

**Companies seen (virtually) this month: Sampo.**

**Carl Stick**
Fund Manager

**Alan Dobbie**
Fund Manager

**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.**

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