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Rathbones
Look forward

# Rathbone Income Fund

## Update January 2020

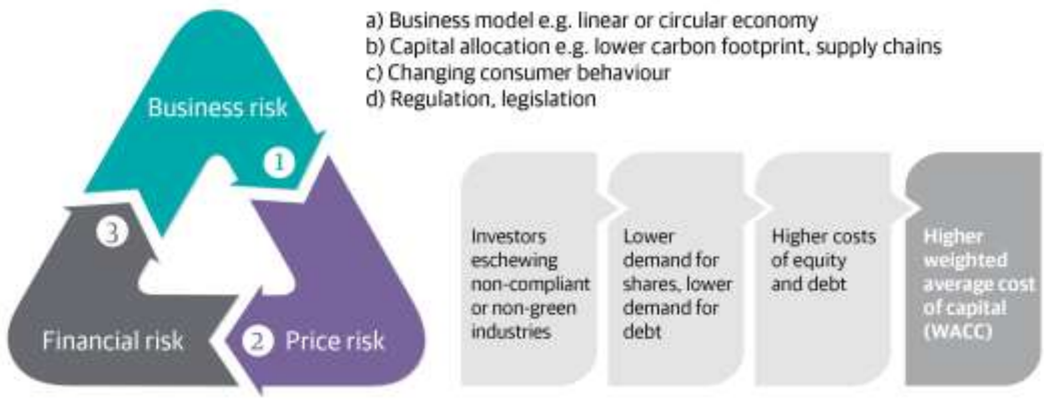
Attitudes to sustainability have evolved dramatically over the last three years. Once peripheral to the worlds of business, politics and consumers, the topic of sustainability is now central to modern discourse, a discussion that has great ramifications for anyone making investment decisions. Politicians will be encouraged to make big statements without necessarily doing the maths, but regulation will have a broader impact. Business models will be revolutionised, and customers will change their habits and predilections. It is incumbent upon fund managers to develop methods that navigate these new trends without making knee-jerk reactions in one direction or another. This letter touches the surface of how we view the waters ahead.

**Sustainability and the Trinity of Risk**

Executives and directors will need to look at their business models and ask if they are still appropriate, a task made more challenging by fluid definitions of sustainability and the difference between headline noise and equitable business practice. Ultimately, it will be up to business managers to decide these questions. But their actions will influence who the appropriate owners of certain companies should be; investors may price industries too low because they do not resonate with the current zeitgeist, and they may be lost to the public markets. However, that is maybe a topic for another letter. Nevertheless, when we talk to businesses we want to understand how issues of sustainability are influencing their capital allocation decisions.

The sustainability agenda is impacting sources of financing too, by raising the cost of both equity and debt for industries deemed to be on the wrong side of the argument. On the other hand, some companies in a 'hot spot' are perhaps enjoying much cheaper financing than their risk should require. This goes hand in hand with the market value of a business – the price risk – and changing investor attitudes to the value of equity and debt. Premia and discounts are attributed and fluctuate in accordance with these arguments. It is wholly appropriate that issues around sustainability are integral to our investment decisions, but this does not guarantee that markets will not get distorted and prices misaligned with risk.

Challenging enough as it is to forecast when these risks may be recalibrated, it is incumbent upon us to develop a method that encompasses sustainability arguments within an orthodox investment process. Our response has been to avoid overcomplicating the process.



## The impact of sustainability on business risk

Are these sustainability factors a necessary inconvenience, are they an opportunity, and are they affecting real cultural change? You can often get that information by observing the body language of management teams, and watching whether their responses evidence true enthusiasm. Fundamental changes to business models may reflect extraordinary new opportunities or existential jeopardy. The answer to this second question has a real impact on investment returns, and there is substantial opportunity for the companies that can allocate capital into areas that can ride these waves; conversely, if a retreating or even dying business does not recognise its fate, investment will destroy a lot of value.

Our approach may be to draw up some simple classifications to bring some sense of order to our investment universe. One category, the Green category say, may be businesses that fulfil all of our environmental, social and governance (ESG) requirements, while also doing something positive, definable and measurable to improve the planet. We already have a method here as used by our Global Sustainability Fund. Over on the dark side, (and remember, the Income Fund does not follow a sustainability mandate), let us define a Red category. Granted, there is subjectivity here, but we might include tobacco, defence companies (both sectors which we own), gambling companies (which we don't), and other industries where the ESG hurdles are clearly not met and where we feel it inappropriate to argue any positive merits beyond commerce. As I say, this may be as much an art as a science and we should be very careful to avoid occupying any moral high ground. Our analysis within the Trinity of Risk framework will balance real or perceived business pressures against the price risk afforded, with the subsequent cost of capital and with the investment decisions established in relation to these pressures. Every sector is different – for example, defence contractor **BAE Systems** has hit new highs this year as tensions in the Gulf have risen, while **Imperial Brands** continues to languish, bereft of support. We argue ESG factors can have a significant impact on price so it would be remiss to ignore them. Not ignore whole industries, that's not our mandate. But to be aware of all of the risks to share prices, regardless of the driver.

However, the key area is the large middle ground, populated by industries that are very important for the equity income sector. If we are colour coding this area, it might be a spread of yellow with a tint of green. Generally clean businesses that are not really generating positive impact, through to amber businesses with obvious ESG challenges, yet making efforts to change direction. There are inevitably all the shades in between. This space warrants a lot of work. It includes sectors such as pharmaceuticals, energy and utilities – industries that are fundamental to human existence and progress, and whose evolution will be determined by their reactions to contemporary sustainability and ESG arguments.

## Energy – we cannot do without it

There are currently clear headwinds buffeting the oil and gas sector: prices swelling on Middle Eastern tensions, then plummeting on global growth concerns exacerbated by the novel coronavirus scare. Lower prices mean lower profits, meaning less cash to invest in future projects, pay dividends and, importantly for this sector, reduce gearing. As a whole, these oil and gas businesses' financial risks are rising which reduces their attraction as investments, despite the compensation of sky-high dividend yields. But this is geared up further by the existential threat posed by the sustainability challenge. You could navigate an oil tanker through the chasm that separates the climate change agenda on the one hand and the impact of fossil fuels on the other.

This chasm exists because the value of the industry's core product is tied to its carbon intensity; any reduction in the industry's carbon footprint is a diminution of their *raison d'être*.

But they are also part of the solution. It may be optimal for us all to drive around in electric vehicles, but we are years away from that scenario. In the meantime, the transition to hybrid vehicles necessitates oil and gas use. There's also the extra electricity that needs to be generated in the first place; and the infrastructure to be built; and planes and ships still need oil; and we shouldn't penalise developing economies; and how sustainable are the new technologies; and what about the supply chains; and what about the technologies of the days after tomorrow – how quickly will today's investment become obsolete; and, and, and…?

The analysis is beginning. Only this week, **BP** announced its ambitious climate targets, pledging to cut its greenhouse gas emissions to net zero by 2050 across all its operations, including products consumed by customers. The word 'net' is important, as it means that other technologies such as carbon capture will be used to complete the maths. Investors in BP like the $8.4 billion in dividends it paid out in 2019. It also invested $14 billion into its core oil and gas business, dwarfing investment into new technology. The shares went up on the announcement, but organisations like Greenpeace said the measures do not go far enough. Different audiences want to hear different things.

The City is learning how to think about these issues, with analysts creating expansive reports assessing the industry's transition to a low-carbon world. All recognise the tension between gradual moves in the right direction and the sheer scope of investment in the core product. Oil and gas companies will still be oil and gas companies 30 years hence, unless they stop being oil and gas companies.

Investors have to juggle several arguments: as ever, is the investment in new carbon intensive product rational and value creative? This is a function of cost of capital, which is a function of the risk investors are willing to take and the premium they demand for it. How fast will the economy transition to a low-carbon model? What new technologies are yet to come? What demands will this technology have on existing and new energy generation? As highlighted above, the arguments are numerous and circular.

### Lots of work to do

We are but a few steps down the path, but we believe we have a decent map in our Trinity of Risk matrix. It seems sensible to start with the industries that have a large impact on income mandates. How do we deal with the ethical criteria that challenge investment in pharmaceuticals, such as animal testing and inequitable pricing? We need to understand the role that the utility industries play in the broader energy market, and especially the need for the **National Grids** of this world to build the infrastructure to facilitate transition.

And finally, how do we think about price risk? There are many companies out there that are being disregarded perhaps unfairly. Conversely, there is clearly an ESG premium being allocated as well. How wary do we have to be that some businesses are being bid up because they fit the current sustainability photo-fit without due reference to the business risks that they pose? Is there a danger that we create, for the sake of the planet, a re-make of the 1996-2000 TMT bubble?

Finally, it will become increasingly incumbent on us as fund managers to explain our positioning. Our fund is not a sustainability fund, but we should be able to map out our positions within a sustainability framework to assess the risks they pose, hence our interest in a workable method. Sustainability, like the planet, is here to stay. Investors should be inquisitive as to their place and identity in this world.

**Recent Trading**: Concerns about market levels after the strong end-of-year rally encouraged us to raise some cash, broadly reducing our larger positions. We also sold down a large proportion of **United Utilities**, which has been outstanding through the second half of 2019 and especially once the election risk diminished. At month end cash represented 6.2%.

**Companies seen this month**: **WPP**

**Carl Stick**
Fund Manager

**Alan Dobbie**
Fund Manager

**This is a financial promotion relating to the Rathbone Income Fund. Any views and opinions are those of the managers, 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 may go down as well as up and you may not get back your original investment. Performance data is sourced from Financial Express, mid to mid, net income re-invested.**