Rathbone Unit Trust Management
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Rathbones
Look forward

Rathbone Income Fund

Update December 2019

By any measure, 2019 was an extraordinary year.

In the UK, 12 months of political shenanigans (or maybe we should include all 42 months since the referendum) reached some level of climax with a resounding election victory for Boris Johnson's Conservatives and the implosion of support for Jeremy Corbyn's Labour Party. The reduction in political uncertainty, driven by the expectation that we're on the road to getting "Brexit done", boosted markets despite the hurdles that remain ahead. Elsewhere in Europe, the German economy faltered and the *gilets jaunes* protests continued to squeeze French President Emmanuel Macron's reform efforts.

Through it all, the US economy was resilient. President Donald Trump continued to write his own rules, escalating the trade war with China, and at home seeking to influence the Federal Reserve. The backdrop for all of this, of course, was the threat of impeachment. 2019 was also the year of climate activist Greta Thunberg and huge forest fires in California, Siberia, and Australia. The climate change debate is only going to develop.

Amidst the noise, risk assets moved higher. Any economic and political duress was trumped by persistently low interest rates, which meant that too much cash continued to chase too few assets. In the US, the S&P 500 hit yet another all-time high on 27 December. In the UK, the FTSE All-Share generated a total return of over 19%, a figure that belied the political and economic challenges. The fillip of a business-friendly government returning to No.10 no doubt helped markets, although most of the gains were achieved ahead of the vote on 12 December.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	4.32%	6.23%	18.59%	17.37%	39.10%
IA UK Equity Income Sector	7.20%	8.32%	20.07%	19.58%	38.22%
FTSE All-Share Index	4.16%	5.48%	19.17%	22.01%	43.84%

Source: FE Analytics

In absolute terms, 2019 was a strong year for our fund. Not only did we make you a total return of 18.6%, we also increased our income payments by 6.3%, a strong, inflation-proofed 'pay-rise'. A job well done.

We reiterated our cautious positioning at the start of 2019, emphasising our preference for late-cycle industrial sectors (pharmaceuticals, oil & gas, consumer staples) and recessionary plays (tobacco, utilities). We focused on value, especially in the UK, and we preached the importance of balancing risk across our portfolio – that is, not putting too many eggs in the same basket. This conservatism contributed to us producing marginally lower returns than both the stock market and our IA UK Equity Income sector.

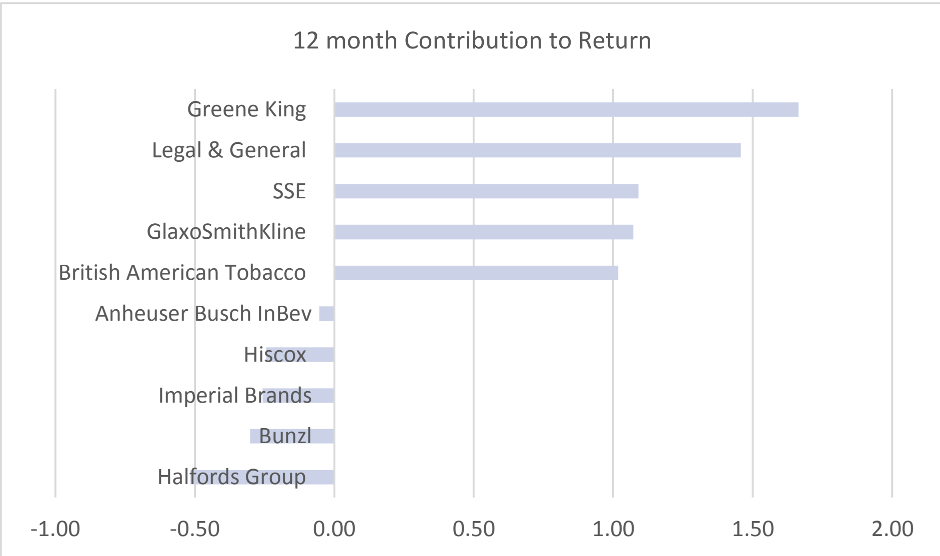
12-month performance attribution

The UK consumer

Analysis of the primary contributors to our performance reveals fascinating contrasts and trends. Brewer **Greene King** was acquired in August by CK Asset Holdings, the vehicle that holds the commercial property assets of Hong Kong billionaire Li Ka-Shing. The 50% premium to the prevailing price capped what had already been a good share price performance earlier in the year. Greene King is an asset-backed, cash-generative business, operating in a secure environment. We think similar businesses may be attractive to other wealthy overseas buyers now that the political risk in the UK has diminished.

This may bolster investor opinion of retailer **Halfords**, our principal laggard for the year. Further strategic change is carded for 2020, funded in part by the not-unexpected cut in dividend announced last year. On the one hand, we must question whether we should cut and run after years of tough trading conditions; on the other, we recognise that Halfords is unique, financially secure, and proffers a free cash flow (FCF) yield of 12%, which provides a substantial margin of safety. Although the shares languish at multi-year lows, we are minded to remain patient for a little while longer.

12-month – biggest contributors to performance –stock level



Source: StatPro

The UK value plays

We were rewarded for our conviction ahead of the election. Reflecting political risk for much of 2019, **Legal & General**'s share price was looking poorly back in August. However, as the mood music improved, the shares recovered through the autumn, spiking higher in the immediate aftermath of the election. Both major parties promised grandiose infrastructure expenditure; with billions of pounds on its balance sheet, and expertise and passion in this area, Legal & General could yet prove to be a valuable partner for the new Johnson regime.

Utility **SSE** also recovered from lows early in the year as investors warmed to the news of the potential (now confirmed) divestment of its retail business. For many years, this division was a magnet for regulatory and media disapproval. Mr Corbyn posed an almost existential threat to the entire utility sector, so Labour's loss was SSE's gain. Its share price leapt into the year end. SSE represents a good way of playing renewable energy in the UK. We hope that, after several years in the shadows, its future is bright.

The tobacco conundrum

No sector encourages as much debate in client meetings as the tobacco industry. Difficult headlines on the subjects of traditional (tobacco) and next generation (e-cigarettes, vaping) products initiate many of these discussions, which often progress to the ethical ramifications of owning the sector. However, they are currently too cheap, and their cash flows and dividends too attractive, for us to ignore. We believe the existential threats are overplayed. Of course, we obsessively reconsider all of the above within the framework of the business, financial and price risks we are adopting. In 2019, **British American Tobacco** performed strongly in the first and fourth quarters (after 18 months of steady drift). We are minded to take profit on further strength. By contrast, **Imperial Brands** remains largely unloved. The latter is perhaps another valuation anomaly, with a 14% FCF yield and an 11% dividend.

Fewer losers in a buoyant year

Unusually, it is **Hiscox** that caused us some angst last year. Two decades of consolidation have shrunk dramatically the UK insurance sector, but Hiscox remains a quality operator – quality that is reflected in the price. However, this leaves little margin of safety if there is bad news. The hit to profits this year on the back of greater catastrophe losses was expected and explainable: part and parcel of the industry. What raised eyebrows in the November trading statement was the reference to increased claims and reserves in Hiscox's US private company directors and officers (D&O) exposure. This is the coverage offered for decisions made by firms' executives and directors. The ever-changing social environment has increased both the demand for coverage, and the ultimate cost to the sector, as claims increase. The market will settle down eventually, but we worry whether risk is currently correctly priced.

Finally, **Bunzl**'s underlying growth was slower than expected due to mixed macroeconomic and market conditions across the countries in which it operates. A dull performance from what is normally a steady Eddy stock. We were right to trim at the start of the year; it made us content to buy back a few of those shares at a cheaper price in December.

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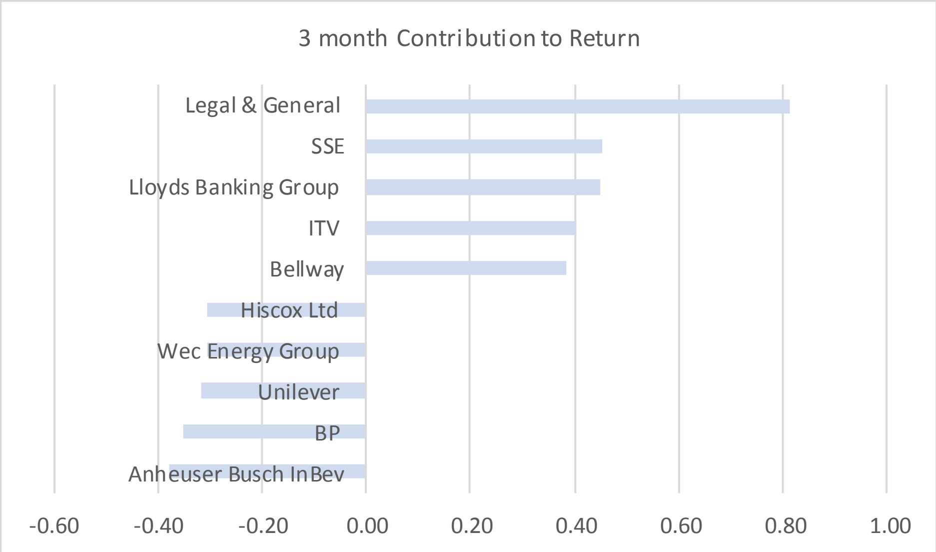
Three-month performance attribution



Source: StatPro

In brief, Q4 performance echoed many of the trends detailed above. UK-oriented stocks performed very well as the political environment improved. By contrast, there was a slight rotation out of the FTSE's multinational giants in favour of more domestically focused names. Oil stocks were generally weak, which hurt us considering our large absolute position in the sector.

Outlook

We were cautious at the start of 2019, caution misplaced in hindsight following the robust returns achieved during the year. Twelve months later, we are feeling moderately optimistic. Yes, markets have been on one of the longest bull runs in history, but the joy has been unevenly spread, and this means that there is value to be found, especially within the UK. Therein lies the great opportunity for our fund.

Political risk has diminished in the UK. Brexit is not yet done, multiple challenges lie ahead and the full ramifications are as yet unknown, but we are a lot further along the road than we were a year ago. Stability gives businesses greater confidence to invest, just as it gives overseas entities greater confidence to buy up the opportunities on offer. Investment should beget growth. After a decade of ultra-loose monetary policy, there now seems to be greater appetite for fiscal solutions, which may add further impetus. And the UK is cheap versus other developed markets.

We therefore see little need to adapt our positions. We want to own businesses that generate good cash flow returns on their invested capital, enabling them to pay out dividends that increase year after year. If we can own them at attractive prices, 2020 may yet be another strong year, despite the undoubted challenges that lay ahead.

Recent Trading: At the start of the month, we added to **Carnival**, Legal & General and Bunzl, and post the election we further supplemented **Micro Focus International**, BAT, **Unilever**, **Jupiter Fund Management** and **National Grid**. As markets recovered further into the month, we trimmed **Berkeley Group** and **GlaxoSmithKline**.

Companies seen in December: We had meetings with **Reckitt Benckiser** and **Daily Mail & General Trust**.

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.

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