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Rathbones
Look forward

Rathbone Income Fund

Update February 2020

Carl had a lovely walk with his dogs Sunday morning. After weeks and months of rain and trudging through mud with animals (both bi- and quadrupedal), thoroughly miserable, it was wonderful to be out in dry, clear conditions. Not quite sunny, but with the bulbs coming up in the woods, the lighter morning, the contented dogs bouncing along, enjoying life. Having seemingly been robbed of a proper winter, it appeared that spring finally had arrived.

And yet it hasn't really, has it. We have made three attempts to write this investment letter, but each one has been superseded by the events of the day. Whether our initial response to market volatility, or an endeavour to interpret "Black Monday" and the oil price shock, or the dramatic falls of subsequent days. In the end, writing has taken a back seat to the day-to-day task of taking stock of what is occurring. We're not sure that the coming days are going to be any different. The evening of Friday 13 March saw the US market snap back, the largest increase in the S&P 500 Index since 2008 reversing some of the biggest falls since 1987.

With volumes low and volatility high, we recognise that end-of-week moves are notoriously fickle, and smack of short-closing. The weekend policy responses have been dramatic, yet again. However the speed at which the coronavirus is taking hold in Europe will provoke further dramatic reactions this week.

We do not pretend to have any answers, but we do have intentions and disciplines, which we wish to outline in this letter.

What are we seeing ...

Market volatility will persist, driven by news, exacerbated by the lack of liquidity. We are all dealing with a set of events that we have never come across before. And by 'we' we mean everyone: politicians, investors, businesses, consumers, old and young, rich and poor. Things will change, and the first thing for us to do is to remind ourselves that we cannot predict the future, so our decisions should reflect humility and the relative paucity of our knowledge.

The Covid-19 pandemic will take its course; we hope that the outcomes are better than feared, for reasons substantially more important than global markets. These outcomes will be swayed by millions of individual decisions. The headlines will be generated by the politicians, and policy pronouncements will influence behaviour and eventualities. From a narrow economic perspective, central banks will play a fundamental role, but they are also re-inventing their own playbooks. This is not a re-run of the global financial crisis. It is very different and needs a very different plan.

A big difference from 2008 may also be the lack of a co-ordinated global response. Our memory of the financial crisis was a sense that, as the turmoil took hold, governments and banks were acting in concert, that there was the semblance of a global plan. However, the last decade has seen a fracturing of this trust, reflected in greater inequality at an individual level but also in a body politic that is altogether more unilateral, more nationalistic. The country-by-country response to the current crisis is possibly correct, but it does further emphasise this disintegration. Those at the helm of states are inevitably going to be motivated by their own political agendas, as well as the greater good.

If fiscal stimulus wasn't on the cards prior to these events it most certainly is now, and governments may need to make some dramatic decisions, If 2008 saw huge monetary stimulus, 2020 may invoke dramatic fiscal stimulus geared towards individuals and small businesses. The UK government has already promised £12 billion of combined aid for the NHS, small business and households, and pressure will be upwards. Expect further monetary and fiscal stimulus.

Finally, the discussion as to whether markets were expensive at the start of the year, when Covid-19 was in its infancy, is irrelevant now; they were never pricing in the current reality. This does not help us to understand how low they could go or the route they could take to get there. Markets will jerk up and down in response to news flow, and pricing stocks will be difficult. They are unlikely to be a true reflection of risk, either up or down. We will need to be very patient and very thoughtful.

… And what we are doing

Let's not further complicate an already-difficult and fast-moving set of circumstances. We revert back to first principles, and this means looking to mitigate losses and secure our dividends. This market is going to break things. The rules have changed and we must act accordingly. If this means that we have to swallow pride and crystallise losses, so be it. But volatility will also throw up opportunity.

We do own businesses for whom the coronavirus is an existential threat, through a combination of falling revenues and persistent costs, perhaps exacerbated by debt. Good days in the market will be used to reduce this exposure. By our own estimates, they make up about 5% of our portfolio. We are stress testing our dividend forecasts. Although a large proportion of our income has already been defined in full-year numbers, there will be pressures in the second half and into next year. None of this is beyond what we do anyway, however, it's just that we are exercising even greater vigilance and urgency today.

Just two weeks ago our tactics were to consistently rebalance our portfolio towards value; now our emphasis is shifting back to security, but without disregarding price risk. Expect us to hunker down in more defensive sectors, such as pharmaceuticals, consumer staples and utilities, and retreat from areas of more distressed value – for the short-term at least.

Our current top-10 represents more than 40% of our portfolio:

Reckitt Benckiser
GlaxoSmithKline
National Grid
SSE
British American Tobacco
Unilever
BP
Legal & General
Roche
Royal Dutch Shell

A significant risk in our core exposures remains the oil sector. And with yields at eye-watering levels, there is a clear challenge to the sustainability of these companies' dividends, especially in light of the recently fractured OPEC/Russia relationship. BP and Shell yield more than the sovereign debt of Iraq and Mongolia, but that is irrelevant if oversupply and falling demand means the payments can't be made. While they do represent deep value, given the above, we are reassessing their weights in our portfolio.

Beyond the energy sector, we are also reviewing our cyclical exposure in light of the inevitable brakes on global growth. Once more we are focusing on the appropriateness of debt levels and the security of dividends. Fortunately, in the early throes of the turmoil, these disciplines have held us in good stead. In light of our risk-based approach it is incumbent on us to outperform a falling market in a meaningful way.

However, we must also keep one eye on the medium-term strategy. As markets and economies evolve, new opportunities will arise. There will be a point in the future when some great businesses are up for sale at bargain prices. New areas of the economy will come alive – humanity needs to revamp approaches to healthcare. Today's events show how important is it to be able to work – and study – remotely. Should we be looking at ways to take advantage of technology names in our fund, especially if prices retreat further?

The key will be to ensure that we are in great shape to take advantage of these opportunities when they occur; to move from defence into attack. Now is not the time, but it will come. Cash in the fund is approaching 7%.

"Reinvesting when Terrified"

Back in 2009, the famed US investor Jeremy Grantham wrote a letter entitled, "Reinvesting when Terrified".

"Every decline will enhance the beauty of cash until, as some of us experienced in 1974, 'terminal paralysis' sets in. Those who were invested will be catatonic and just sit and pray. Those few who look brilliant, oozing cash, will not want to easily give up their brilliance. So almost everyone is watching and waiting with their inertia beginning to set like concrete. Typically, those with a lot of cash will miss a very large chunk of the market recovery.

We remember Mr Grantham's letter having a profound effect on us, because at a time of maximum noise it provided instruction for a logical course of action. He would admit, we are sure, to being particularly fortunate with his timing: we seem to recall a headline attributed to him along the lines of, "You'd be an idiot not to invest now," not in patronising terms but highlighting the absolute value in the market, which pretty much coincided with the absolute nadir. But the point was made: do not get so caught up in the noise that you become frozen in indecision. Right now, the danger is greater, if only because so many people are likely to be working remotely, on their own, transfixed by screens, scared to act.

We do have a plan, both tactically and strategically. We have no idea if it is optimal, but we do believe that it fulfils the needs and aims of our investors.

Jeremy Grantham once more:

"Finally, be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."

Recent Trading: We sold **United Utilities**, following share price strength both before and after the election. We added to **Rio Tinto** and **Lloyds Banking Group** on valuation grounds, and reduced **Big Yellow Group**, **WEC Energy** and **Reckitt Benckiser**, also on price. Finally, we took advantage of liquidity in the market to lighten the load in **Headlam**.

Companies seen this month: We saw **Micro Focus International, Smurfit Kappa,** Rio Tinto, **Bunzl, Persimmon, The Restaurant Group, and Kingspan.**

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