

# Rathbone Strategic Income Portfolio

Quarterly investment update, January to end March 2022



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## Hot topics – ‘Top-down’ (market and macroeconomic)

**Rising rates.** The first quarter of 2022 really was grim: fears of recession, war, rapid inflation, an energy crisis, a cost-of-living crisis and a stock market correction. This assortment of risks sent bond yields aboard a rocket ship. The 10-year UK government bond yield soared from 0.97% to 1.61% over the quarter, and then pushed above 1.80% in early April. The rise of the US 10-year was even more dramatic: from 1.51% at the dawn of 2022, it finished



three months later at 2.35%. At time of writing, it had surpassed 2.80%. Investors expect central banks to deliver a whole bunch of interest rate increases and reverse their quantitative easing schemes, perhaps more tightening than is indeed possible. Meanwhile, the values put on company profits (price-earnings multiples) have retreated – to an average of 19x in the case of American stocks – roughly where they were before the pandemic upended markets back in 2020. Put plainly, investors want much higher returns for lending money or putting up equity because of the foggy future. Even as company profits are actually growing at a fair clip. Investors are finding it extremely difficult to weigh up shorter-term risks with longer-term opportunities. This is leading to some pretty bizarre moves in share prices. Some stocks reporting earnings have dropped 10% in the morning only to finish the day 10% higher than where they started. That's barmy. But, mad as it is, it creates plenty of opportunities for us to trim winners and pick up bargains as we rebalance carefully and often to keep our portfolios prepared for rough waters ahead.

**Upended energy.** The war in Ukraine puts the spectre of a worldwide energy crisis front and centre. The news flowing from the embattled nation is awful to see, yet two months on Ukraine's defiant stand continues to frustrate Russia, which commands vastly more troops, supplies and equipment. Russia's attempts to pound Ukraine into submission have failed and instead sparked renewed discussion of wider sanctions among European Union (EU) members, specifically on Russia's copious oil and gas exports (which the US has already implemented). The price of energy has skyrocketed because of the uncertainty created by one of the largest producers invading its neighbour. If the flow of Russian oil and gas to Europe is halted, the effect on both Russia and the EU would be catastrophic. Many European nations would struggle to keep the lights on as energy costs rocket, while Russia would be stripped of a crucial flow of foreign cash. The whole mess has taught Europe an important lesson about energy strategy and security. But it will take more than a few years to put right. In the meantime, soaring prices for gas, petrol and electricity are squeezing households and businesses



from Seattle to Singapore and virtually everywhere in between. This led the World Bank to cut its forecast for 2022 global growth to 3.2% from 4.1%. Households and businesses have broadly come out of the pandemic flush with cash and a hankering to spend. But a sustained increase in costs with no end in sight will rein that optimism in. Recent surveys suggest that may already be happening, but it's really too early to tell how long the squeeze will last. By summertime we should have a better idea of the path of inflation and how people are feeling about life.

**Virus fatigue.** The latest wave of COVID-19 in the UK has broken and numbers of daily infections are falling once again (although daily reported deaths are still climbing). But given that there was less than three months between this viral resurgence and the last one, you have to wonder whether to pencil in another variant and another wave for the summer holiday. COVID-19 has lingered much, much longer than any of us expected. The US seems to be a month or two behind Europe, going off daily case numbers, yet it's right in lockstep on its fatigue for the



situation. After years of caution, testing and procedures, people are beyond tired of the virus and its effect on their lives. You will have seen the change as the months have slid into years: many of those initially most worried about their health have faded into a mixture of resigned acceptance and grim determination to do whatever it is they want to do. This of course makes it easier for the virus to spread, especially as every other month it makes itself more infectious. It seems unlikely that governments will implement any more lockdowns – with some exceptions, the most important being China – to combat any future spikes in the virus unless COVID-19 becomes markedly deadlier. However, the sheer number of people getting ill and falling out of the workforce for days at a time must surely drag on economic activity, particularly when many companies are struggling to find staff. Of course, the flipside of this devil-may-care attitude is a positive: people want to enjoy themselves, and if you've been out anywhere lately you have probably noticed that places are noticeably busier than the recent past. That's good for businesses and the people they employ. Let's hope COVID-19 doesn't have any more tricks up its sleeve.

## Portfolio activity

Key purchases/additions	Key sales/trims
Ashtead (new purchase)	Clorox (sale)
DBS Bank (new purchase)	Ashmore (sale)
Home Depot (new purchase)	Lockheed Martin (trim)
US Treasury 4.5% 2036 (addition)	Coca Cola (trim)
UK Treasury 4.25% 2027 (addition)	BP (trim)

Source: Rathbones

We added to a range of sovereign bonds as yields rose over the quarter, including the **US Treasury 4.5% 2036** and **UK Treasury 4.25% 2027**.

We took profits in **BP** because it has had a strong run over the past year and there were increased risks for the business due to its 20% stake in Russian oil-exploration-to-pump business Rosneft. We also trimmed **Lockheed Martin**, as its price jumped significantly in response to higher military spending in Europe.

We used the first-quarter market correction to add to our stocks across the board. We also used the turmoil to buy some new companies. The first was **Ashtead**, a construction equipment rental business – cherry pickers, drills, small diggers, compactors, chainsaws, that sort of thing. The company is listed in the UK, but 80% of its sales are made in North America. The outlook for construction is pretty bright, both in the UK and especially in the US. Housing is going up fast and infrastructure is in dire need of upgrade and replacement.

Another investment focused on the US housebuilding boom was in **Home Depot**. This business is the place to go for DIY warriors, with good value tools and materials, and well-skilled and knowledgeable staff who can give advice on getting the job done. But it is also one of the most popular suppliers for small and medium-sized trades businesses. Its professional sales relationships are thriving because of Home Depot's investment in its supply chain, delivery service and staff.

We also bought **DBS Bank**. Set up in 1968 as an arm's length development bank by the government of Singapore, it has grown into a solid and responsible commercial bank and lender. It operates across Southeast Asia, albeit with a heavy focus on Singapore and Hong Kong. It also has a presence in the UK, US, Australia and United Arab Emirates. It is growing modestly yet dependably, with a solid return on equity that should have a tailwind if global interest rates continue to rise.

Finally, we sold bleach and home goods producer **Clorox**. The business's profit margin has fallen back in recent results, lending weight to concerns that it will have to absorb rising input costs rather than passing them on to customers or offsetting them with lower expenses.

## Spotlight

In this quarter, the spotlight is on **WEC Energy** and **National Grid**.



# nationalgrid

### WEC Energy (Wisconsin Energy)

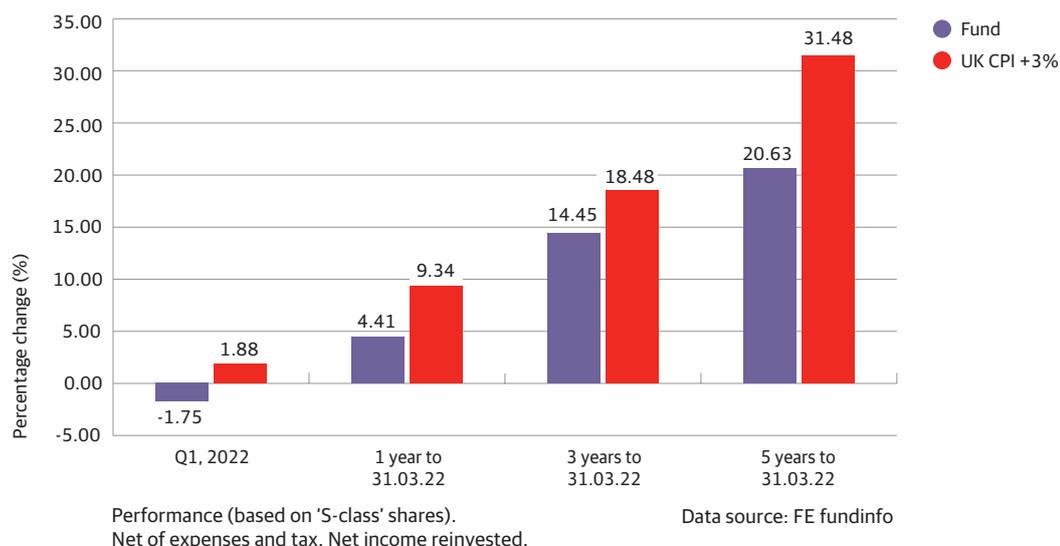
- US based multi-utility company providing energy to predominantly Wisconsin, with some assets in Illinois and Minnesota
- The company is consistently considered one of reliable electricity company in the US and a market leader, critical in places where weather can be severe (-20 degrees Celsius is not uncommon)
- Favourable regulatory and political regime compared to UK or European equivalents – reduced threat of nationalisation!
- They are well diversified by energy source between coal, natural gas and carbon free, with plans to further reduce coal as they replace the older less efficient coal plants
- The company is able to generate the inflation-proofed revenue expansion expected of a utility, but it also benefits from local economic growth too, potentially giving it a growth booster

### National Grid

- A UK utility focused on transmission and distribution of electricity and gas
- National Grid are a key enabler of the energy transition and continue to support this through the modernisation of its network and a target of being net zero by 2050
- They have a balanced and well-diversified portfolio of energy assets across the US and UK with stable returns from a regulated asset base
- The company has made significant investments in large-scale renewable energy projects, including wind, solar and battery storage for use across the grid
- Focused on other diversity in renewable energy with an ambitious programme looking to build a hydrogen test facility in England to help decarbonise the energy system



## Fund performance



Discrete annual performance					
Year to:	End Mar 2018	End Mar 2019	End Mar 2020	End Mar 2021	End Mar 2022
Fund	+0.23%	+5.16%	-7.31%	+18.26%	+4.41%
UK CPI +3%	+5.82%	+4.87%	+4.74%	+3.46%	+9.34%

Price performance based upon bid to bid prior to 21 January 2019 and single price (mid) thereafter. 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.

Our benchmarks are calculated on the rate of change of the CPI index, over different time periods (e.g. if we were calculating year to date figures in January 2021, we would look at the percentage change from December 2020 to the end of January 2021). So we take CPI to the current value, and add on 3%, prorated over a year (roughly 0.25% per month). If the CPI Index benchmark were to fall, more than the amount pro-rata, the benchmark year-to-date will be negative, even though inflation as reported by the media (calculated specifically as a 12M rate of change), remains positive.

Top performers (%)			Bottom performers (%)		
Holding	Performance	Contribution	Holding	Performance	Contribution
Schlumberger	+42.22	+0.16	Aptiv	-25.34	-0.21
Rio Tinto	+31.51	+0.32	Next	-24.24	-0.17
Lockheed Martin	+28.53	+0.33	Estée Lauder	-24.15	-0.16
Invesco Markets US Energy Infrastructure ETF	+22.29	+0.17	Ferguson	-20.31	-0.14
BP	+14.58	+0.14	Jupiter	-19.14	-0.05

Note: Top and bottom performers are taken from the list of all holdings of 0.25% and above of the portfolio. Performance and contribution data shown above is based on unhedged GBP capital returns.

Source: Rathbones

As you would expect in a period which saw most commodities rally significantly in price, our exposure to this area was a key positive contributor. Our holdings in **Shell**, **Schlumberger**, **Total**, and **BP** in the equity space all rallied to differing degrees but contributed meaningfully. Schlumberger in particular was very strong, perhaps buoyed further by the expectation of more drilling and exploration required to close any supply gap should sanctions on Russia spread further into the energy sector. During the quarter we had discussed the possibility of the Biden administration pressing US oil producers to start drilling again and we saw some evidence of that at the end of the quarter with Mr Biden suggesting measures such as levies on US oil producers who were not making use of their drilling licences on public lands. This could also be having a positive impact on Schlumberger.

The **commodity basket ETFs** were also material contributors to portfolio returns given the large moves across the broad commodity complex. The position we had built in **US TIPS** (US index-linked government bonds) over the last 18 months provided notable support to the portfolios as US breakevens moved materially higher through the quarter, albeit did come back slightly towards the very end of the quarter.

## Fund performance (continued)

In October last year, we added a **Nasdaq put option** to the funds to help protect us from a crash in equity markets, but specifically an equity market fall more focused on the growthier names which tend to be more prevalent in the Nasdaq index. This put option helped to protect the portfolios during some of the worst of the market falls, both the January rotation which hit the Nasdaq hardest, and then latterly when a period of broad risk off sentiment took hold after the Russian invasion of Ukraine. Importantly though, those puts gave us the confidence to add into some of the highest quality names in the portfolio towards market lows. The addition of the **US rates volatility notes** in 2021 also helped in the first quarter of the year as rates volatility was indeed higher. We took advantage of a drop in the price in January to add a little more into these notes to provide us more protection from increasing volatility in the US rates space. These notes both provided a helpful positive performance contribution for the quarter and between them were a key part of mitigating some of the equity drawdowns.

Despite equity market falls, the asset class was a marginally net contributor to returns in the first quarter of 2022. It was fixed income which detracted the most, with **UK credit** being the largest driver of that negative contribution. During the quarter we of course saw yields move higher but also credit spreads widened, both of which negatively impacted credit markets. Our longer-dated **US conventional government bonds** were also a detractor over the period given the meaningful rise in yields. Finally, as the US dollar rallied over the quarter, the hedge we have against around 60% of our US dollar exposure detracted from performance

## Asset allocation ranges

Liquidity	Equity-type risk	Diversifiers
5% to 40%	40% to 80%	0% to 40%

## Asset allocation change and strategy

There were no significant asset allocation changes during the quarter.

Asset allocation split	31.12.21	31.03.22	% Change		12 month change	
Liquid assets	22.90%	22.19%	-0.71%	▼	-1.28%	▼
Equity-type risk	73.68%	74.32%	0.64%	▲	3.27%	▲
Diversifiers	3.42%	3.49%	0.07%	▲	-1.99%	▼
	100.00%	100.00%				
Asset class split	31.12.21	31.03.22	% Change		12 month change	
Equities	58.66%	59.95%	1.29%	▲	3.26%	▲
Index-linked bonds	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Conventional government bonds	11.44%	11.65%	0.21%	▲	-5.25%	▼
Corporate bonds	22.14%	21.59%	-0.55%	▼	6.70%	▲
Emerging market debt	3.20%	2.87%	-0.33%	▼	-0.94%	▼
Private equity	1.02%	1.06%	0.04%	▲	0.15%	▲
Alternative investment strategies	1.36%	1.34%	-0.02%	▼	-1.10%	▼
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Cash	2.18%	1.54%	-0.64%	▼	-2.82%	▼
	100.00%	100.00%				

For more information on our liquidity, equity-type risk and diversifiers (LED) risk framework, please consult our investor brochure.

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## Investment outlook

The pall of uncertainty hanging over the future leads us to focus on ensuring our portfolios are ready for whatever jumps out of the gloom. This year is looking like it will be a tough one for households, businesses and some governments. Because of this, we are focusing our investments on 'quality' companies – those that have little debt, make a lot of cash and have products and services that are hard for their clients to pass up.

Strong cash flow really is so important for companies, especially when economies start to slow. Put bluntly, cash equals flexibility. It gives managers options: the ability to invest in promising ventures or take out struggling rivals for a song, to pay down debt or take on more at reasonable rates. These businesses have the best chance of coming through difficult situations unscathed – and sometimes even stronger.

While we're prepared for short-term pain, we still note that there's a chance of things turning out better than people expect right now. Prices in bond and stock markets suggest people are anticipating a royal flush of bad stuff. Yet the Citi Economic Surprise Index, which measures actual economic news against expectations, has risen sharply this year showing that so far, the reality hasn't lived up to the nightmares. When the news is jammed full of war and inflation and pandemics it can lead you to think the world is going to the Inferno in a shopping trolley. But these things have plagued us before and, sadly, will again. People can be terrible, yet only a fool would bet against human ingenuity in the long run. To paraphrase the immortal Jeff Goldblum, humanity finds a way.

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Look forward

**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.**