Rathbone Strategic Income Portfolio

Quarterly investment update, July to end September 2019

Rathbones

Look forward

Hot topics – 'Top-down' (market and macroeconomic)

Down the rabbit hole. For the first time in her race for the Democratic presidential nomination, Elizabeth Warren is now *the* challenger of frontrunner Joe Biden. She has steadily gained in popularity and by early October Mr Biden's ratings had fallen under the cloud of his son's past directorship of a Ukrainian gas company, putting her in touching distance. Fellow radical Bernie Sanders has stalled lately, leaving him firmly in third place. Senator Warren's supporters have a catch phrase: "Warren has a plan for that". And the market is getting nervous of a couple of them in particular: finance and healthcare. She's still a long way from gaining her party's nomination – let alone taking the White House – but you could see those sectors stir in response to her boost in the polls. Our exposure to healthcare is limited, but we do own a couple of specialist US banks and credit card companies. More generally, the policy swing from a Trump White House to a Warren one would be whiplash-inducing. If Mrs Warren appears likely to win in 2020, we would have to carefully review our American holdings.

Same same, but different. Boris Johnson used the Conservative Party Conference in early October to deliver his compromise deal for the European Union (EU). To longsighted folk like me (David), it looked virtually identical to Theresa May's. But Will has sharper eyes than me. Mr Johnson has come up with a slightly different arrangement to the Irish backstop which combines some of the untested technological solutions that the EU has refused in the past with a division of law at the Irish Sea that the UK had previously called a red line. Whether the EU will agree to it – or British MPs for that matter – was yet to be seen when we wrote this. The plan's struggle for success in the tough world of ideas won't affect our positioning any. We've been set for the Brexit end game (or lack of it) for some time. We have kept our UK exposure low and we are waiting for certainty before leaping back in. This could mean we miss out on some relief rally or resurgence in British stocks, but we'd prefer that to investing in a quagmire.

Perception ≠ Reality. All the talk of the death of oil and the growing importance of renewable energy sources makes it easy to forget a universal truth: virtually everything synthetic you touch has the taint of crude oil. It's plastic or wrapped in it. Petroleum has been spun into fibres for your clothes or used to send them round the world by jet or ship. Even your organic food has been delivered to your local market by truck or van. This is a problem! And not just for the environment. The whole global economy is greased by the black stuff – a commodity that is overwhelmingly exposed to some of the world's most precarious regions. A peaceful Middle East is an oxymoron, yet things have been getting even worse there recently. We felt the chance of a disruption to the Middle Eastern oil industry – a major artery for global commerce – was rising and the risk underappreciated by global investors. Then Iranian/Yemeni missiles and drones took down half of Saudi Arabia's productive capacity, sending the oil price spiking toward $70. The Saudis managed to patch up their damaged refineries and get back to touching distance of full production nationwide in under three weeks. Maybe we should get the Saudis to tender for the M4 project – it would be done in four weeks, not four years...

Portfolio activity

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Key purchases/additions	Key sales/trims
Singapore Government 2.25% 2021 (new purchase)	Danske Bank (sale)
BP (addition)	Baillie Gifford Japanese Income Growth Fund (trim)
Legal & General (addition)	Smith & Nephew (trim)
Accenture (addition)	WEC Energy (trim)

Source: Rathbones

We reduced our duration during the quarter, selling the UK Treasury 4¼% 2027 and bought the UK Treasury 8% 2021.

We exited **Danske Bank** during the quarter because we became increasingly concerned about the viability of European finance companies in a negative-interest-rate environment. What seemed like a passing phase is now looking pretty permanent.

We bought the **Singapore Government 2.25% 2021** bond, the highest yielding two-year AAA sovereign. Another bit of protection was buying more put contracts on the S&P 500 Index, which give us the option to sell our index exposure at a certain level. This mitigates losses we would suffer if the stock market slumps.

We trimmed the **Baillie Gifford Japanese Income Growth Fund** in August. After a strong run, we felt that we should take profits and move the cash to the US. Our research tells us that it's best to consolidate into defensive stocks at this time in the cycle and the American market tends to be the most defensive stock market in the world.

Spotlight

In this quarter, the spotlight is on our **Gaming Basket** and **Accenture**.

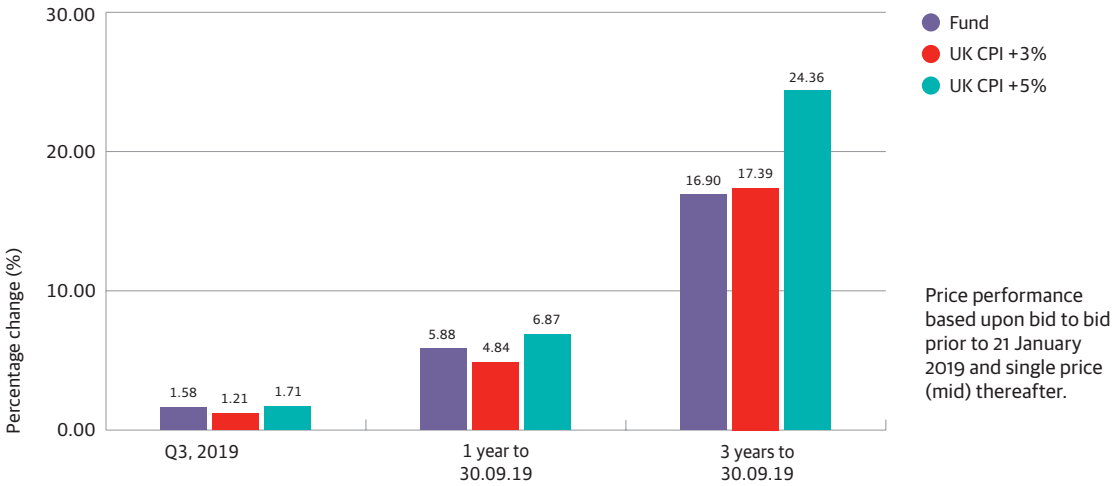
Gaming Basket

- The gaming market is large and is growing quickly – it is estimated there are already around 2 billion gamers across the globe and the revenues are already greater than that of the movie industry
- Move to downloading and streaming games has meant the market can be larger and more profitable as the need for physical discs and places to sell them reduces – 5G could also increase the addressable market with better game streaming on the move
- The average age of a gamer in the US is 35 years old – these are people with jobs and money to spend rather than the stereotypes
- 'The International' is an annual e-sports event where teams play the game Dota 2 in an arena watched by thousands in person, and many more online. The prize pool this year was $34 million with the winning team taking home $15 million – there is real money in gaming and we expect it to continue to grow rapidly
- We own four gaming stocks to provide adequate diversification and to address the higher volatility you can see in these names – they tend to fluctuate a great deal around their latest game release
- In our gaming basket we own, Electronic Arts (FIFA football game franchise), Ubisoft (Assassin's Creed games), Activision Blizzard (Call of Duty games), and Take-Two Interactive (Grand Theft Auto games)

Accenture

- A global professional services firm specialising in consulting and outsourcing – across 40 industries and 120 countries
- The world is changing quickly and large organisations are under threat in the new world – they have the ability to support these organisations in adapting to this new world, not only with ideas, but with end-to-end delivery
- Many businesses are still early in their digital transformation and Accenture has significant expertise in supporting their clients through this process – this need for digital transformation plays to their strengths
- The focus on areas such as cloud, big data, artificial intelligence, and cyber security mean they are at the forefront of how businesses need to evolve to deal with these new threats and opportunities
- The strong relationships they have built over a number of years with many large global firms, such as Microsoft, provide excellent insight to where the world is moving, but also a very loyal client base

Fund performance



Performance (based on 'S-Class' shares).
Net of expenses and tax. Net income reinvested.

Data source: Financial Express

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 2019, we would look at the percentage change from December 2018 to the end of January 2019). So we take CPI to the current value, and add on the 3% to 5% respectively, prorated over a year (roughly 0.25% and 0.42% 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.

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.

Top performers (%)		
Holding	**Performance**	**Contribution**
Vodafone	+24.78	+0.18
ASML	+22.29	+0.11
WEC Energy	+18.56	+0.16
Rentokil Initial	+18.09	+0.11
Alphabet	+16.47	+0.11

Bottom performers (%)		
Holding	**Performance**	**Contribution**
Micro Focus	-42.25	-0.45
Sampo	-13.13	-0.15
Rio Tinto	-10.28	-0.11
Schlumberger	-9.93	-0.04
AIA	-8.96	-0.08

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 returns.
Performance (table above only): Gross of charges.

Source: Rathbones

Vodafone has a good quarter and was the largest positive contributor to the returns of the fund over the period. After cutting the dividend earlier this year many feel this has freed them up from a payout that was looking pretty difficult to maintain, to tackle debt and invest in new technologies. Despite being an income fund we voted to cut the dividend as we would rather ensure sustainability of the payout, than the highest payout possible at the detriment of the business. Many appeared to feel that same way as, rather counterintuitively, it has been supportive for the share price. This was then followed in July by news that they were planning to spin off their European masts business and expect a floatation valuing this masts business at around €20 billion, which triggered another swift rise in the share price. The new chief executive officer was the former chief financial officer, which brings us comfort on capital discipline, but also he is delivering on exactly what he said he would do.

Our **iShares Physical Gold ETF** in the portfolios followed up a strong second quarter with a good third quarter. As we have mentioned before, gold is an important part of the portfolio as we believe it serves to protect when geopolitical tensions rise. But importantly, gold should be a key beneficiary from a negative rate environment given that, whilst gold does not produce a yield, this is superior to negative yields on offer across a number of bond markets.

Government bond yields fell (prices rose) sharply during the quarter, which was supportive for our government bond exposure in the portfolio, although given we had not wanted to buy longer dated debt due to the price, we did not participate as much in the rally, but it was a helpful contributor. The fairly small difference between longer dated bonds and shorter dated bonds in the US and UK, means that we do not have to accept a large reduction in yield to reduce our interest rate sensitivity and buy shorter dated bonds.

The **put contracts** we own in the fund were a negative contributor over the quarter as equity markets ended higher. This is what you would expect from these assets in rising markets, but they are an important part of the portfolio designed to protect us during bouts of heightened volatility.

Asset allocation change and strategy

There were no significant asset allocation changes during the quarter.

Asset allocation split	30.06.19	30.09.19	% Change		12 month change	
Liquidity assets/lower volatility	23.62%	21.73%	-1.89%	▼	+1.25%	▲
Equity-type risk (economically sensitive assets)	69.94%	70.24%	+0.30%	▲	-2.67%	▼
Diversifiers	6.44%	8.03%	+1.59%	▲	+1.42%	▲
	100.00%	100.00%				

Asset class split	30.06.19	30.09.19	% Change		12 month change	
Equities	54.86%	54.34%	-0.52%	▼	-1.44%	▼
Index-linked bonds	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Conventional government bonds	13.44%	17.73%	+4.29%	▲	+4.85%	▲
Corporate bonds	14.03%	13.87%	-0.16%	▼	-2.33%	▼
Emerging market debt	2.56%	3.49%	+0.93%	▲	+1.15%	▲
Private equity	0.83%	1.17%	+0.34%	▲	+0.20%	▲
Alternative investment strategies	4.05%	3.99%	-0.06%	▼	-0.85%	▼
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	2.39%	3.09%	+0.70%	▲	+1.32%	▲
Cash	7.84%	2.32%	-5.52%	▼	-2.90%	▼
	100.00%	100.00%				

Asset allocation ranges

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

Investment outlook

The long-vaunted 'great rotation' of 'growth' stocks toward 'value' ones showed signs of stirring into life this quarter.

Value companies – those that are closely linked to the ebb and flow of economic growth – have performed so poorly for so long that many people believe they have to come good at some point. The idea is that there will be a large and sustained move away from the growth companies that are more highly valued and less affected by economic downturns. This 'great rotation' story gets a lot of play at value investor campfires and about once a year the yarn goes mainstream. And yet the rotation hasn't actually come to pass. We don't believe it will, either. Sure, there will be weeks, months and sometimes even quarters when value will outdo growth. But in a low-growth world, we think investors will inevitably be dragged back to those companies that can reliably boost their earnings regardless of the wider economy.

October is shaping as a pretty pivotal month. It tends to be a particularly spicy one for stock markets, but it could be a real 'vindaloo' this year, given recent concerns about GDP growth and the effect of the US-China trade war on businesses all round the world. Many investors will no doubt see the October earnings season as a referendum on commerce in 2020. It will almost certainly have a bearing on the US Federal Reserve's monetary policy and that is *the* variable for most investors these days.

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