Rathbone Strategic Income Portfolio

Quarterly investment update, October to end December 2019

Rathbones

Look forward

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

Thermodynamics rule #2. All things trend towards disorder. That's not to say we're all doomed though! To paraphrase Bill Yeats, things have been falling apart since the world began. That's just how time works. Practically speaking, this means you shouldn't be surprised when your toast lands butter side down, or when it all kicks off in the Middle East. As we said last quarter, instability there has to be accepted and expected. Because of this, we own a spread of oil majors to protect ourselves when the price of oil spikes because of a lightning bolt crisis in the world's figurative petrol station. Iran will no doubt try to take revenge on the US, but it will do so in plausibly deniable ways and much further into the future. In the immediate aftermath, it was almost embarrassingly obvious that Iran took the absolute minimum response to save face because it had zero appetite for war with the US.

Misfits and weirdos. After three and a half years we finally have a solid government and an unequivocal mandate for Brexit. Boris Johnson led the Conservatives to their strongest electoral showing since Margaret Thatcher and has since firmly set out his plan for pulling the UK out of the European Union (EU). The Conservatives' success in northern England and Wales – areas that used to be dyed red – transformed the government from a straitjacketed minority to an ascendant powerhouse. The basis for this change was Mr Johnson's promise to "get Brexit done" alongside a promise that, under him, the Conservatives would lend more attention to those left behind. It's dangerous to wholeheartedly trust a man who is notorious for having a strained relationship with the truth, but we believe the Prime Minister will do as he promised.

He has said himself that many have only "loaned" him their votes, and if he can deliver on his promises, he may be able to convert swathes of the country to the Tory party. If successful, it would change the parliamentary calculus for a generation. With that in mind, we anticipate greater fiscal spending, particularly in the North. If done right, that should boost GDP growth and – more importantly – improve the productivity of the UK ex-London. According to the Office for National Statistics, job productivity in the North is less than 60% that of London. All this makes us cautiously optimistic about the UK and the businesses that operate here. We feel it's time to get more excited about UK assets.

Resolutions. There's something about the beginning of a year that drives people to do odd things. You know the sort: buy an annual gym membership that you'll use a handful of times, or, if you're an investment talking head, recite the mantra: GDP growth will accelerate, inflation will be benign and company earnings will rise by mid-to-high single digits. In truth, no-one knows what the future will bring so making grand forecasts tends to be a waste of time. We make a habit of jotting down some predictions each year, but ours tend to be more tongue-in-cheek. Debates have been raging for months about whether the world is folding up into recession or if GDP growth has simply slowed temporarily. Throughout this time, we felt that – while we couldn't know for sure – the likelihood of a recession seemed low. Our belief was based on multi-decade lows in unemployment, solid household spending and incredibly resilient consumer sentiment in the US. When recession does come, however, it will no doubt creep up on us as successfully as everyone else. That's why, despite our optimism, we have carefully built up a range of assets that should protect our portfolio during a sustained fall in stock markets. Instead of trying to time markets – which tends to be a fool's errand – we try to ensure that our portfolio is well diversified and the companies in which we invest will still be alive and thriving in 10 years' time. Rather than try to determine the outcome of the global economy in six or 12 months' time (one of the most complicated systems in the world) we focus on what we can understand: finding well-run businesses with the products, market heft and cash to dominate their industries.

Portfolio activity

Key purchases/additions
CME (new purchase)
Christian Hansen (new purchase)
DCC (new purchase)
FTSE 250 ETF (additions)

Key sales/trims
ITV (trim)
ASML (trim)
HgCapital (trim)

Source: Rathbones

We bought more **iShares FTSE 250 ETFs** in October because we believed the election would provide greater certainty over Brexit and that the UK was undervalued.

We bought three new companies in the quarter. **CME** runs many varied commodities and derivatives markets, offering futures and options for traders and producers to hedge their risks or speculate. CME has the scale to bring efficiencies and the very best technology to bear on these huge global markets. The second purchase was **Christian Hansen**, a Danish manufacturer of enzymes, cultures and other biological additives for food and agriculture. This company has a strong position in its small-yet-crucial part of the market, giving it hefty pricing power. The share price has dropped off quite a bit in late 2019, giving us the chance to add it to our portfolio at an attractive valuation. The third was global distribution company **DCC**, which we have held in other funds.

We took profits from several companies that posted strong gains. These included UK broadcaster **ITV** and **ASML**, a Dutch company that designs the machines that print computer chips.

Another slight trim to the portfolio was selling some of our shares in **HgCapital**, which is a portfolio of private equity companies in the UK and the Continent. In November, HgCapital's share price rose above its net asset value (NAV), meaning investors were willing to pay more for the shares than the assets were actually worth. We took the opportunity to rebalance our holding.

Finally, we bolstered our portfolio protection by buying some more **JP Morgan S&P 500 Put Contracts**, which will mitigate our losses if American stock markets fall.

In this quarter, the spotlight is on **Amphenol** and **Smith & Nephew**.

Amphenol

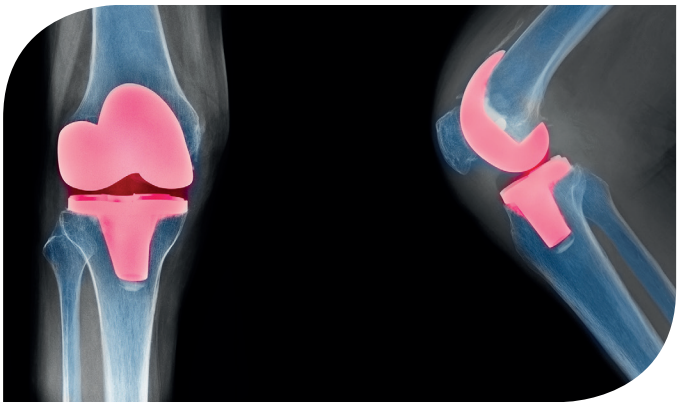
Smith+Nephew

Amphenol

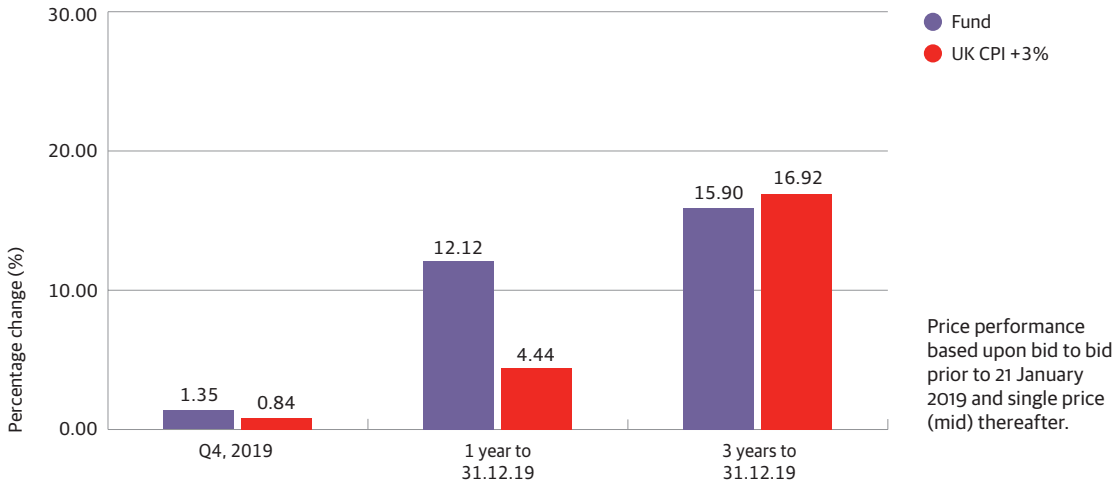
- One of the largest manufacturers of interconnect products in the world. They design, manufacture and market products such as connectors, sensors, antennas and cables
- Their products are found everywhere from ejector seats to smart phones and from cars to fridges
- Focus on reasonably low-tech, but high quality and mission critical products – you can't afford for the cabling in your ejector seat to fail!
- Their products are not only vital, but low cost components relative to the overall end product value, which therefore helps protect pricing
- The interconnect market is already worth over $130 billion with the numbers of sensors and connectors in products increasing over time as electronics become more complex and sophisticated
- They focus on building strong relationships with clients to embed themselves into their businesses right back to the design stage of products. Key global customers include Apple, Google, Audi, Lockheed Martin, and Amazon

Smith & Nephew

- An international diversified advanced medical technology business producing products in areas such as arthroscopy (keyhole surgery) and orthopaedic reconstruction products (hip and knee replacements)
- Three main business lines; orthopaedics, sports medicines, and advanced wound dressings that are designed to improve efficiency and reduce cost, within which Smith & Nephew have a kit that no one else can produce
- The company have been able to generate additional growth through acquiring companies over time who improve their offering with innovative products
- One company they acquired created robotics and integrated computer technology to improve the satisfaction from knee replacement surgery – this technology can create 3D plans of the surgery and can stop the drill if the surgeon moves outside of the designated area
- Smith & Nephew are well-aligned with and benefit from the long-term themes of more people living longer, improvements in medical technology and procedures, and growth in emerging markets



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 2020, we would look at the percentage change from December 2019 to the end of January 2020). 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.

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**
ITV	+22.23	+0.17
Legal and General	+21.98	+0.20
Ferguson	+17.14	+0.15
Amgen	+16.60	+0.14
TR Property Trust	+16.22	+0.07

Bottom performers (%)		
Holding	**Performance**	**Contribution**
Invesco Markets US Energy Infrastructure Fund	-14.44	-0.14
Johnson Controls	-13.15	-0.11
Unilever	-10.50	-0.10
WEC Energy	-9.16	-0.10
BP	-7.11	-0.06

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

Source: Rathbones

Sterling rose by around 8% over the last quarter of the year and hedging much of our overseas currency exposure back to sterling was a significant benefit over the period. With sterling materially undervalued due to Brexit concerns, the risk to the portfolio was always that we had a series of sterling positive Brexit developments. Our overseas currency holdings felt the pain of this. Our hedged positions we have in place limit the impact of this and certainly came into effect in Q4 as sterling rallied strongly as more clarity came about on the path for Brexit, culminating in a resounding election win for Boris Johnson and a mandate to push ahead with his Brexit deal.

We have a number of more domestically sensitive UK stocks in the portfolio which rallied strongly as the clouds of uncertainty began to lift around Brexit and the path from here became somewhat clearer. Names in the portfolio like **Legal and General** and **ITV** were beneficiaries of the more positive sentiment towards UK domestic stocks. We also benefitted from owning some broad FTSE 100 Index exposure in the form of our **FTSE 100 Index accelerator structured products**. We added a **FTSE 250 Index tracker** early in the quarter as we began to believe that the likelihood more clarity on Brexit would be forthcoming with Boris Johnson at the helm of the Tory party. The tracker saw a significant rally after Mr Johnson won the December General Election.

Amgen, a global biotech company we own, rallied on strong results and posted a good set of numbers in October and management raised their expectations for the full year. Management stated that they are defending their mature product suite well, driving volume for newer names, and have a record number of exciting names in the pipeline. This all resulted in a very good Q4 for the stock after a more challenging first half of 2019.

Gold ended a strong year with a more lacklustre Q4 as equities rallied and global government bond yields rose (prices fell). We have noted before about the strong correlation we have seen between the gold price and negative rates, and clearly there was some unwinding of this in Q4 as bond yields began moving higher, albeit still in in negative territory across in the case of countries like Germany and France. The **S&P 500 Index Put options** we added throughout this year were the main detractors from performance in the quarter as the S&P 500 Index rallied. These positions are still key to protecting the equity risk in the portfolio and clearly performed as expected in the quarter given stronger US equity returns.

Asset allocation change and strategy

We increased our exposure to UK equities during the quarter.

Asset allocation split	30.09.19	31.12.19	% Change		12 month change	
Liquidity assets/lower volatility	21.73%	23.87%	+2.14%	▲	+4.02%	▲
Equity-type risk (economically sensitive assets)	70.24%	69.01%	-1.23%	▼	-3.53%	▼
Diversifiers	8.03%	7.12%	-0.91%	▼	-0.49%	▼
	100.00%	100.00%				

Asset class split	30.09.19	31.12.19	% Change		12 month change	
Equities	54.34%	54.51%	+0.17%	▲	-1.30%	▼
Index-linked bonds	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Conventional government bonds	17.73%	16.27%	-1.46%	▼	+3.14%	▲
Corporate bonds	13.87%	12.98%	-0.89%	▼	-3.58%	▼
Emerging market debt	3.49%	3.32%	-0.17%	▼	+1.68%	▲
Private equity	1.17%	1.12%	-0.05%	▼	+0.23%	▲
Alternative investment strategies	3.99%	3.46%	-0.53%	▼	-2.13%	▼
Property	0.00%	0.00%	0.00%	◀▶	0.00%	◀▶
Commodities	3.09%	2.84%	-0.25%	▼	+0.82%	▲
Cash	2.32%	5.50%	+3.18%	▲	+1.14%	▲
	100.00%	100.00%				

Asset allocation ranges

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

Investment outlook

2019 was a great year for investors, albeit the figures were flattered a little by the large correction in late 2018. The strong market performance seems to have been overlooked by most in a strange and stressful year when virtually everyone seemed to be gloomy all the time.

All year, investors and journalists were focused like laser beams on the US-China trade war and the worry that a recession was just over the horizon. And, if they were British, you can add the third concern: Brexit. Yet we can't shake the feeling that the public attention was elsewhere. Sure, people either love or hate Donald Trump and everyone in the UK has an opinion about Brexit. But we feel like they long ago got bored with the same old arguments. And – without the shock of rising unemployment – few people outside the economics sphere worry endlessly about recession. People have, in the main, simply got on with living their lives. Google Trends shows the reality well. While we were all poring over the economic tea leaves and second-guessing the Don, the top internet searches for 2019 were cricket, cricket, the new iPhone, Game of Thrones and cricket.

The US and China now look as close to a deal as they've ever been, and Britain has finally got its boots on and is now ready to walk the Brexit path. It will be a bouncy year, no doubt, with plenty of potential surprises. Who knows, recession may actually be one of them. But for now, we feel like the global economy has actually been ticking over rather nicely, considering all the debris strewn in its way last year. As long as developed market households remain upbeat – American ones in particular – so will we.

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Look forward

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