



RATHBONES

RATHBONE INCOME FUND

QUARTERLY UPDATE MARCH 2024

We are long-term investors. To re-iterate the famous aphorism attributed to the godfather of value investing Benjamin Graham, ‘in the short-term, the market is a voting machine, but in the long run, it is a weighing machine.’

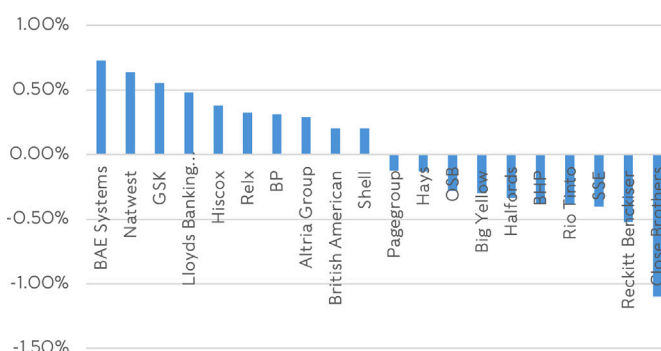
On a day-to-day basis, share prices can go up or down for many reasons. This may often be something fundamental to a company's well-being, but more frequently it's the vagaries of the crowd – what's the zeitgeist of the moment? But over the long run, the inherent quality of a business will shine, cutting through the market noise; and if you can buy shares when the crowd is looking the other way, so much the better.

Without doubt, this has been a disappointing start to the year. We may adhere to the weighing machine philosophy of long-term investment, but that does not mean that we can stick our heads in the sand and dismiss periods of underperformance as market vagaries. We want to address three issues in this review, two stock specific, one market oriented. In preview, we are frustrated, but remain comfortable in our positioning.

Despite a strong start to the year for most major equities markets, the UK was pretty mediocre in January and February. March then delivered a 4.8% jump in the FTSE All-Share Index, which we lagged significantly. This meant our fund inched forward a meagre 0.4% in the first quarter, undoing our good work catching up with the market and peers in the final period of 2023. The IA UK Equity Income Sector gained 2.5% in Q1, while our benchmark, the FTSE All-Share, rose 3.6%. We lagged despite continuing strength from defence contractor **BAE Systems**, a consistent performer over the last few years – operational excellence combining with the increased demand for defence equipment and services during the tragic war in Ukraine. Pharmaceutical business **GSK** is beginning to repay our faith in it as a ‘value’ and turnaround story, with the shares perhaps bolstered by diminishing Zantac litigation fears, as well as increasing evidence that its development pipeline is starting to bear fruit.

Interestingly, our banks have also performed very well, with **NatWest** and **Lloyds Banking Group** recovering strongly through the period. We know that there are a lot of moving parts here. Banks benefit from long-term bond yields rising relative to short-term ones (‘steepening’ of the yield curve) because they make money by borrowing short (deposits) and lending long (mortgages and business loans). But if interest rates rise too far, people and companies default, and banks start to lose money. Equally, if fears of impending recession increase and rate expectations deteriorate, this could squeeze lenders' profit margins. Yet lower rates and thereby the possibility of economic recovery are arguably positive. Whatever the driver, our high street banks pushed ahead.

Q1 CONTRIBUTIONS



Source: StatPro; Rathbones

Close Brothers

This time last year we commented on a good meeting with **Close Brothers**; we have continued to have many more, but we must recognise the detrimental impact that owning the shares has had on our fund over the last 15 months, and specifically this last quarter.

We regard Close as an important cog in the UK economy. If you let us disregard for the moment the trading arm Winterflood and the asset management business, the core bank lends to a very broad spread of small and medium-sized businesses, provides consumer finance via motor and insurance intermediaries, and also offers specialist deposit facilities to corporates and individuals alike. It has historically been a steady way of playing the growth in the UK economy, without necessarily saddling ourselves with the volatility of the high street sector.

But the last quarter has been a real test, with the announcement of the Financial Conduct Authority's (FCA) review into motor finance, relating to historical claims of unfair costs linked to the commissions paid to third parties. Many businesses make car loans through intermediaries (high street banks as well as specialist lenders), and it's highly contentious that there's been any wrongdoing. Nevertheless, Close has been hit especially hard as motor finance makes up a reasonable portion of its £9.5 billion loan book. Close has also made the prudent decision to cancel its dividend until the full extent of any recompense is known.

This has been immensely troubling. We have had plenty of communication with the company, but there is very little it can say. We believe any likely financial redress is already in the share price. But, to a degree, this is irrelevant. Irrespective of the question marks over whether there has been any wrongdoing at all (there is a strong argument that this is a retrospective application of rules that were not in place at the time), the uncertainty and the inevitable vacuum caused by the lack of any of substantive and quantifiable newsflow has had a big effect on the shares.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone Income Fund	0.4%	5.4%	6.0%	21.4%	26.8%
IA UK Equity Income Sector	2.5%	7.0%	7.6%	19.6%	25.8%
FTSE All Share Index	3.6%	6.9%	8.4%	26.1%	30.3%

	31 Mar 23- 31 Mar 24	31 Mar 22- 31 Mar 23	31 Mar 21- 31 Mar 22	31 Mar 20- 31 Mar 21	31 Mar 19- 31 Mar 20
Rathbone Income Fund	6.0%	2.6%	11.6%	30.1%	-19.7%
IA UK Equity Income Sector	7.6%	0.2%	10.8%	32.6%	-20.6%
FTSE All Share Index	8.4%	2.9%	13.0%	26.7%	-18.5%

Source: FE Analytics; data to 31 March, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future returns.

When something like this goes wrong, we are always faced with a difficult decision, especially when we continue to believe in the quality of the business. The shares currently trade at 0.4x price to book, which is very low for a bank that traditionally makes a double digit return on equity – our basic rule of thumb is that 1x is fair value for 10%. Returns for this year could be substantially lower of course, but at its lows, the market was pricing in outcomes that seemed absurd to us. The share price has begun to recover, as of 31 March it was up 50% from its mid-February nadir. But it still needs to double to get back to where it was at the start of the year. On a very low price-earnings multiple of 6x, this is a deep value special situations play on the UK economy, and we continue to own the shares. But this quarter, without doubt, has been painful.

Too early, or wrong?

Back in 2020, when most investors were ignoring inflation risks, we were very successful in our pivot to 'value' and 'cyclical' businesses, whose profits are more sensitive to changes in economic growth. In 2023, we gradually reversed this, reflecting our view that the risk/reward balance was swayed back towards 'quality' defensive growth companies, which tend to be more expensive and more insulated from economic vagaries. If the fear takes hold that disinflation may go hand in hand with economic slowdown, or even recession, we felt the reward from holding these stocks could be great indeed.

Good in theory, but in practice it has been value cyclicals that have ruled the roost so far in 2024, a situation exacerbated by increased geopolitical fears that have pushed up energy prices and maintained a degree of global inflationary pressure. This has supported the commodity-heavy FTSE 100, but has made a temporary mockery of our asset allocation decision. Still, on a medium-term basis, we remain confident that the appropriate balance within our portfolio is to tilt back towards secure earnings growth, especially at current valuations, which should be rewarded when the rate cycle turns.

Reckitt Benckiser

The second stock-specific issue to darken our door this quarter arose from Reckitts. Full-year results were disappointing, but the share price reaction was excessive. Nevertheless, two aspects remain troubling.

As [we highlighted in last month's letter](#), just because you are a company selling everyday products, like Dettol, Strepsils, and Finish dishwasher capsules, doesn't mean that you can ignore basic operational efficiency. Secondly, Reckitts is still paying the price for its monumental acquisition of US baby nutrition company Mead Johnson back in 2017. A US court awarded substantial damages in a lawsuit linked to one of Mead Johnson's products for premature babies. Again, this is a case that is far too complex to go into in detail here, and it's wrong to extrapolate this award, which is being contested, but it does show the effect of being caught up in the US mass tort litigation system.

To have two of these types of issue in one quarter may seem unfortunate or careless. Reckitts is arguably as cheap as it has ever been, but it is annoying that this is another instance of a company losing value after a big acquisition. Echoing the Close situation, the shares are likely to languish until there is greater visibility. Coming as it does at a time when there has been a mini-rotation back out of defensives simply adds to the aggravation.

Outlook and positioning

We sense a little bit of a mood change, with a few more advocates for the UK market putting their heads above the parapet. Despite the obvious cheapness of the UK market, [we've written about the need for a catalyst to get people excited](#); well, maybe in reality there's more than one.

As the global market rally begins to broaden, this value will start to attract attention, especially if US rates stay higher for longer, maybe stalling the astonishing tech boom of the last few months. And this value is encouraging more mergers and acquisitions, and [making more companies see the attraction of buying back their own shares](#). Right now, with valuations this low in the UK, this is often a very good allocation of capital.

The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

What if the Bank of England has greater scope to cut rates? What would it mean for relative valuations if the US Federal Reserve has to be more hawkish, as recent inflation data the other side of the pond suggests?

Our politics remains a pantomime, although that can be said elsewhere as well, but whisper it very quietly – could some sort of deal with Europe be on the cards? And there seems to be increased recognition that our listed companies need more help. If the likes of **Shell** (which we own) are discussing where they should list to bolster their share prices, the government must listen. [The British ISA, announced in the Spring Budget](#), is no silver bullet, but it does suggest attention has been grabbed.

If our economy recovers, inflation eases, unemployment levels remain settled, and monetary policy gets easier, this could be an interesting year for the UK market.

So, we hope we were early rather than wrong in our pivot back to growth and quality. Of course, if the UK economy does recover, we will need to have exposure to the domestic plays most exposed to that rebound. At the same time, falling rates should reward 'bond proxies' (companies with steady earnings and larger debts, which, like bonds, tend to benefit from falling rates) and quality growth businesses. The difficult geopolitical situation has kept energy prices high. There is no clear road ahead, but there are opportunities. We remain flexible, we remain balanced, and we hope that, after a difficult start to the year, we are rewarded by this approach.

Recent trading: We have added to our new positions in UK supermarket giant **Tesco**, and GP surgery and other primary healthcare property group **Assura**. We have further bolstered our domestic UK exposure by adding to Lloyds, and to our housebuilders, **Persimmon** and **Taylor Wimpey**. These purchases have been financed by taking some money off the table in BAE Systems, media company **Relx**, and utility **SSE**.

Companies seen in March: Relx, **Rio Tinto**, **Hiscox**, **Breedon Group**, Persimmon, **Unilever**, Close Brothers, **OSB Group** and Shell.



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For more info on our fund, including factsheets, performance and fund manager views, please click [here](#).

If you require further clarification on this commentary, then please contact your adviser or Rathbones at the contact details below.

Any views and opinions are those of the investment manager, 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 and the income from them may go down as well as up and you may not get back what you originally invested.

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