



Rathbone Income Fund

Update, December 2011

“The mirror, he said, contains the old image, for we look with old eyes on its necessary similarity to remembered images of ourselves. Our mind forces us to connect the picture we see with past pictures, creating a false continuity. But we are new every moment. Every moment we have the possibility of breaking the old pattern, which is just a mental construct, and creating something new.”

Angry White Pyjamas – An Oxford Poet Trains with the Tokyo Police

Robert Twigger, 1999

The Japanese ceremony of Kagami Biraki (literally translated as “opening or breaking the mirror”) is performed at many martial arts dojos at the first training session of the year. An opportunity to break from the past, fresh targets are set for the New Year.

A glance back into 2011 reminds us that the storm clouds that worried us at the start of that year continue to rumble overhead. The US remains horribly in debt, at every level. Official US government debt is forecast to be about 98% of GDP in 2011; however, unfunded liabilities (Medicare, Medicaid, Social Security) represent in excess of 500% of GDP. In 2010, the US government spent \$1.5 trillion more than it collected in revenues. The Americans may accuse Europe of profligacy, but they themselves may be embarrassed by their own bankrupt cities and states. The US Federal Reserve has deployed vast monetary firepower, yet the politicians have yet to decide on any form of fiscal austerity. In an election year, the political divide shall widen further, and there is a clear danger that the economic stresses come home to roost in 2012, despite the recent up-turn in economic data.

In the UK, we at least have austerity measures in place, but with the consequence that we are flirting with a double-dip recession. Unemployment is drifting higher, and consumer confidence is low. We do have our own currency, which can devalue, and make our products more competitive (but may also import inflation), but sadly so much of our future is out of our control. We face the same problem as most Western nations – how do we simultaneously grow ourselves out of trouble and establish an austerity agenda?

The Eurozone faces a more intractable conundrum – can the European Central Bank afford to keep Greece and others within the Eurozone, or shall we see disintegration of the union? Neither choice is attractive, but the credit spreads are pricing in the latter. It is the welfare of Spain, and more dramatically Italy that concerns us most. With almost €500 billion of debt to be re-financed by these two sovereigns in 2012, the success or otherwise of this operation shall be a principal determinant of the health of the wider market. We worry that across Europe, banks too scared to look into the abyss, still refrain from recognising major losses on their balance sheets.

Then there is China, arguably the biggest cumulo-nimbus of all. China shall be, undoubtedly, the cornerstone of global growth over the coming decades. In the short-term, however, it faces a credit bubble of massive proportions, and it is very difficult for anyone in the West to fathom if and when it may burst. There has been too

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much credit, too much construction, too many investments in property ...think the US, think Spain, think Ireland writ large.

Ok, so that's not a very cheerful look in the mirror, but we are in the risk business, and these are once more the biggest ones facing us as we embark on 2012. On a much more positive note, however, economic data have been more benign, especially in the US, and corporates are in ruder health than three years ago, with more cash and stronger balance sheets. If these businesses are given the encouragement to invest, and this will arise from greater trust in the providers of credit (i.e. banks), then we may start to see growth and job creation. Finally, a recent survey of UK economists by the Financial Times was almost universally gloomy, which may in itself be a good sign. At this juncture, markets have rallied, and we would suggest that current prices do not necessarily make the best entry point, so we remain circumspect.

The mirror reflects not only the outside world, but is also the self, and ancient tradition suggests that Japanese polish mirrors to clarify the mind, and strengthen sense of purpose.

So we need to keep looking for companies that can engineer change, that have the power over their own destiny, and the willingness and ability to invest and generate a sustainable return. We like global businesses like **Diageo** and **Anheuser Busch**, companies that have strong brands that do not need to be re-invented; we like small companies such as events company **Tarsus**, and Irish pharmaceutical distributor **United Drug**, both of which have sensibly allocated capital in order to establish strong market positions; and we like asset light businesses such as **Intercontinental Hotels** and **Daily Mail & General Trust**, whose shares shall be top of our shopping list if markets do retreat. We need to trust in our own methodology and be very strict in our investment criteria, because 2012 shall be difficult. However, market volatility may enable us to pick up very good businesses at bargain prices, and that is the great opportunity. Equity markets may even end the year higher than from where they started, but it shall be a very rocky ride. Let us learn from 2011, and then discard it. "Every moment holds potential for newness" – 2012 is another very big year.

Recent trading activity

We traded very little during a quiet December. The management teams of Smiths Group and Daily Mail & General Trust came into the office, and we attended a group meeting with Tesco.

In a difficult year, the Rathbone Income Fund held up well, achieving a total return of -0.3%, versus a fall of 3.2% from the FTSE All-Share index.

Carl Stick, Fund Manager

George Viney, Assistant Fund Manager

The information contained in this note is for use by investment advisers and journalists and must not be circulated to private clients or to the general public. Source performance data, Bloomberg, bid to bid, net income re-invested.

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