

Rathbone Income Fund

Quarterly investment report, January 2010 to end March 2010



Overview

We can report on a satisfactory quarter, as the Rathbone Income Fund has managed to keep close to a market that has built further on the gains of last year. Over the first three months of the year, the fund achieved a total return of 5.66%, versus 6.42% from the FTSE All-Share index, and 5.11% from the IMA UK Equity Income sector.

Why is this satisfactory? The FTSE All-Share index has, in price terms, rebounded 63% from its low on 3 March 2009. Economically, we are in a better place than we were 12 months ago, and equity markets are reflecting this. However, we contend that amidst this euphoria, certain obvious frailties remain, and so we have adopted a particularly defensive stance. Therefore, our performance needs to be judged from this standpoint.

Past performance should not be seen as an indication of future performance.

Performance review

There is no clear thread. We benefited from our tobacco exposure, but our utilities lagged the market. Perhaps this illustrates the extent to which leveraged balance sheets are still anathema in the market. We maintain our utility exposure, but we are mindful that there must be a heightened probability that they look to raise equity over the next twelve months. Our underweight meant that we did not participate in the rally from the large miners (*BHP Billiton* and *Rio Tinto* having had very strong quarters), but our engineers that enjoy exposure to the commodity markets (*Weir Group*, *Fenner*) performed well. In this case, we view “valuation risk” as our principal objection to the large miners. Upgrades driven by raised expectations of future commodity spot prices do not create intrinsic

value, in our opinion. On the other hand, we do see greater value in the engineers, although we are mindful that here we are also seeing stretched valuations. Most importantly, the fund moved ahead on the back of companies producing good numbers, driven by fundamentals rather than sentiment and future expectations. Generally speaking, our investments generated cash, raised their dividends and reduced debt. Aerospace company *Senior Group* more than satisfied market expectations, reducing debt by £72 million – an experienced management team successfully navigating a difficult market. Another experienced team, this time at *Restaurant Group*, produced a super set of results, generating cash on the back of growing revenues, profits and earnings per share, despite the weakness in the UK economy. Indeed, the theme that resounds through the fund is the solid operational performance from much of our small and mid cap exposure: strong domestic operations from *Halfords*, *Cineworld*, and *William Hill*; overseas resilience from the likes of *Fenner*, *Weir* and *Keller*, and recovery from *Severfield Rowen*.

National Grid and *Scottish & Southern* held us back, and we highlight their leveraged positions above, but we do appreciate their other defensive and yield attributions. *Headlam* is perhaps too steady a business to react to markets rising on increased risk appetite, but its market positioning and management are very strong. *Dechra Pharmaceuticals* disappointed in the period, on account of slower than expected US sales of their canine product Vetoryl, but the long-term story remains as robust as ever. *Man Group* is more problematic, in that the market is polarised with regard to the viability of its core AHL product. A difficult quarter for AHL has inspired share price weakness in the parent company, but our contention is that the share price does not fairly value the strategic importance of the company, therefore we maintain a watchful hold.

Outlook

Our gut feeling is that a degree of complacency has infiltrated the market at current levels. We worry that US banks will face further impairments as sub-prime mortgages are re-set during the remainder of the year; we worry about the risk posed by the leverage inherent in the Chinese banking sector, or an asset bubble within commodities, and we worry about the continuation of sovereign debt anxieties in Europe. However, our biggest anxiety is that none of the above is being reflected in current share prices. Our defensive positioning suggests that we are likely to face headwinds versus a market driven by a greater appetite for risk. Conversely, a more cautious and broader-based progression should be to our benefit in the long run.

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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. **Past performance should not be seen as an indication of future performance.**

Source performance data, Bloomberg, bid to bid, net income re-invested.

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