



RATHBONE INCOME FUND

MONTHLY UPDATE NOVEMBER 2024

This has been such a frustrating year. At the start of 2024, the UK equity market was undervalued: it still is at year-end.

We looked forward to the promise of more structured and stable government in 2024, a commitment to growth and an economy in recovery mode. It seemed like a year of opportunity lay ahead. Ah, the sunny uplands of the spring! In the dark days of winter, much of our optimism has ebbed away. But might too much despondency mean we risk missing a trick?

To cut to the chase, yes. The last month has *seemed* particularly hard. It's difficult enough to promote an argument for UK businesses and markets without the government throwing a big spanner in the works. And yet, if you ignore the noise, the sentiment and the momentum (gulp!), the positive argument for UK equity still stands, even if precious few seem to be listening.

The Autumn Budget: squandered opportunity or necessary medicine?

Hopes that the new Labour administration would quickly prove a safe pair of hands faded through a summer of gloomy messaging and an Autumn Budget that dismayed business leaders and economists alike. One retailer we've spoken to recently said that they could deal with the rise in the National Living Wage or higher National Insurance Contributions or the introduction of new packaging taxes. But getting all of them together all at once was a terrific strain at this point in the cycle. Business will step back from making investment and employment decisions. And many worry that all the negative headlines are feeding through to nervous consumers. Rather than being pro-growth, could the Budget measures end up stifling any nascent recovery?

Our optimistic view is that the answer is 'no', although the government clearly hasn't done itself any favours with British business. Many companies have strong balance sheets and are generating cash. Despite their grumbles, they're in decent shape to deal with current challenges. The valuation argument for the UK market remains front and centre. Yes, of course, a lot can go wrong, but the UK's low entry-point is the margin of safety absent on the other side of the Atlantic.

Cash returns

Clients have recently been asking a couple of very specific questions.

First, will small and mid-cap businesses manage to maintain dividend payments in light of the Budget? Secondly, how might the current vogue for share buy-backs impact on the way companies return cash to shareholders?

When we assess the quality of a business, we think about cash flow returns on investment. This means we're interested in cash profits, and by extension what cash is left over once the tax man and the lenders have been paid, once money has been spent to keep the business ticking over and after investment in future growth through capital expenditure (long-term investment in things deemed critical to expand the business) and acquisitions. After that, the company can hold on to the remaining cash (maybe for a rainy day?) or it can hand it over to shareholders, via a dividend or another mechanism. When costs go up, whether through inflation, increased regulation or competition, this impacts on cash returns. The leaner the profit margin, the greater the stress. Working out how all this stacks up is fundamental to our analysis and our investment decisions.

Of course, many of our companies are enduring periods of stress, but there seems to be enough fat on their bones to get them through. By way of example, auto service provider and retailer **Halfords** will be impacted by all the headline Budget changes, but believes operational efficiencies and its growth strategy can insulate it from many of the headwinds. As a result, it's confident it can maintain pay-outs at current levels – indeed, it has net cash on its balance sheet.

Food retailers are in a much stronger position than many as they can pass a lot of the increase in their costs on to customers. Bad news for consumers, but a buttress for dividend generation. **Tesco** and **Sainsbury** are both gaining market share according to the latest Kantar data. Moving away from the consumer, other domestic names (which are what we're focusing on here as global businesses are less impacted by the Budget changes) are similarly protected.

Housebuilders face the perennial challenge of a delicate housing market, but enjoy the support of structural growth, potential planning reform and falling mortgage rates to encourage dividend progression – neither **Persimmon** nor **Taylor Wimpey** are cash poor. We can go on, but the point is, across our portfolio we can see security in dividend generation.

Of course, the dividend tail must not wag the investment dog. But aiming to provide unitholders with a pay rise every year is central to our proposition. That means we try to be laser focused on the challenges and opportunities that may arise for companies as they seek to generate cash (and the growth needed to do so).

Broad balance sheet health is further evidenced by the scale of share repurchases under way. We've not always viewed buybacks as altogether positive, especially when they happen irrespective of the price of the shares, *à l'Américaine*, and with little reference to appropriate levels of indebtedness.

But these days in the UK, buybacks can be viewed as indicators of rude balance sheet health alongside absurdly low stock valuations. Large businesses like **Shell**, extraordinarily **AstraZeneca** (bearing in mind its large investment pipeline, but in response to share price weakness), **NatWest Group** (buying out the government), and **Legal & General** are all looking to take advantage of the large returns on offer through buying back their cheap stock.

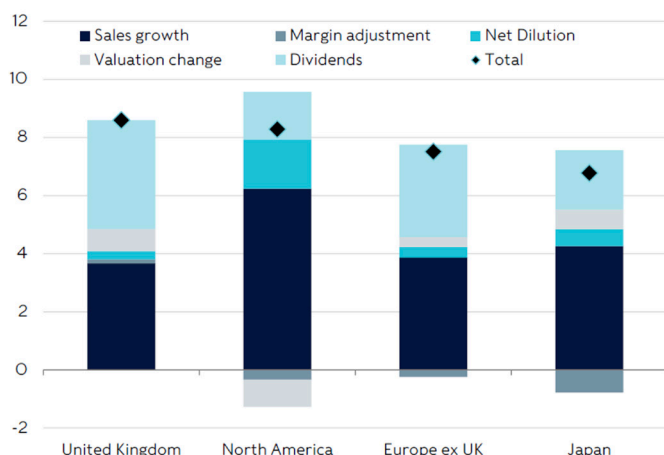
Smaller businesses are getting in on the act too. Steel and foundry technology business **Vesuvius** is belying the strains on the global steel market by being so efficient and cash rich that it can announce a second £50 million repurchase scheme. And global distributor **DCC** triggered a bounce in its share price by stating its intention to offload its technology and healthcare divisions (it doesn't even have buyers or prices yet) and return cash to shareholders. The market, in a positive way, is very sensitive to these statements – that's the valuation point coming to the fore again. And we emphasise, companies are returning cash via buybacks on top of dividend pay-outs, not instead of them.

Might the glass be half-full?

The chief economist at investment bank Peel Hunt Kallum Pickering is more bullish than many on the UK economy. While recognising that predilection, his latest health check on the UK includes several compelling points. He notes: the UK is not alone in seeing weakening PMI data, ex-US it's a trend among developed markets; despite the post-Budget bleating, companies are generally positive; sterling is robust; the UK market is cheap; consensus estimates for UK GDP growth in 2025 and 2026 have actually risen; inflation and interest rates are coming down; and the housing market continues to recover.

We admit that all these positives don't include any immediate catalysts that might shake the UK market out of its relative funk. Nevertheless, for all the doom and gloom, UK stocks' low valuations alongside the country's decent economic health together make for a heady mix.

COULD THE NEXT DECADE BELONG TO UK EQUITIES? EQUITY RETURN PROJECTIONS* BREAKDOWN (%)



Source: Rathbones Asset Allocation Research, Robert J. Shiller, LSEG

*Please note: Forecasts are not a reliable indicator of future performance

Yes, US companies will grow faster, but their scope for margin or valuation expansion is limited. Both are already stretched.

The Trump bounce takes very little account of how tariffs might impact on global growth and US inflation or how aggressive immigration policies could hurt US GDP growth (remember, population growth has been key in driving the latter), or the risk of government dysfunction. And, of course, there's the crowding effect as more and more people pile into passive investment strategies that oblige them to buy more and more of the same shares. History tells us that, eventually, the elastic must snap.

Our challenge

This has been a challenging year. Although we're delivering good absolute outcomes, and a pay-rise through the growth in our dividend, we are lagging the index by a margin. We're keenly aware that our key competition is not just the Mag7, but passive investment vehicles too. When markets seem on a repeat cycle of gains (and, remember, the UK is notching up successive gains despite all the gloom), active investment faces a formidable foe in the form of low-cost passive alternatives.

That foe may be vanquished only if markets take not just a tumble but an almighty fall. Of course, we aren't making any predictions. But we do contend that valuations in the US offer no safeguards at current levels. In the UK, the bad news is pretty well-known and priced in. How comfortable you are with the risks that may lie ahead depends very much on your individual investment goals.

Ultimately, our biggest challenge may be relevance. At the moment, asset allocators may look at the UK, recognise that it represents a small percentage of the global market, and conclude that it isn't worth the effort. That conclusion is out of our control. However, our commitment is to emphasise repeatedly the importance of income strategies and the opportunities within the UK market on account of the dividend yields and valuations on offer. For clients with demands for income and capital flexibility, the UK market jolly well should retain its relevance, and we must tirelessly champion that cause!

Recent trading: The big financial story in the UK is the legal investigation into motor financing and historic payments of commission for insurance. We have de-risked our exposure to further contagion by substantially reducing our holding in **Lloyds Banking Group**. This has funded a new position in **HSBC**, thereby maintaining our financial exposure through the purchase of shares in a global titan yielding more than 6% and trading at a discount to book value. We trimmed **BAE Systems** on valuation grounds, and have made a more committed sale of a large portion of our position in Swiss pharmaceutical giant **Novartis**, wondering if the story has run its course for the moment. On the other side of the coin, we have further added to aggregates business **Breedon Group**.

Companies seen in November: **GSK**, **Assura Group**, **Breedon Group**, **SSE**, **Halfords** and **Big Yellow**.



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Find out more about the Rathbone Income Fund by watching [this webinar](#) and also [these videos](#) in which Fund Manager Carl Stick explores the implications of increased longevity.

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.

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