

UNDER THE BONNET

Q3 2022 REVIEW



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INVESTMENT BACKGROUND

How quickly things change. The quarter started well for global markets, with bond yields declining and equity markets rising. Inflation showed signs of peaking in the US, which, with emerging weakness in some measures of economic activity, led to hopes of a Fed pivot and increased confidence that the Fed Funds rate would peak at around 3.75%.

This all changed in August and September as the Fed doubled down on their hawkish rhetoric, with Jerome Powell making clear that policy would remain restrictive in his Jackson Hole speech. This was followed by a US CPI print (for August) in September which was slightly higher than expected and which was notable for its breadth, with core CPI ex food and energy rising by 6.3%. Coupled with sharply rising gas prices in the US through the quarter (since reducing), continued strength in nominal wage data and a decision by OPEC+ to cut production, it is no wonder that Treasury yields renewed their rise. By the end of the quarter the market implied peak in the Fed Funds rate had risen by c 100bps to c 4.75%. Having started August at 2.57% the US 10-year Treasury yield climbed to 3.83% by quarter-end.

If it was a tricky picture in the US it was a horror show in the UK, particularly in September. UK market participants had a lot to digest with the appointment of a new Prime Minister, an energy support package, the composite PMI indicating economic contraction, a somewhat surprising 50bps Bank of England base rate hike, the new Chancellor's 'mini-budget' and ultimately an intervention from the Bank to bring some stability.

Dealing with some of the economic data first, the S&P CIPS UK Composite PMI notably entered contraction territory at 49.6 for the first time since February 2021, driven by declining services data. Transaction data released from Barclaycard indicated a sharp moderation in consumer spending between July and August, whilst consumer confidence as measured by GFK continued its negative trajectory, reaching another new all-time low since records began in 1974, the 4th time in five months.

Against this backdrop, the Bank of England opted to hike interest rates 50bps at its delayed MPC meeting, surprisingly resisting calls for a 75bps hike. The decision was quickly followed by the Chancellor's widely anticipated 'Growth Plan'. The government had already announced an energy price cap plan costing c £60bn* in the initial phase. The Growth Plan was more focused on deregulation and tax cuts to stimulate the supply side of the economy.

Whilst much of the content of the Growth Plan had been widely expected, markets took a dim view of additional tax cuts in the absence of offsetting revenue or spending cuts, particularly in light of the expected heavy costs of energy support. Worse, there was a lack of unity within the Conservative Party about some of the more headline grabbing proposals and a perceived lack of joined-up thinking between the Bank and the Government. Gilts sold off aggressively, with yields on the 10-year rising as high as 4.5% in the days after the statement, from c3.3% immediately prior. Sterling came under extreme pressure, at one point falling to near parity against the US dollar.

The rapid increases seen across the UK yield curve had knock on effects in the UK pensions markets and forced the Bank to intervene by cancelling their planned quantitative tightening (QT) programme and re-initiating purchases at the longer end of the curve.

Within equities, defensives continued their outperformance over cyclical and long-duration assets. In the UK, combined with the weaker pound, this benefited the FTSE 100 and the FTSE All Share, which fell on 2.7% and 3.4%, over the quarter, compared to a decline of 7.3% (9.7% in September) for the more economically sensitive FTSE 250. Aa at the end of September, the FTSE 100 is up 0.9% over 12 months whilst the FTSE 250 is down 23.5%.

*FTSE performance quoted in GBP

The Fund's mindset all year has been cautious in the face of an extraordinarily difficult backdrop and possibly the worst conditions that we have faced as managers despite all of the crises we have faced since launching the product in 2008. The cautious mindset has shaped many of the decisions we have taken, starting as far back as mid-2021, as we thought about re-cycling M&A capital from a number of portfolio names that were being taken over.

On a relative bases, the fund has held up reasonably well. This has been achieved through a number of measures:

- Increasing the fund's exposure to the FTSE 100 (currently c 70%, with nine of the fund's top 10 active positions)
- Ensuring focused exposure to potential idiosyncratic outperformance (something we thought would be imperative in a tough investing backdrop)
- Maintaining good balance between cyclical and defensive earnings (whilst ensuring we don't get seduced too early to bombed out UK retail earnings) and
- Ensuring healthy exposure to reasonably priced growth situations (we think near 40% of the current portfolio)

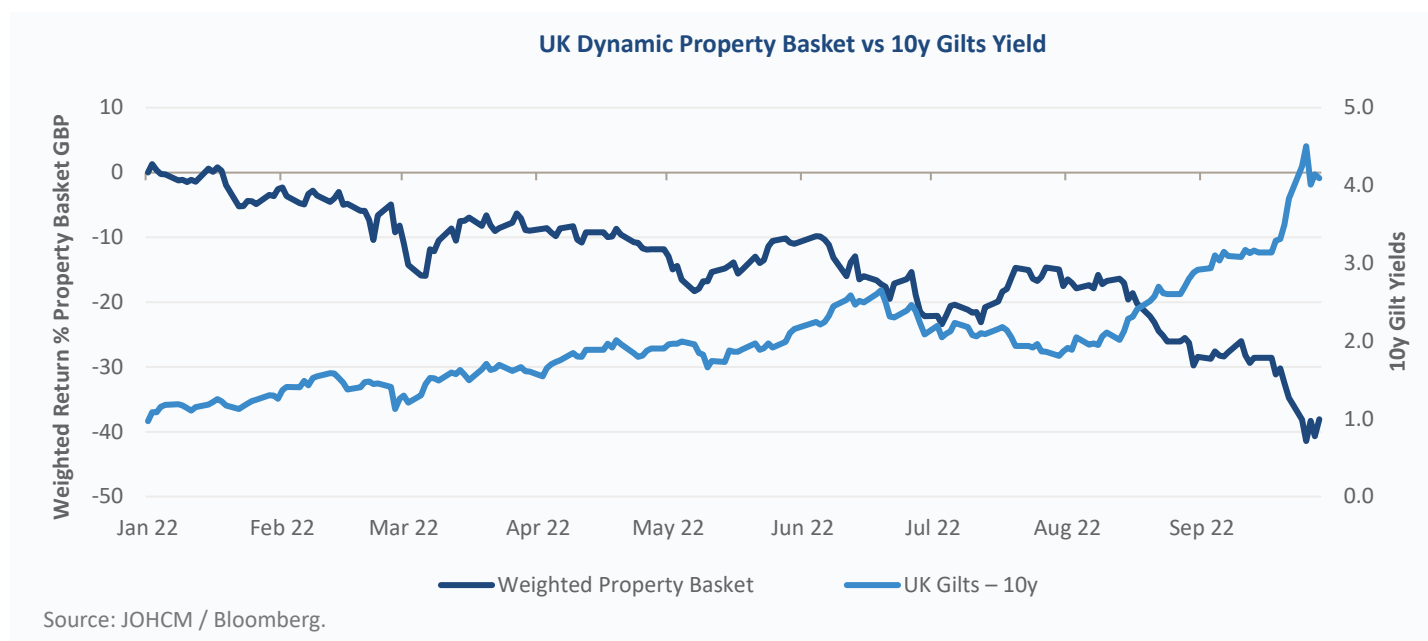
That said, given the sheer scale of recent economic and political news and the related uncertainty and fear driving markets materially lower, the third quarter has been difficult regardless of any positive idiosyncratic developments at a stock level and regardless of the balance or level of reasonably priced growth in the portfolio.

Through a mixture of negative market mix, profit taking in stocks that had done well year-to-date and an absolute buyers' strike in any stock or sector remotely correlated to bond yields, the fund fairly materially underperformed its benchmark, falling by 6.86% in absolute terms, 3.57% under the benchmark index, the FTSE All Share. That left the fund down 10.05% year-to-date, 2.58% behind the benchmark.

Whilst the data will show that the underperformance over the quarter was as much to do with stock selection as it was to market allocation effects (allocation -1.02%, selection -1.79%), the reality is that the overwhelming majority of actual news flow over the quarter – of which there was a lot – was remarkably positive. Of a portfolio of 40 stocks we had results or trading statements from 38 of them. Of these we count 12 companies that beat and raised current year guidance on either revenue, earnings or cash flow, three where the outlook was explicitly lowered, one 'broadly' in-line and the rest firmly in-line. We wonder whether we have ever had as successful an in-year earnings period in the face of such challenges and we are sure we have never seen a period where share prices have diverged from the path of earnings so obviously.

Looking at sector performances first, we see where the mix effects have been difficult for this fund. The fund is underweight technology, energy, basic materials and consumer staples, the four sectors that outperformed over the quarter. Energy and basic materials underweights are a particular headwind given their size in the index. While we have some exposure through positions in BP, Anglo American, Centrica and Shell, we are overall underweight and particularly underweight coal exposures (which we do not want). Not owning Glencore alone detracted 40bps. It helps when what you do own in a strong sector participates for you but, surprisingly, Centrica had a poor quarter (-28bps) despite a blockbuster earnings report and an increase in interim dividends, covered below.

At the other end of the scale the fund was exposed to the move in gilt yields most markedly through any stock with even a passing exposure to real estate. The four stocks in the fund most clearly affected were Landsec, Crest Nicholson, Travis Perkins and Shaftesbury (subject of an ill-advised and ill-timed merger with Capco (which we both argued against and voted against). In combination these stocks were c 8% of the portfolio and collectively fell c 40% over the quarter. As can be seen in the chart, they have become highly negatively correlated with rising gilt yields for now.



Of these **Landsec** was the largest individual negative contributor (-59bps). The share price fall has taken the shares to a 50% discount to the last stated NAV despite the fact that:

1. Valuations for the company's assets in the retail, leisure and office space still reflect post COVID trading conditions and therefore valuations may be more resilient than the market perceives
2. It sold a development asset (21 Moorfields) for a headline £809m and a net £733m over the quarter, the proceeds of which reduce stated loan-to-value by 400bps (down to 30%)
3. It confirmed guidance for earnings and therefore dividend growth for the year
4. It showcased c £1bn of development assets in Bankside which we think offer strong development returns
5. Management have highlighted they will balance development with the returns offered by buying back their own stock

We have been around long enough to understand that any news in the stock market is immediately yesterday's news, but still, even by those standards we find this move quite extraordinary.

The Telecoms sector was another weak one where the Fund has exposure through **Vodafone**. Vodafone offers, as regular readers will know, possibly the biggest ongoing restructuring within the Fund. We won't go over the extraordinary amount of portfolio activity that has taken place over the last few years but we will add that this quarter saw the official start of services in Ethiopia for Vodacom, the sale of Vodafone Hungary, the confirmation of merger talks with 3 UK, the partial sale of Vodafone New Zealand Tower Assets and confirmation that the company was in talks to sell down a further part of their stake in Vantage Towers, with a number of interested parties. This final part is very important as we look to the company not only to slim down for focus (reallocating capital from Hungary to bulk-up in the UK actually feels right to us) but to generate proceeds from highly valued assets in order to more quickly reduce the leverage taken on after acquiring Liberty Global. It has taken longer than expected to complete some transactions and the market this quarter seems to have given up. But the commitment to transformation, focus and de-leveraging from this board is unwavering. And did we mention they confirmed cash flow forecasts this quarter and attracted another new (activist) investor in the founder of Iliad Xavier Nell? Very interesting developments at a company now yielding c. 8%.

Centrica rather curiously struggled this quarter (-28bps) despite stellar interim results that led to substantial earnings upgrades (2022 EPS now looking like c 16-20p against a c 70p share price. Rather than focus on actual results and strategy, which have endowed Centrica with the strongest balance sheet for a generation, the market has responded to various stories around regulatory interventions, capital allocation decisions and newspaper articles about what might happen to their energy trading business if power prices spike this winter. Lots of ifs, buts and maybes. We prefer to try and think about a business where competition in energy supply has been decimated, regulatory interventions have failed and are being refined in favour of more predictable and better thought-through policy. Current cash generation offers material optionality in the form of capital allocation decisions, undervalued owned assets in the shape of Rough Gas storage and the Morecambe Bay reservoir, that could be seen as critical pieces of national energy infrastructure (such as for hydrogen or carbon storage)), and an LNG supply and trading business that has moved from a drain on earnings to a long-tail driver of earnings. There is much to be wary about with regulation and normalising commodity prices, but the shares trade at 1.5x EBITDA with a grossed-up balance sheet that offers so many options. Curious.

When we look at the positive relative contributors over the quarter we see that **Pearson, Ricardo, RS Group, Beazley, MoneySuperMarket** and **NCC** (a new position over the quarter) show up in the top 10. The majority of these names were in our list of 12 holdings that upgraded guidance over the quarter. They are stocks which we might describe as having GARP-like characteristics (defined here as reasonably consistent revenue and earnings growth capability and with reasonable financial strength characteristics). Our list of current stocks with GARP qualities also includes **Convatec, Smith & Nephew, GSK, 3i, IMI, PZ Cussons, QinetiQ** and **Unilever**. Together these account for c 40% of the portfolio and as we look at 2023 earnings we see relative stability for now and a median expected growth rate of 11% (Bloomberg data as at today's date). The median PE of this cohort of investments is c 13x. Reasonable.

Of the other 60% of the portfolio there are so many names that we think could and should make the cut but we don't include them either due to their current macro exposures or too much cyclical or where they are in their transformation lifecycle. But names like **Aviva, Anglo American, Centrica Landsec, WPP, Elementis** and even **Rolls Royce** are doing so much to restructure their operations, their asset portfolios and their balance sheets to put them in a position to be able to allocate capital for more consistent and predictable growth and in all cases with a more sustainable business model. They may today represent a different shorter-term risk factor but ultimately they are becoming better versions of themselves and that will have long-term positive benefits. And that is what this Fund is all about; patiently backing business transformation that leads from restructuring to growth.

OUTLOOK

The next quarter will be extremely important as we get deeper insight into second half trading via Q3 trading statements which start soon. It will be these statements and the following full year results which will set the tone for analyst earnings forecasts for 2023. No doubt this could be a very noisy and volatile quarter as some companies' fess-up having spent the year hoping that conditions will improve whilst others will confound the doom mongers by perhaps meeting and beating low expectations.

Undoubtedly as the second half has progressed headline conditions have been extremely tough but interestingly we see signs that some margin pressures have been abating. The demand outlook has brought down some commodity prices, there has been a gradual loosening of the tight labour markets and logistics bottleneck pressures have abated. A key feature of the interim results period was supply chain resilience and inventory build. Cash generation notably lagged earnings as a result. Q3 will be the first sight into how cash flow has trended in the second half and will be perhaps more important than earnings for some companies. For those with excess free cash flow, the attraction of buying back capital, equity or debt will be too attractive. Whether this will appease a bearish market is difficult to judge, but we are, given low expectations and comedy valuations, optimistic.

FUND PERFORMANCE

JOHCM UK Dynamic Fund performance (%):

	1 month	3 months	1 year	5 years	10 years	SI annualised
Fund	-7.44	-6.86	-8.17	2.24	100.39	7.96
Benchmark	-5.72	-3.42	-4.33	11.42	78.81	5.43
Relative return ¹	-1.83	-3.57	-4.02	-8.24	12.07	2.40

Discrete 12 month performance (%):

	30.09.22	30.09.21	30.09.20	30.09.19	30.09.18
Fund	-8.17	49.19	-30.55	0.83	6.57
Benchmark	-4.33	28.31	-16.51	2.72	5.84
Relative return ¹	-4.02	16.28	-16.81	-1.84	0.69

Past performance is not necessarily a guide to future performance. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus.

Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as at 30 September 2022. Inception date: 16 June 2008. Note: Performance data for the period 16 June 2008 to 22 October 2009 is for Ryder Court UK Dynamic Fund. From 23 October 2009 onwards, the Fund converted to JOHCM UK Dynamic Fund. All fund performance is shown against the FTSE All-Share TR Index (12pm adjusted). Performance of other share classes may vary and is available upon request. Data representative of JOHCM UK Fund (U.K.) onshore OEIC. ¹Geometric relative.

ONE MONTH STOCK RELATIVE CONTRIBUTORS

Top five			Bottom five		
Rank	Stock	Relative Return Contribution %	Rank	Stock	Relative Return Contribution %
1	Pearson	0.22	1	Land Securities	-0.48
2	WPP	0.22	2	Melrose	-0.30
3	NCC	0.19	3	Glencore*	-0.30
4	National Grid*	0.13	4	Diageo*	-0.25
5	Smith & Nephew	0.13	5	Barclays	-0.24

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Source: JOHCM/FTSE International/Bloomberg. Figures are at end of day and calculated gross of fees on an arithmetic basis in GBP. All performance is shown against the FTSE All-Share TR Index. Data from 31 August 2022 to 30 September 2022. Data representative of JOHCM UK Fund (U.K.) onshore OEIC. *Stock was not held during this period.

Q3 2022 STOCK CONTRIBUTORS

Top five			Bottom five		
Rank	Stock	Relative Return Contribution %	Rank	Stock	Relative Return Contribution %
1	Pearson	0.63	1	Vodafone	-0.60
2	Ricardo	0.37	2	Land Securities	-0.59
3	RS Group	0.36	3	Melrose	-0.49
4	AstraZeneca*	0.28	4	Diageo*	-0.43
5	Beazley	0.28	5	Shell	-0.43

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Source: JOHCM/FTSE International/Bloomberg. Figures are at end of day and calculated gross of fees on an arithmetic basis in GBP. All performance is shown against the FTSE All-Share TR Index. Data from 30 June 2022 to 30 September 2022. Data representative of JOHCM UK Fund (U.K.) onshore OEIC.



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