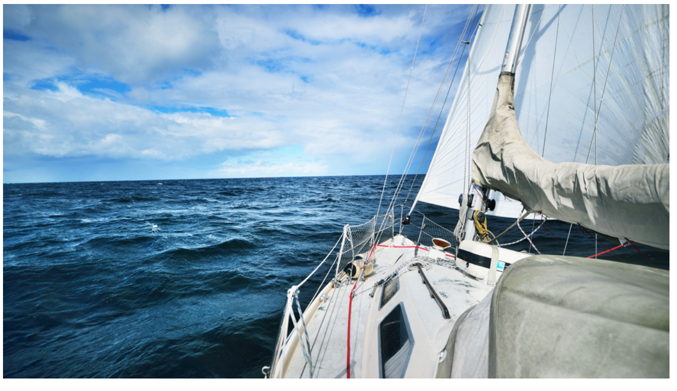
CORE THOUGHTS

Fund Literature	Fund Facts	Latest Fund Webinar

Navigating Uncertainty

Staying cautiously positioned as the financial belt tightens



The **JOHCM UK Opportunities Fund** employs an investment philosophy focused on three key pillars:

1. **Thematic Growth** – The team identify long term thematic tailwinds whilst avoiding cycle up/cycle down companies or those with structural headwinds
2. **Capital Preservation** – The team see capital preservation as an essential component of long-term value creation, and place significant emphasis on balance sheet strength, competitive position and valuation control
3. **Engagement** – The fund managers engage directly with companies to encourage them to improve their impact on the environment and society

The JOHCM UK Opportunities Fund is a concentrated portfolio of 20-40 large and mid-cap companies. It is not constrained by benchmark weightings.

Inflation and interest rates have been the chief concerns for the market this quarter, with the delayed impact on mortgage rates and consumer confidence a looming threat. Higher rates will undoubtedly cause financial stress for many, however, it is worth noting that only 28% of UK households have a mortgage and more than 30% own their homes outright. Nevertheless, fixed-term mortgages taken out during the pandemic and due to expire now could see rates move from 1.5% to over 6%.

UK inflation has been stubbornly high despite energy prices falling out of the annual comparator. Wage growth is currently running around 7%, which has at least given a boost to consumers dealing with c20% food inflation.

The key point here is that these numbers are large, unpredictable, and not what businesses or consumers have been used to. We believe a cautious investment approach is necessary, especially regarding financial leverage. We will continue to own businesses which can self-fund their growth through cash-generative business models and avoid those where profits don't convert into cash, or the business holds inappropriate amounts of debt for its business model.

Performance

Notable positive performers in the period were Whitbread and Smith & Nephew.

May saw the announcement of Whitbread's full year results. The company continues to benefit from shrinking market supply, particularly in the independent hotels segment. These hotels cannot compete with the scale advantage of their purpose-built and branded competitors. Since 2010 an estimated 78,000 independent hotel rooms have left the UK market, whilst Premier Inn's share of the overall market has doubled from 6% to 12%.[1] This year, it has continued to see growth, with sales up 27% on pre-pandemic rates. The key long-term driver will be its success in replicating this model in the German market.

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The improved performance at Smith & Nephew was partly due to the resurgence of elective surgery, particularly among older US patients who had delayed replacing hips and knees during the pandemic. Ultimately, the demand drivers for healthcare companies are not discretionary. It is our investment preference for such non - discretionary revenues that has enabled the fund to deliver a lower volatility profile since its inception.

The biggest detractor from performance was Future Plc, which we sold in June. Detailed comments can be found below.

The London Market

During the quarter, CRH confirmed its plans to re-list in the US. Companies are periodically hoodwinked by investment banks (who make good fees on this work) into believing that their shares will be more highly rated overseas. Since the announcement at the beginning of March, CRH shares (in US Dollar terms) have risen 20%, underperforming US peer Vulcan Materials (+25%) and Martin Marietta (+29%).[2] We have maintained our position given the company's own admission that a "change in listing structure will have no impact on CRH plc".[3]

Concerns that the current level of shareholder protection offered by a premium London listing is too onerous for the new generation of moon-shot tech start-ups and crypto exchanges has led the FCA to propose more relaxed rules that might encourage such 'high-quality' corporates to list in the UK. The results, in the FCA's own words, will "mean passing greater investment risk to investors and greater responsibility on to shareholders."[4] The proposed changes include dropping the requirement for a three-year audited track record for IPOs and relaxing the rules around related party transactions. As a concentrated portfolio of around 30 holdings, we are able to conduct detailed due diligence and high levels of board engagement across the portfolio. Passive and quasi-passive funds may find it more challenging to mitigate these new risks.

Accelerating Transmission

Whilst you will often hear complaints that most British utility infrastructure has been sold off to foreigners, that is not true for the "transmission" assets which connect electricity generation to towns and cities. UK electricity transmission assets are split into three companies, with two, National Grid (England and Wales) and SSE (North of Scotland), listed on the London Stock Exchange. Both of these significant portfolio holdings reported strong full-year results during the quarter.

A lack of transmission connections risks deterring the development of new renewable energy – and pressure is growing to accelerate the pace of investment in the electricity grid. As one wind farm company wrote to the regulator "Security of supply, net zero targets, as well as lower bills for consumers are all largely dependent on the rate of deployment of transmission network infrastructure, and we are deeply concerned that this is not keeping up with what is required".

The war in Ukraine only adds to the pressure to build the connections for the UK's abundant renewable resources. If we want to be less dependent on gas, we must connect our cities to British renewables.

The attraction of owning transition assets is that they receive a guaranteed and ongoing return on the infrastructure they build. In simple terms, the more pylons, the more profit. The return comes directly from consumer bills; however, infrastructure remains a small part of overall costs, which are dominated by energy consumption. Regulation also serves to protect the profits from inflation, giving a fast growing, visible and defensive profit stream which sits well with the outcomes we aim to deliver for our investors.

The key growth driver is, therefore, how fast the regulator will allow the companies to build the transmission infrastructure that is needed.

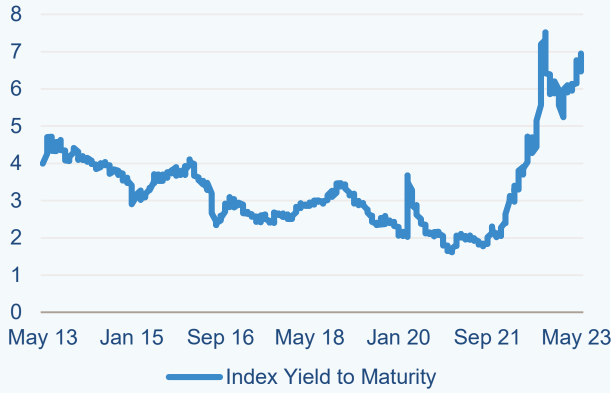
We expect National Grid's electricity transmission assets to grow 40% by 2027 and another 40% by 2032.[5] The company's UK assets sit alongside its US electricity assets that are subject to the same growth tailwinds.

Growth at SSE is likely to be even more significant given the abundance of wind in places like the Shetlands, and the distances that need to be covered to get it to large populations. In May, the company announced that it expects its transmission asset base to grow by 75% by 2027 and another 75% by 2032.

SSE now expect earnings to grow between 13% to 16% every year until 2027, and we assume a similar level of growth out to 2032.[6] These assumptions may prove conservative, with the company expressing the view that "these targets are only going in one direction".

Debt and Destruction

The rise in the cost of corporate lending continued during the second quarter. This chart shows the cost of sterling debt for UK companies with a credit rating of BAA. It includes companies such as BP, Vodafone, and HSBC. We should clarify that a BAA rating does not represent a list of ultra-high-risk enterprises.



Source: Bloomberg.

As owners of equity, we need to remember that we are last in the line of potential creditors. Despite this, our pleas to finance directors over the last decade to reduce leverage have largely fallen on deaf ears. Cheap debt has funded dividends, buybacks and record levels of value-destroying M&A. Being concerned about interest cover seemed something quaint that happened in an era before mobile phones or the internet.

Until now, the most recent spike to almost 7% in BAA yields was seen briefly during the financial crisis, after which followed a downward trend, bottoming well below 2% at the end of 2020. Very few people currently in the role of Finance Director have been responsible for negotiating loans when the cost of debt has actually mattered. The waves of refinancings will undoubtedly squeeze the net profit margins of highly indebted companies.

By way of example, in May, ASOS (which is not held in the fund) announced new debt facilities with an interest rate of 11%. This compares to its facilities in place during 2019, where we can estimate an effective rate of only 2%.[7] It is reasonable to assume that this was not part of the plan when CAPEX began to significantly outstrip cash generation to fund an ambitious international expansion. As a result, market expectation for ASOS FY24 profit before tax has fallen by more than70%. The implied interest cover is 1.3x.[8]

There are three obvious defences against the impact of higher corporate interest rates:

- Firstly, we can own companies with more stable revenues. Interest is a fixed cost, it doesn't fall if revenues fall. As the cost of debt increases, so will the volatility of net profits.
- Secondly, we can own companies that start with a higher margin and thus have more levers to pull to offset rate rises.
- The third and most obvious solution is to own companies with low levels of debt and thus, low interest costs regardless of the rate environment.

Our portfolio is built with all three defences in mind. We favour businesses with high levels of revenue visibility, such as Relx, Serco or our holdings in the utilities sector. The portfolio operating profit margin is currently 20%. Our aggregate portfolio leverage is below 1.5x ND:EBITDA – and more importantly, interest cover is above 13x for 2023.[9]

Engagement

We had meetings with non-executives at several companies to discuss remuneration during the quarter. Our concentrated portfolio allows us to engage early in the three-year remuneration cycle to stress the importance of incentives tied to the long term prosperity of the companies that executives are entrusted to manage. It is sadly not unusual to find chairs of remuneration with limited knowledge of the mechanics or the implications of the schemes over which they preside. Remuneration policies are generally designed by third party consultants and based on the generic requirements of overstretched proxy voting organisations. We suspect that the growth of passive and ETF investing is making this situation worse.

One company where we have had a positive remuneration engagement over the quarter is Hargreaves Lansdown. In early 2022 at the time of our initial investment, short term executive incentives were eight times as valuable as long-term incentives. We raised our objections to this topsy-turvy structure with the chair and head of remuneration in 2022, and voted against the approval of the Remuneration Report at the AGM later that year.

During the quarter we met again with the remuneration chair to discuss a new policy proposal which realigns executive incentives towards longer-term performance. There is more work to do on the finer details, however, we consider the new proposal to be a significant improvement.

We have continued to engage with companies on environmental and social issues. Disclosure remains a key issue with most companies seemingly determined to distract attention with glossy sustainability reports and anecdotal case studies, whilst avoiding reporting hard numbers.

A good example of this is Anglo American whose reporting of land remediation has room for improvement. Best practice for mining companies is to return mine-sites back to a natural state after the mine has closed. Over time the amount of land disturbed should broadly be matched by the amount of land remediated. Failing to do so has not only a social and environmental impact, but could lead to a significant financial liability. During the quarter we continued to press the company for the data on land disturbed that would allow us to assess their progress in this area.

The same is true for SSP Group, who claim a sustainability target to "reduce food waste by 2025".[10] Whilst this is an admirable target, it leaves many unanswered questions: How much will they reduce it by? How much do they produce now or last year? These questions are not answered in SSP's 41-page Sustainability Report. There are some internationally established guidelines on food waste disclosure which we are encouraging the company to follow.

Portfolio Changes

Towards the end of May, we sold our position in Future Plc. This has been one of our most unsuccessful investments and it is worth reflecting on what went wrong, and on the lessons that can be learned.

Our investment thesis in Future was based on its position as a leader in a growing online market, with a particular focus on independent product reviews. Our research suggested it had an industry leading technology platform delivering "evergreen" content and advertising. It operated as a consolidator in a market where it had significant scale benefits.

Over the last three months, there has been a change in CEO, leading to what looks like a radical change in strategy. In particular, the new CEO announced a pivot towards more news-based content, together with plans to increase spending on a US salesforce. This change in strategy comes at the same time as a deteriorating cash-flow and a sudden drop in revenue. We have not been able to reconcile the change in operational performance with the explanations given by management. In addition, we have new concerns around the threat to the business model from the availability of consumer facing AI platforms. With the painful benefit of hindsight, this business had too much reliance on a single revenue stream, and on a business model that was too new to be considered well established. Our bread and butter are long-established, simple to understand businesses with growth prospects that are highly likely to endure for decades to come.

In June we started a position in outsourced catering business Compass Group. The company is the global market leader benefiting from scale advantages in procurement where it is the largest buyer of food in the US. The business operates thousands of bespoke contracts across 40 countries, with an annual retention rate of around 95%.[11] Contracts contain cost-indexation to protect against inflation. There remains a long-term structural trend towards outsourcing with around 40% of organisations still using in-house operations, despite significant cost benefits from outsourcing.[11]

Most significantly, Compass is highly cash generative, maintains a strong balance sheet, and is able to fund its growth without the need to access debt markets.

Outlook

We remain sceptical on suggestions that global economies will smoothly negotiate higher inflation, higher interest rates and the heightened tension between Western liberal democracies and much of the rest of the world. We increasingly expect a bumpy ride for businesses with poor cashflow and excessive leverage. We have continued to tilt the portfolio towards stable and resilient cashflows, whilst maintaining our focus on growth that is more structural than cyclical.

References

[1]Data from Whitbread FY 2023 Presentation, p21

[2]Data from Bloomberg to end June 2023

[3]CRH FY2022 Results p7

[4]FCA CP 23/10 - Primary Markets Effectiveness Review: Feedback to DP22/2 and proposed equity listing rule reforms p5

[5]JOHCM Estimates

[6]Full-year Results Statement and Strategic update on https://www.sse.com/investors/reports-and-results/ and JOHCM estimates

[7]JOHCM Estimates

[8]Bloomberg, JOHCM Estimates

[9]Source: JOHCM estimates

[10]https://www.foodtravelexperts.com/sustainability/sustainability-framework/

[11]Compass investor presentations, JOHCM estimates

JOHCM UK OPPORTUNITIES FUND Q2 2023 Review

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FUND PERFORMANCE

Periodic performance (%)	1 month	3 month	1 year	3 years	5 years	SI	SI annualised
Fund	**0.31**	**-1.11**	**11.95**	**15.69**	**14.09**	**228.80**	**7.00**
Benchmark	0.12	-0.57	7.75	32.56	16.07	177.76	5.98
Relative return[1]	0.19	-0.55	3.90	-12.72	-1.71	18.38	0.96

Discrete performance (%)	30 Jun 23	30 Jun 22	30 Jun 21	30 Jun 20	30 Jun 19
Fund	**11.95**	**-10.48**	**15.45**	**-5.61**	**4.48**
Benchmark	7.75	1.64	21.04	-12.56	0.14
Relative return[1]	3.90	-11.93	-4.62	7.95	4.33

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 June 2023. Inception date: 30 November 2005. 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. [1]Geometric relative.

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