J O Hambro
Capital Management Group

JOHCM UK DYNAMIC FUND

UNDER THE BONNET

Q3 2023 REVIEW

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Strategy Update

Slipping Through the Analysis Gap

The JOHCM UK Dynamic strategy fared well over the last three months to the end of September, rising by 5.2% over the quarter. This represented quarterly relative outperformance of the FTSE All Share (12pm adjusted) of 263bps. The performance was driven by stock selection with a small number of very strong individual stock performances, on which we will comment shortly.

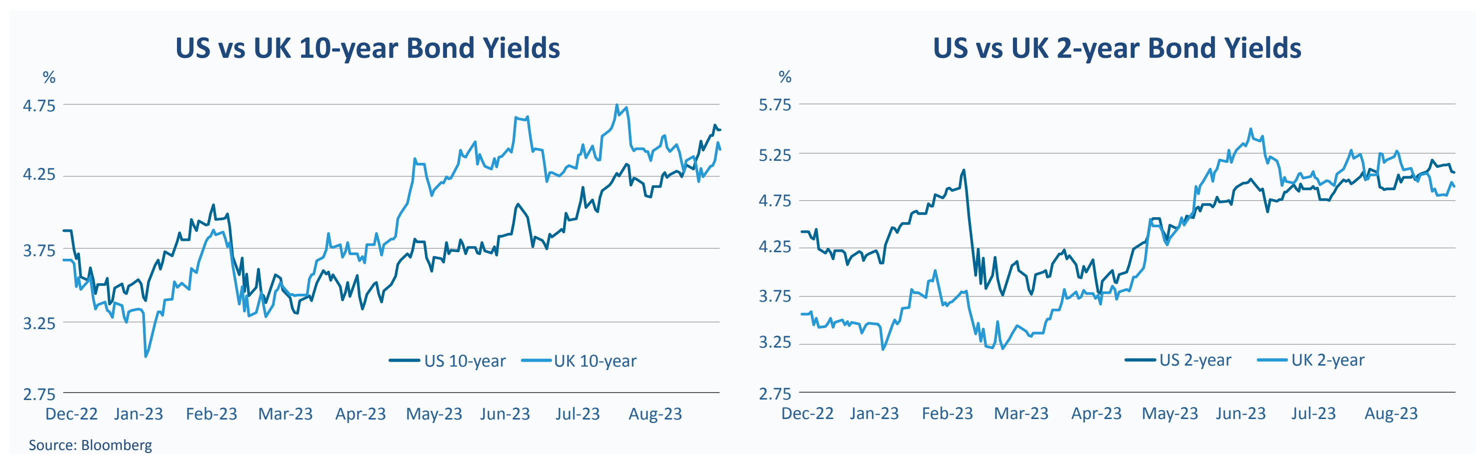
Despite another year of major economic headwinds where the market narrative has been dominated by inflation, interest rates and earnings recessions, it is extremely pleasing to report that year-to-date the Fund has risen by a not insignificant 8.0%, 292bps ahead of the benchmark. That performance has been driven c30% by the Fund's asset allocation decisions and 70% by effective individual stock decisions. At the end of September, the Fund had achieved its highest ranking since inception in the Lipper All Companies universe of 5th*.

It is interesting in this context to note that this performance is coming from a Fund which focuses on the much maligned UK stock market, continually the world's favourite regional underweight. This quarter it is worth noting that UK GDP was revised upwards again, finally dispelling the false myth that our country's recovery from COVID undershot the rest of Europe. The UK stock market also fared materially better than most other developing markets over the quarter, the FTSE All Share rising by c2.0% (driven again by the FTSE 100) whilst others broadly fell: the S&P was -3.3%, the FTSE World was -2.2%. The UK even managed to beat the NASDAQ index.

As well as focusing on the UK, this is also a Fund which attempts to invest with balance rather than outright skew. It is interesting to note therefore that by weight there is as much of the portfolio (c50%) that has underperformed the benchmark this year, and in fact by individual holding it is considerably more. This offers material opportunity to dynamically recycle capital as the year progresses in order to both protect and hopefully continue to further drive outperformance.

Collectively we feel that the opportunity for dynamic capital reallocation has seldom been as ripe. Personally, I feel that the bifurcation in outcomes predicted by share prices is as extraordinary as I have seen in my 27 years in the industry. I have no doubt it is a direct result of the widespread disruption as interest rates and inflation continue to wreak havoc on capital allocation decisions. As ever, the focus in the stock market is on the short-term, leaving a distinct 'analysis gap' around management's long-term strategic decision-making and relative assessments of strategic success.

Blame It on the Yield Curve



Source: Bloomberg

*Source: Lipper Hindsight. Performance ranking based upon IA UK All Companies Sector to 30 September 2023

The backdrop of easing inflation leading to a re-assessment of where rates might peak this cycle led to some fairly dramatic moves at the short-end of the curve. At the beginning of the quarter the 2-year swap rate in the UK was c6.2% yet it finished the quarter closer to 5%. In the US, whilst shorter-term rate moves were less dramatic, a re-assessment of how long rates might stay high saw the US 10-year yield move dramatically higher over the quarter, rising by c73bps over the quarter to end at 4.57%. After period-end they moved higher still. These moves had a fairly large impact on factor performance through September with longer-duration growth defensives underperforming - particularly those with a US flavour. This was broadly supportive to the Fund's performance with large index component Diageo in particular having a weak quarter.

Key Contributors

Valuation Anomalies

This environment is leaving large valuation and performance anomalies within the Fund that has seen stocks like **Johnson Matthey**, **Landsec** and **Dowlais** touch new lows. Dowlais in particular stands out on a PE of c5.5x next year's expected earnings despite strong results and upgrades at the recent interim results. The autoworkers' strike in the US – which is likely to be resolved at some point – seems to have been the dominant performance driver of late. Landsec suffers from its link to interest rates and a relatively spurious connection to weak central London and City office demand. With 100% occupancy in their vast Victoria office estate, one wonders what the fuss is about. All three of these stocks ended the quarter as larger positions in the Fund than they started.

For Johnson Matthey the share price has responded to earnings downgrades driven by their exposure to declining Platinum Group Metals (PGM) prices. We have just finished a set of deep dive meetings with Johnson Matthey and having got to know the business over the last nine months, whilst we remain more cautious over short-term PGM profits, we are highly confident in the trajectory of the fast-growing but loss-making hydrogen technologies business and are increasingly confident in the longevity and upside optionality within the clean air business (auto catalysts). We await further evidence from the catalyst technologies business where upside opportunities are large and play directly into the group's core strengths. Elsewhere there is material hidden value in some of the remaining non-core assets which are up for sale and which could see a material cash inflow to the group. On balance we have become more confident in the undervaluation of the Group and have been increasing the Fund's position. Interestingly Standard Industries, a strategic investor in the chemicals sector and owner of industry competitor W R Grace & Co, upped its stake in Johnson Matthey over the quarter to c10%. Whilst the shares rallied 10% on the news, the rally faded with the shares giving up all the gains subsequently. But this is not insignificant news.

WPP cut guidance over the quarter after disappointing trends in the US business where both media and creative spending, particularly from technology clients, missed expectations. Whilst the guidance was partially expected, the shares performed poorly given ongoing fears over the impact of AI and strategic uncertainty over the company's position in both the US which seems to continue to underwhelm and China where the performance has not recovered as expected. We think the shares are clearly cheap (trading on a PE of c7.5x) and in our view have huge sum-of-the-parts value should they want to realise some of it. GroupM, Ogilvy, VMLY&R, FGS Global, Wunderman Thomson, Kantar, AKQA – the brand list is a creative advertising, media and communications who's who. But does the Group get the value from this holding company structure to the degree they should? The restructuring under Mark Reed since 2018 has been good and has moved the organisation in the right direction, but we wonder whether it is yet enough. Whether this board wants to pursue a strategy that is somewhat more radical than the current is currently questionable. They may need some persuading.

Moneysupermarket delivered a negative contribution of 40bps as the shares underperformed despite strong interim results where full-year earnings were upgraded and dividend growth was reintroduced for the first time since COVID. The performance was driven by a resurgent motor switching market augmented by good strategic delivery that is supporting growing market share. The market chose to take a dim view of when energy switching might return and this was used as an excuse for the shares to underperform. **Ricardo** shares were weak after full year results despite an excellent performance from its key energy & environment division, which grew revenue by 16% and operating profit by 47%. The automotive divisions disappointed somewhat, working capital was a minor miss and interest charge guidance was higher than expected. Whilst marginally disappointing these elements are dwarfed by the ongoing success from the energy & environment division which alone is arguably worth the value of the whole Group. We remain a large shareholder in this interesting and highly undervalued turnaround.

Finally **PZ Cussons**. We covered this in detail last quarter and our comments remain the same – except for one point of detail. We were wrong in our assessment that the government's decision to let the Naira float more freely against the dollar might allow the company to repatriate some of their trapped Nigerian cash. In fact the opposite has happened in the short-run and for various reasons dollars are scarce and economic pressures building. The group is strategically performing well, but for now events in Nigeria will continue to drive the shares lower. Having cost c23 bps in negative contribution over the quarter we should be braced for more underperformance. The position is currently c1.3% of the Fund's assets.

Lastly, **Pearson** made the surprise announcement that CEO Andy Bird would be retiring to be replaced with Microsoft's Omar Abbosh. Despite the surprise the shares responded reasonably calmly, partly due to the confirmation of the start of the expected share buy-back programme. Omar is a seasoned ex Accenture and Microsoft executive and the board in our conversations seemed genuinely pleased and excited about what skillsets he brings. We will wait and see but it feels to us that the whole strategy may again be rethought. We shrunk the Fund's position after the news as we reconsidered everything we thought we knew.

Positive Contributors

Turning to the positive contributors over the quarter, **Centrica** was by far the standout, delivering 115bps of relative contribution. The strong performance was a direct response to the interim results in late July where earnings for the half-year came in ahead of most analyst's full year forecasts, a remarkable result. The performance was particularly strong at a cash generation level with the Group finishing the half with a net cash balance of over £3bn. The transformation of the balance sheet has been extraordinary. In 2019 the Group finished with the year with over £3bn net debt. A £6bn swing in just three years. As well as being returned to shareholders – £1bn share buybacks announced thus far – the cash is being used both to drive future growth through investing in the retail proposition and into core infrastructure assets. Returns on investment look sensibly struck and support a growing earnings and dividend profile once gas and power prices normalise. On a current PE of c5x, rising to c8x on a more normalised 2024 set of forecasts, the shares remain a very good investment.

The second standout performer was **Rolls-Royce** which delivered 53bps of positive relative contribution. Interim results were substantially ahead of expectations with a particularly strong performance from the civil aerospace business as flying hours recovered, but more importantly strategic actions around pricing and operational delivery started to come through. Margins for the division of 12.4% in the first half (after a negative 3.4% last year) were a major positive surprise and have dramatically changed the narrative about what is achievable from the transformation under the new CEO. Earnings forecasts for 2023 rose by c50% after the results. The shares responded accordingly, rising by c46% over the quarter.

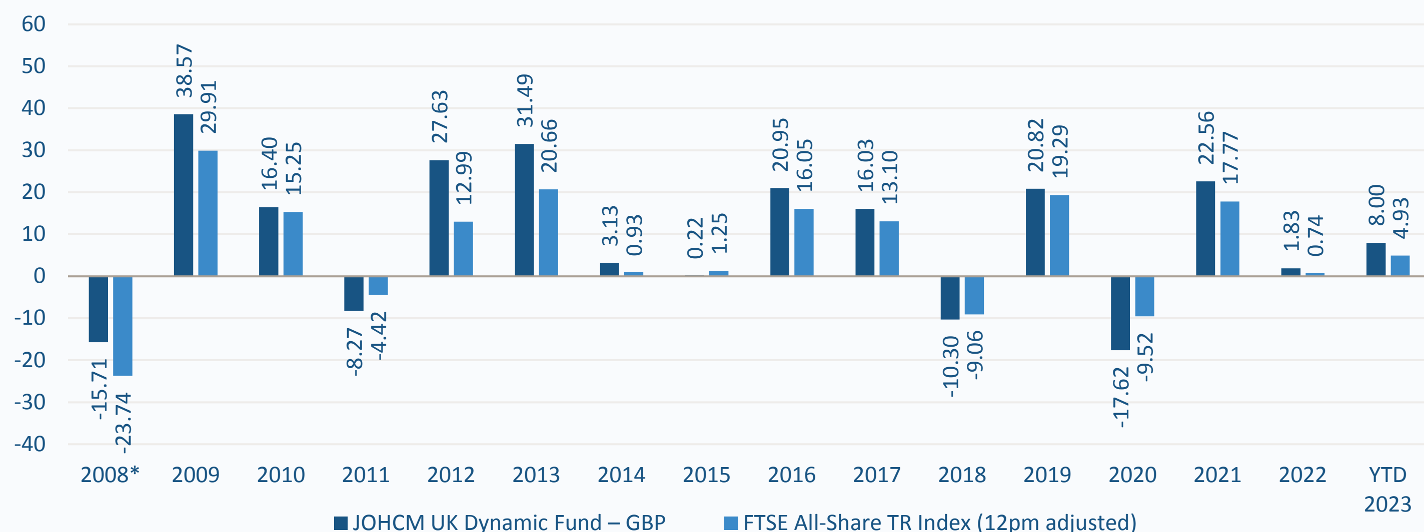
Elementis' share price is also worthy of mention given its outperformance against a tough chemicals sector backdrop. Firstly, interim results came in slightly ahead of consensus with no accompanying downgrade of full-year expectations, but then late in the quarter Franklin Mutual, a c10% shareholder, published a letter urging the board to immediately announce a sales process. Shares responded well to the letter as the market speculated on the potential outcomes as other shareholders publicly voiced their own concerns about the company's management, strategic direction, prior capital allocation decisions and serial undervaluation. It should be of no surprise to unit holders of this Fund that we share some of the same concerns as other shareholders. As seven-year veterans of experiencing every major decision that has taken place within this company under this management team we are acutely aware of the disappointing outcomes for all stakeholders. We have both publicly and privately made our feelings known about the poor capital allocation decisions that have led to excessive debt through needless M&A and the poor returns on invested capital from those acquisitions. We are watching the situation with interest, have engaged with the board to give our own perspectives and have made it clear that we feel this marks the beginning of the end for this current iteration of board strategy and management.

Other noteworthy positive contributions over the quarter came for **3i Group** through continued positive trading at key asset Action but also supported by very solid asset performance within 3i Infrastructure. **Direct Line** positively surprised by announcing the sale of its brokered commercial insurance business to RSA for £520m and **Convatec** upgraded revenue and margin expectations for the full year. Strangely for Convatec, this positive trading was overshadowed by news that the board representative of major shareholder Novo Holdings A/S would step down from the Convatec board. The market speculated that Novo may now sell down their c20% stake and the shares were the worst individual stock contributor in the month of September.

GSK outperformed Astrazeneca over the quarter, which was again beneficial to the Fund given the long GSK / underweight Astrazeneca positioning that we have. As well as being the value play in the sector GSK was a deserved outperformer responding to a number of positive pieces of news over the period, including upgraded short-term guidance for the Group in its interim results, a successful FDA review of blood cancer treatment Momelotinib which received a broader label than expected, excellent early distributor take-up of new RSV vaccine Arexvy and upgraded medium term guidance for their HIV business ViiV Healthcare.

The company has genuinely impressed with recent data and in our view did not outperform the market anywhere near as much as it should have done given all the news with Zantac still acting as an overhang and a deeply sceptical analyst audience. We have just completed a major deep dive review of GSK and have been very encouraged by what we have heard and understood. There is plenty more that the company needs to do to convince the market of the underlying quality and longevity of key business units like GSK Vaccines or ViiV Healthcare, to rebuild its R&D credentials, prove its commercial competitiveness and convince the market of its overall capital allocation discipline. But what we have seen is a capable and highly motivated new team, many with outside GSK skillsets who seem to be dramatically transforming the culture and dynamism of this organisation. We think the market is missing a multi-year improvement story here.

FUND PERFORMANCE



Periodic performance (%):

	1 month	3 months	1 year	5 years	10 years	SI annualised
Fund	**2.40**	**5.23**	**22.27**	**17.30**	**87.44**	**8.84**
Benchmark	2.17	2.63	14.49	20.53	73.10	6.00
Relative return[1]	0.22	2.53	6.79	-2.68	8.28	2.68

Discrete 12 month performance (%):

	30.09.23	30.09.22	30.09.21	30.09.20	30.09.19
Fund	**22.27**	**-8.17**	**49.19**	**-30.55**	**0.83**
Benchmark	14.49	-4.33	28.31	-16.51	2.72
Relative return[1]	6.79	-4.02	16.28	-16.81	-1.84

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 2023. 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 UK Dynamic Fund, a sub fund of J O Hambro Capital Management UK Umbrella Fund domiciled in the UK. *Part period return from since inception 16 June 2008 to 30 September 2008.

ONE MONTH STOCK RELATIVE CONTRIBUTORS

Top five

Rank	Stock	Relative Return Contribution %
1	Diageo*	0.27
2	Barclays	0.19
3	GSK	0.14
4	3i	0.13
5	Elementis	0.13

Bottom five

Rank	Stock	Relative Return Contribution %
1	Convatec	-0.42
2	Shell	-0.30
3	Glencore*	-0.23
4	PZ Cussons	-0.19
5	AstraZeneca*	-0.16

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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 2023 to 30 September 2023. Data representative of UK Dynamic Fund, a sub fund of J O Hambro Capital Management UK Umbrella Fund domiciled in the UK. *Stock was not held during this period.

Q3 2023 STOCK CONTRIBUTORS

Top five

Rank	Stock	Relative Return Contribution %
1	Centrica	1.15
2	Rolls Royce	0.53
3	Diageo*	0.36
4	Elementis	0.32
5	Prudential*	0.29

Bottom five

Rank	Stock	Relative Return Contribution %
1	Shell	-0.50
2	Moneysupermarket.com	-0.40
3	WPP	-0.39
4	Ricardo	-0.26
5	PZ Cussons	-0.23

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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 2023 to 30 September 2023. Data representative of UK Dynamic Fund, a sub fund of J O Hambro Capital Management UK Umbrella Fund domiciled in the UK. *Stock was not held during this period.

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