JOHCM Continental European Fund

CONTINENTAL EUROPE

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Europe three months on – a steadier ship

We wanted to update you on what we have been doing since our last note in late March. As it turned out stock markets bottomed out on March 18th, which roughly corresponded to the period of blanket lockdown imposition across Europe.

Our mind-set through this crisis has been, as far as we can, to look beyond the economic deepfreeze and take the opportunity to invest in anomalously valued, strong franchise companies. These are businesses either able to recapture former glories quickly or priced for the worst but where the reality is not as bleak, at the same time as not compromising on balance sheet strength.

The Fund's relative performance has recovered well. From being 4.1% behind the index (MSCI Europe ex UK index – 12pm adjusted) at its worst point (on March 19), to being 0.5% ahead by June 12. We believe we are emerging from the Covid-19 crisis with a portfolio of strong companies with considerable outperformance potential.

Fund Performance 2020 YTD

	31 Dec 19 – 19 Mar 20	19 March 20 – 12 June 20	YTD to 12 June 20
JOHCM Continental European Fund	-27.59	30.56	-5.45
MSCI Europe ex UK Index (12pm adjusted)	-24.49	24.54	-5.96
Relative	-4.11	4.84	0.54

Past performance is no guarantee of future performance

Source: JOHCM/MSCI Barra, NAV of Share Class A in GBP, net income reinvested, net of fees. Performance of other share classes may vary and is available on request.

Portfolio changes

In our last paper, we reported we had significantly reduced our banks exposure to a large underweight and moved heavily overweight in healthcare in early March. We also reduced a number of names which we felt lacked the balance sheet resilience to survive the crisis, as well as a number of names which were particularly hard hit by the pandemic and lockdown e.g. Airbus.

During the market sell-off in early March, we added to a number of companies with excellent franchises that were trading at bargain valuations. These included **CRH**, **Alstom**, **Philips**, **Fresenius Medical Care** and **ASML**.

Lockdowns had been imposed everywhere by late March. We therefore knew that we were likely in the period of peak pessimism and, by definition, close to the nadir of economic activity. Looking back, April looks to have been the month of maximum economic pain. What we didn't know was how long the low point would last for, but new Covid-19 case data from the likes of Italy and a quickly flattening curve in Germany gave hope that some degree of normality would likely return in the coming months. In light of this, we added around 2% each to industrials and materials in April and May, whilst adding 6% to our insurance sector weighting. We financed these changes by deploying our cash in full and, after a period of very strong short-term outperformance, reducing our healthcare weighting back down to 5%. Whilst our portfolio activity has been high over this period, the relative performance has unquestionably benefited.

Insurance companies, when not affiliated to banks, have shown themselves to be resilient in previous crises. Crucially the sector came into the crisis with very high Solvency II ratios, which were well equipped to absorb the headwinds. Even now, we would expect all our insurance holdings to have solvency ratios exceeding 185% at the end of June. The insurers know their exposure to the current problem policy areas of business interruption and event cancellation. But they have been quick to assure investors that losses here are largely limited. For instance, Allianz estimates a €1bn profit hit from its property & casualty line for the full year. The losses occurring here are softened by some benefits for the multi-line insurers, not least within autos, where miles driven have clearly plummeted, and hardening rates in commercial lines. In our view, the greatest source of risk for the sector has been within the insurers' investment portfolios and their exposure to credit downgrades. However, concerns here are dissipated by the backstopping of credit markets by the central banks, particularly the US Federal Reserve's purchases of high yield bonds.

We have therefore been able to add sector exposure in names trading on just 5-6x P/Es, lowly price-to-tangible-book ratios versus returns and very high free cash flow yields. Stocks here include **Allianz**, **Axa** and **NN Group**. We await further clarity on dividend payments, which have largely been suspended except for the German and Swiss insurers. But Axa's recent announcement confirming it would pay half its dividend in July and the rest as a potential exceptional dividend later in the year leaves us optimistic for the sector.

Elsewhere within financials, we are 5.5% underweight in banks. We struggle with the visibility on earnings given the impossible task of predicting the extent of credit losses, particularly given the interplay with government liquidity guarantee schemes. Furthermore, we know that credit losses will lag real economy improvements and therefore the headwinds will be with us for quite some time.

Our big stock overweights

We thought it might be useful to add some colour on the Fund's current largest active weights, all being 3-3.5% overweights.

We added significantly to **Capgemini** during April after the shares had almost halved during the sell-off. Based on adjusted numbers, we could see the company trading on around nine times its 2021 earnings, a remarkably low valuation for a company at the heart of facilitating many technology trends, such as the move to the cloud and digitalisation. On average, the company trades on a 15x forward multiple. Even in the 2009 global financial crisis, it showed its resilience in recording just a 5.5% fall in revenue. In a world of lockdowns, it was ideally placed to transition to staff working from home, even in emerging markets. This has cushioned any revenue declines this time.

Listening to Capgemini's CEO last week, our view was reinforced that the pressure on companies to transform their IT capabilities has only intensified by Covid-19; digital flexibility is now a business essential. Despite the extent of the disruption, the CEO repeated that the margin effect of the crisis, even including on its recent acquired Altran business, would be no more than 1%. Indeed, the shift to staff working from home brings commercial opportunities. As their clients have now become accepting of online delivery, Capgemini can gain cross-country synergies by putting its best people in front of its global client base by virtual means.

We took a new position in **Eiffage**, the French motorway toll operator and contracting company. As mentioned in our previous letter, we believe infrastructure companies should be looked at, not least as in many cases their share prices collapsed despite their concession lengths spanning multiple decades and liquidity being high.

We started buying the stock in early April at €70 (down from €110), where around two-thirds of the sum-of-the-parts valuation is concession based. The easing of the French lockdown on May 11th saw light vehicle traffic immediately start to rise, from -80% end March to -50% in the third week of May. We see few reasons why traffic cannot largely recover to former levels over the next 12 months.

Such companies are, of course, vulnerable to a second wave. However, when weighed against the recent improvements in case numbers and the huge global efforts to develop a Covid-19 vaccine, we feel the risk/reward profile is skewed in our favour. Indeed, brokers are already starting to upgrade their traffic assumptions from the doomsday levels they dropped to during March. On the contracting businesses, French worksites are now largely fully operational. And whilst productivity may be below the norm given social distancing regulations, the path to recovery is clear. Furthermore, fiscal tailwinds should soften any diminution in private sector demand.

The debt load for a concession company is always higher than most, but crucially with the concessions operators the debt is non-recourse. In Eiffage's case, the holding company had €2.6bn cash at the end of last year and a €2bn undrawn credit facility current liquidity, so despite the large increase in working capital over the crisis, we expect it to return to 3.5x net debt/Ebitda in 2021. On a normalised basis, we see 25% upside potential remaining in Eiffage.

Deutsche Post has been in the portfolio for some time, but recent events gave us the opportunity to resize the position. Buying into this company on a single-digit P/E is a rare opportunity. To the extent that any company can have a good crisis, in a business sense, Deutsche Post is one of the few that has given the demands upon its Express delivery business. Normal cargo capacity in passenger aeroplanes naturally evaporated, leading to full utilisation of DHL's own fleet. The business-to-consumer Express business has been very strong, while the B2B business will recover as businesses get back into operation. This clearly also applies for its parcel delivery business, not least in Germany where demand has held up relatively well and cushioned the fall in direct mail volumes. The company is well placed to benefit from structural trends. Even after its share price has rebounded to €30, we still see 20% upside potential from here.

RWE remains one of the Fund's largest positions and is currently the fourth-largest overweight. It was surprising that the shares did not show more resilience in the sell-off, falling from €34 to €21, peak to trough. However, this was likely exacerbated by forced investor deleveraging. As we have mentioned on numerous occasions, the asset swap with E.ON has repositioned RWE as a major European renewables player. The company currently has an 8.7GW renewables capacity and a pipeline of some 22GW, with a target to deliver 1.5GW per year. With the closing of the German nuclear fleet by 2022 and visibility on the coal-powered plants phase out and compensation, the renewables exposure will continue to expand proportionately and the merchant power exposure will be reduced. We have remained fully overweight the utilities sector since January, with additional holdings in **Enel**, **EDP** and **Orsted**. We strongly believe the environmental story in Europe is one of the greatest structural trends in the region for the next 20 years.

For clarity, we would highlight that we have also taken additional new material positions in **Akzo Nobel**, **Accor**, **Credit Suisse** and **Swiss Life**. There have been a couple of occasions (e.g. Aena, the Spanish airports operator) where we bought introductory position sizes but their share prices moved too rapidly away from us, so we have not been made them fuller positions. We will look to revisit such names on any future weakness. What remains crucial is that we stick to our valuation rigour. As a result, we are increasingly selective on the highest priced of the growth stocks. We have now reduced our position in **ASML**. This was after a 60% share price bounce from where we had added near its share price lows in March. We also sold out of Logitech, which is a particular work from home beneficiary.

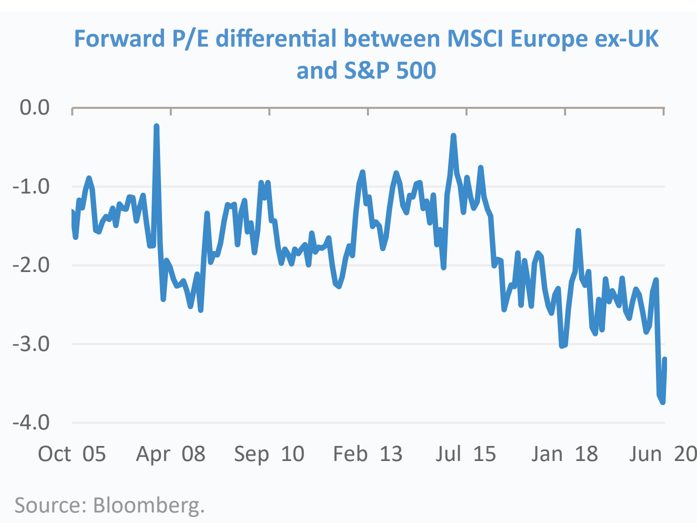
We are inclined to think that the outlook for the lowest quality stocks is also bleak. In current circumstances, we therefore favour a growth-at-the-right-price type approach given the macro outlook ahead.

Source: Bloomberg.

European market thoughts – relative attractions for equities

In terms of the market environment, at time of writing (June 15th) the MSCI Europe ex UK index has recovered some 26% from the

index low on March 18th, leaving the index down 12% year to date in euro terms. The S&P 500 is currently down 6% year to date in dollar terms, helped by the outstanding performance of the FANG+ basket of stocks.



Source: Bloomberg.

Naturally, with the current year earnings per share looking like it will be down over 30% in Europe, the markets have had quite some re-rating and are now trading on over 16x 2021 earnings versus a normalised forward multiple of around 14x. Price-to-book data highlights Europe is a cheaper option on recovery should profits start to normalise in coming years.

The elevated European equity risk premium of nearly 7% continues to highlight the attractions of European equities versus bonds, where it might take a while for yields to rise meaningfully. However, there can be no pretending that markets are out and out cheap at this level, so what we see is relative attraction. We observe that Europe is trading back at its lows versus the US on a forward P/E basis, despite share buybacks in the US having come to an end and serious taxation risks looming should the Democrats win the November elections in the US.

Interestingly, Europe's sustained underperformance has led to its MSCI World index weighting to fall to a meagre 19%, from 32% before the global financial crisis. It also remains somewhat surprising that fund positioning and cash balance data still highlight room for equity market upside, or, at the very least, is evidence that many investors remain ready to buy the dips. For these reasons, we are not expecting a market collapse, excluding a severe recurrence of the pandemic.

European macro thoughts – transformational co-operation at last?

We mentioned last time that the ECB had been proactive in its response to the crisis by announcing further quantitative easing. Member governments also stepped up with furlough schemes and state-backed liquidity for the corporate sector.

Since March, we have seen this support continue, with the ECB boosting the pandemic purchase programme by a further €600bn and signalling a willingness to do more, whilst the EU leaders endorsed a €540bn programme of short-term measures. We would also single out Germany as being the main positive surprise factor. The size of its fiscal plans was unexpected, compromising its historic and firmly held balanced budget orthodoxy. It announced an immediate crisis fiscal stimulus of €450bn, which it followed up with €900bn of liquidity guarantees and a more recent extra €130bn fiscal boost. We would also draw attention to the Franco-German recovery fund proposal, which has now been adopted as a potential EU27 recovery fund. The key point on this €750bn proposal is not just its size and reinforcement of already sizeable EU budget spend, but in its suggested financing, with the EC borrowing on behalf of the EU via bonds issuance backed by member budget contributions. If this proposal comes to fruition in January 2021 – it is currently being voted upon and would need ratification by each member government – it would have a serious impact on reducing the European risk premium and the languishing international appetite to buy European equities. According to HSBC, global equities have seen $36bn of outflows year to date, of which $24bn have been from Europe, leaving an interesting allocation dynamic. Since 2016, 25% of the assets in Europe ex UK equity funds have been redeemed.

We have always held the view that Europe is only as strong as its weakest sovereign link, most often Italy. And with the debt of all sovereigns spiralling upwards post-crisis, breaking the taboo upon joint issuance would be a major step. As always with Europe, the devil will be in the detail, but we should all be watching progress on this front carefully as it could be transformational. With Germany taking over the EU presidency from July 1st, the chances of the proposal becoming reality are much enhanced.

Europe now at the heart of the "E" of ESG

It is worthy of note that Europe is not dropping its carbon neutrality goals in the Green Deal due to recent events. Instead, the programme is seen as a way to advance the region towards a more circular economy. The bedrock of the programme is investment in environment technologies, cleaner transportation, buildings efficiency, decarbonisation and industrial innovation. The fact that Europe is now at the heart of the "E" of ESG is providing some structurally underpinned long-term investment opportunities.

Within the Fund we have focused on the renewable energy utilities, biodiesel, semiconductor facilitators of electric vehicles, consumer staples companies moving away from single-use plastics, efficient logistics providers and the likes of **Schneider** in buildings efficiency. We would clearly say that the Continent's environmental revolution is the single most exciting structural trend in Europe today.

As regards the economic outlook, the ECB last week reduced its full-year growth forecast to -8.7% for 2020 and +5.2% for 2021. The exogenous shock driven by the virus created an air pocket of activity. This very sharp, short recession should be rescued by the colossal size of policy support. These are extraordinary times. As we all know, the European economy has been at a standstill, but we are now seeing data inflect, albeit from off the floor. Having listened to around 20 large-cap company presentations at an online broker conference last week, we sense that some corporates may have fared somewhat better than expected. Business is returning somewhat faster than anticipated. The huge volume of global stimulus and a commitment to keep interest rates in both the US and Europe very low naturally gives a supportive backdrop in H2 2020 and 2021. However, totally recapturing both the lost GDP and earnings from the crisis is unlikely to happen before 2022. As a result, in constructing the portfolio we are focused on the realism of the recovery path for each of our holdings and closely watching normalised valuation multiples.

Where the risks lie

We have to stay attuned to the risks that come in various guises. In the shorter term, this is particularly the danger of a second wave

of Covid-19 cases after the lockdowns end. Elsewhere, we are focused on the US / China trade rhetoric and the aforementioned US elections. In a macro sense, we still think unemployment will linger at quite high levels through 2021 and corporate indebtedness will doubtless necessitate more capital raisings, whilst overall system indebtedness will have some impact on consumption and investment.

These risk factors are clearly in our minds when building the portfolio. We want to take calculated risks, not risk for risk's sake. We realise that some of our recovery stocks will take time to normalise and therefore adjust our valuations accordingly. The portfolio has worked well since mid-March, and we are very confident in its current composition.

Thanks for your patience

Lastly, but most importantly, we are very grateful to our investors who have stuck with us through a tricky period. We firmly aim to repay your patience with outperformance. Should any questions arise from this (rather too long!) newsletter, which we will now undertake on a quarterly basis, please do get in touch.

JOHCM Continental European Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.05.20	31.05.19	31.05.18	31.05.17	31.05.16
A GBP Class	2.00	-4.10	2.38	31.20	-3.02
Benchmark	2.63	-0.04	0.40	35.35	-6.04
Relative return	-0.62	-4.06	1.97	-3.06	3.21

Past performance is no guarantee of future performance

Source: JOHCM/MSCI Barra/FTSE International/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees as at 31 May 2020. The A GBP Class was launched on 7 May 2003. During the period 5 November 2001 to 7 May 2003 the performance record is based on the pre-existing share class that had a higher management fee. Benchmark: MSCI Europe ex UK NR Index (12pm adjusted). During the period 7 May 2003 to 31 December 2012 the Fund was benchmarked against the FTSE Eurofirst 300 TR Index. For the period 1 January 2013 to present the Fund is benchmarked against the MSCI Europe ex UK NR Index (12pm adjusted). Performance of other share classes may vary and is available on request.

The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. The Fund's investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.