Deciphering the dividend gap and our 2020 dividend vision

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- Deciphering the dividend gap – the gap between the Fund's unit price and dividend yield is at its highest ever level. We argue this highlights the Fund's significant undervaluation
- We are upgrading the Fund's dividend growth for 2019 to a mid-single-digit percentage figure
- 2020 vision – setting a positive dividend outlook for our portfolio names against ongoing macro uncertainty and the scope for a recovery in sterling if a Brexit deal is agreed, we prudently forecast low single-digit percentage growth in the Fund dividend in 2020

We wrote recently about the bubble that has developed in growth and low volatility stocks ('Mind the gap again – beware the bubble in growth stocks'). In the six weeks since we published that piece, this bubble has inflated further, helped by global growth worries, collapsing bond yields and a fresh outbreak of trade tensions between the US and China.

Rather than spill more ink on this market distortion, as powerful a headwind as it has proved to be for the Fund and other 'value' managers, we wanted to report an upgrade to this year's Fund dividend forecast and issue an early forecast for the Fund's dividend growth in 2020. This short paper will also explore why we think our positive dividend outlook is credible and what we believe the historically unprecedented gap between the Fund's unit price and its dividend yield is telling us.

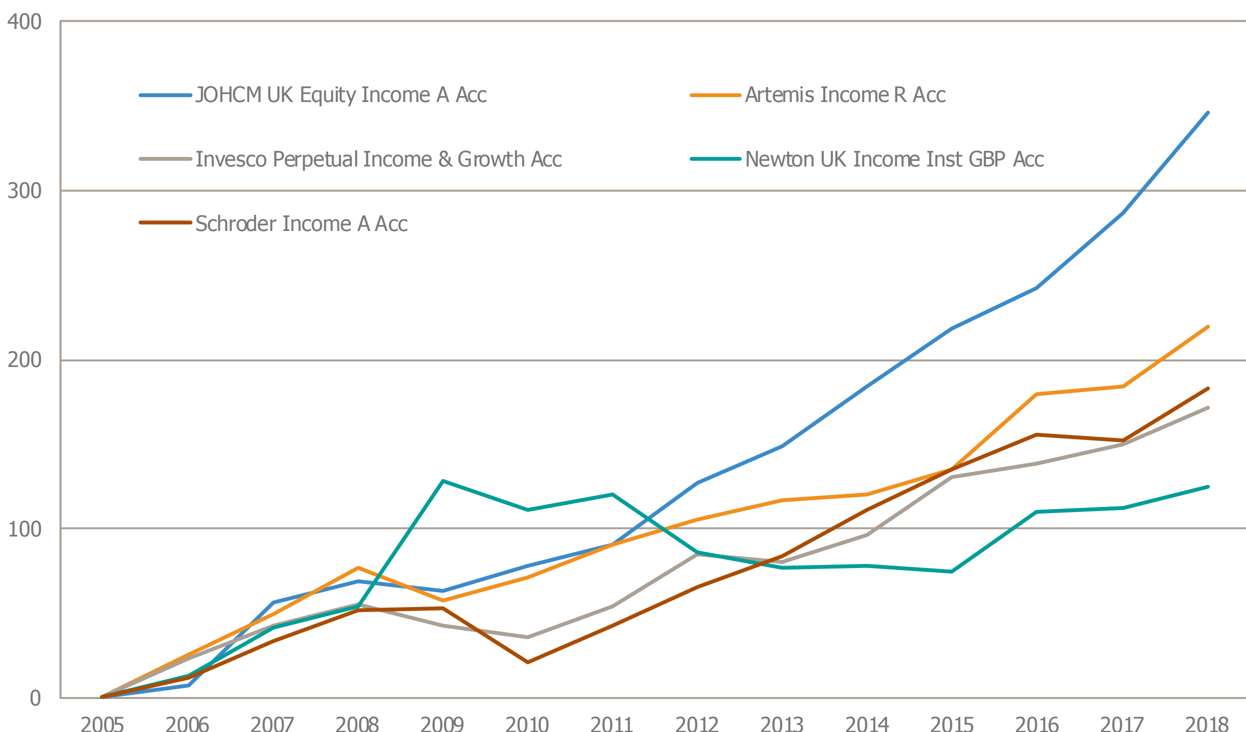
Dividend growth – a brief look at history

Before we look into the near-term future, it is worth briefly recapping the Fund's dividend history since we launched the Fund in November 2004.

Dividend growth has been a crucial component of the Fund's success and a major driver of our first decile since launch track record within the IA UK Equity Income sector: since inception, the compound annual growth rate of the Fund dividend has been 11% and income has accounted for broadly two thirds of the Fund's total return.[1] Our discipline of only holding stocks that yield above the market average and our regimented approach of continually rotating capital out of lower-yielding stocks into higher-yielding names has enabled us to build a dividend growth track record that compares favourably to a number of other large UK equity income funds.

[1]Based on 'A' accumulating share class. Source for IA UK Equity Income ranking is Lipper. All data as at 31 August 2019 unless specified.

Superior dividend growth – JOHCM UK Equity Income vs. select peers since launch (%)



Source: JOHCM/Lipper as at 31 December 2018. Cumulative dividend growth since JOHCM UK Equity Income Fund inception. Peer group represents select funds with assets above GBP1bn.

As the table below shows, the Fund's dividend growth has been broadly consistent year on year.

Fund dividend growth 2012 - 2019

2012	2013	2014	2015	2016	2017	2018	2019
+10.9% (actual)	**+9.6%** (actual)	**+14.7%** (actual)	**+9.1%** (actual)	**+8.6%** (actual)	**+13.4%** (actual)	**+18.2%** (actual)	**+ Mid-single-digit %** (forecast)

Source: JOHCM.

Last year saw unusually strong growth in the Fund's dividend at +18.2%. There were a number of factors behind this powerful showing including sterling's weakness, strength in the mining sector and the first dividend increase in the oil sector (BP) for four years.

For 2019, we are upgrading our initial guidance of low to mid-single-digit growth, issued at the start of the year, to the top end of this range. Given 2018's exceptional Fund dividend growth, we believe this is a creditable achievement, especially in light of the caution pervading many boardrooms because of the macro uncertainty caused by Brexit and the US / China trade conflict. These worries have tempered capital allocation decisions, resulting in slower dividend growth in a number of stocks. In some cases, share price weakness has led management teams to switch course, from what would have been stronger dividend growth to share buybacks (which we do not include as income).

Working with our colleagues in our Risk and Fund Accounting teams, we put a lot of time and effort into our dividend projections and model dividends on a stock by stock basis. Prudence is the name of the game here. This forecast of mid-single-digit growth in 2019 continues to include a buffer to reflect ongoing political risk, particularly surrounding Brexit, as well our view that the pound may well strengthen significantly in the event of a favourable outcome to the Brexit saga or a Conservative party election win.

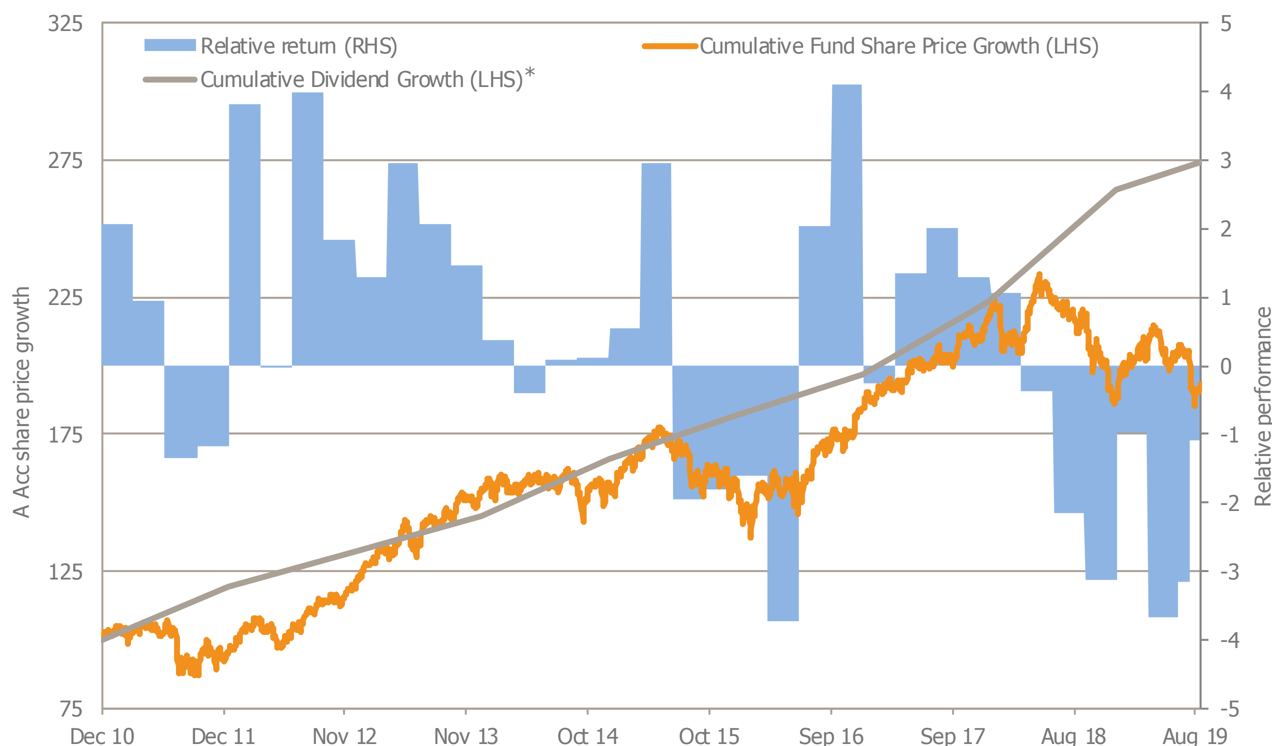
Deciphering the dividend gap

As we detailed in August's 'Mind the gap' piece, it has been a tough 12 months for the Fund, characterised by marked underperformance versus our benchmark, the FTSE All-Share Total Return Index (12pm adjusted).

This underperformance is captured in the chart below, which has three elements. The blue bars represent the Fund's quarterly relative performance – you can see the past four quarters, particularly Q2 2019, have been a struggle.[2] The orange line represents the Fund's share price growth while the grey line records the growth in the Fund dividend. Over the long term, the unit price should broadly track the dividend growth.

[2]Relative to the Fund's benchmark, the FTSE All-Share TR index (12pm adjusted).

The gap between the Fund's unit price to its dividend has materially widened



Source: JOHCM/Bloomberg as at 31 August 2019. *Dividend growth from 31 December 2010 to 31 August 2019 is based on a 5% annualised growth estimate.

The chart, specifically the divergence between the orange and grey lines this year, raises an obvious question: how sustainable is the dividend underpinning the Fund? It clearly indicates that either the Fund dividend is at risk of a substantial fall (c. 40%) or the Fund is significantly undervalued.

Two reasons provides us with confidence that it is the latter. Firstly, the Fund's dividend has fallen only once in its near 15 years' life, during the Global Financial Crisis when it dropped by 7.1%. Current macro conditions might be challenging but bear no resemblance to the global economic heart attack caused by the credit crisis. Furthermore, the Fund is much stronger than at that point: it has significantly lower leverage, higher dividend cover and our companies' earnings are below normalised levels (rather than over-owning as the banks were in 2007/8, for example).

Secondly, our detailed analysis, in updating our dividend forecast for 2019 while also looking forward to 2020, assures us that our individual holdings can meet their dividend commitments and have adequate dividend cover.

Based on our dividend growth forecast for 2020 of low single-digit growth (see below), the Fund would yield c. 6.1% in 2020. This is close to a record level and, in common with our 'value' versus 'growth' analysis (in our 'Mind the gap' paper), suggests the Fund is materially undervalued. The usual caveat of past performance being no guarantee of future returns always applies, but we would point out that prior periods of material underperformance by the Fund have tended to be followed by sharp snapbacks e.g. H2 2016 and H2 2008. We are hopeful for a similar recovery in Fund performance in the coming months, given the current strong valuation signals.

Fund dividend forecast for 2020

Let's set aside our thoughts on the magnitude of the Fund's undervaluation and focus for the remainder of this paper on the prospects for the Fund dividend in 2020. Normally we make our initial Fund dividend forecast for a calendar year in November of the prior year. We have conducted this exercise a few months earlier this year to give fundholders visibility at a time when owning the Fund has perhaps been a harder than normal choice.

Our initial estimate for Fund dividend growth in 2020, based on our detailed individual stock by stock analysis and, crucially, before applying our risk buffer, is 8-10%. As touched on above, our long established process of selling low-yielding shares and recycling the capital into high-yielding shares is crucial to this growth, typically adding 2-3% per annum. This is a strong starting point.

But we need to consider the wider risks against this upbeat forecast, namely the continued high levels of macro and political risk globally and the potential for a successful outcome to Brexit. The latter has important consequences on the dividend front. If Boris Johnson is able to secure a Brexit deal or a clear general election victory followed by Brexit, this is likely to lead to a material rise in sterling. We estimate that the currency could recover to around US$1.40/£ and €1.275/£, from the current anaemic levels of US$1.23/£ and €1.12/£, respectively, at the time of writing in the second week of September. Such a recovery in the pound would reduce UK dividend flow due to this FX translation point, hitting the Fund and wider market dividend level by around 5%.

Conversely, a no deal Brexit outcome or a perceived greater chance of a Corbyn-led government would likely see sterling fall a bit further in the short term. Whilst this might mechanically increase UK dividend flow from FX translation, this could easily be more than offset by increased boardroom caution on distributions until the economic path becomes clearer.

Consequently, it feels right at this stage to apply a healthy buffer to allow for these different risks, such that our initial 2020 Fund dividend forecast is low-single-digit percentage growth.

Why 2020's Fund dividend growth is credible

What gives us confidence we can grow the Fund's dividend at all next year? There are two main reasons. Firstly, the companies in the portfolio are not carrying much debt. Excluding our financials stocks, only two holdings (Vodafone and National Express) have net debt to EBITDA greater than two times, a much lower level of leverage than in 2008/9. The graph below shows the Fund has less leverage than the benchmark (below zero is the average for the benchmark) and leverage has fallen over the last 15 years.

Light on leverage: JOHCM UK Equity Income Fund – aggregate net debt to equity since launch vs. the market

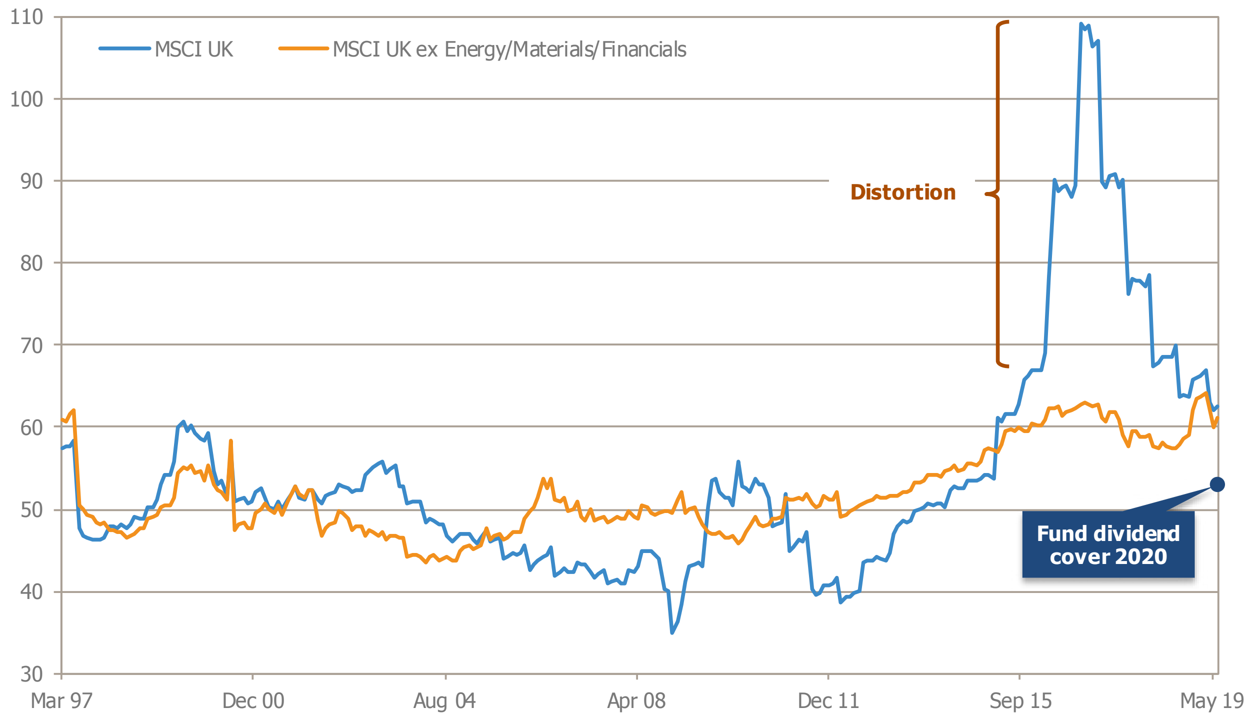
Source: JOHCM and Style Research.

Secondly, the Fund's average dividend cover excluding the property sector (REIT rules compel UK REITS to pay out at least 90% of their property rental business profits by way of a dividend) is healthy at just under c.2x.

The chart overleaf shows that the UK market pay-out ratio currently sits at 60%. It had been distorted by the oil, mining and banks sectors in 2016/7, since when profits and cash flows in these parts of the market have normalised.

The chart also confirms that the Fund's dividend cover (as an average across all 60 holdings) is better than the market (c. 2x versus c. 1.7x).

This is despite having a higher dividend yield, stronger balance sheets and cheaper valuation than the market.

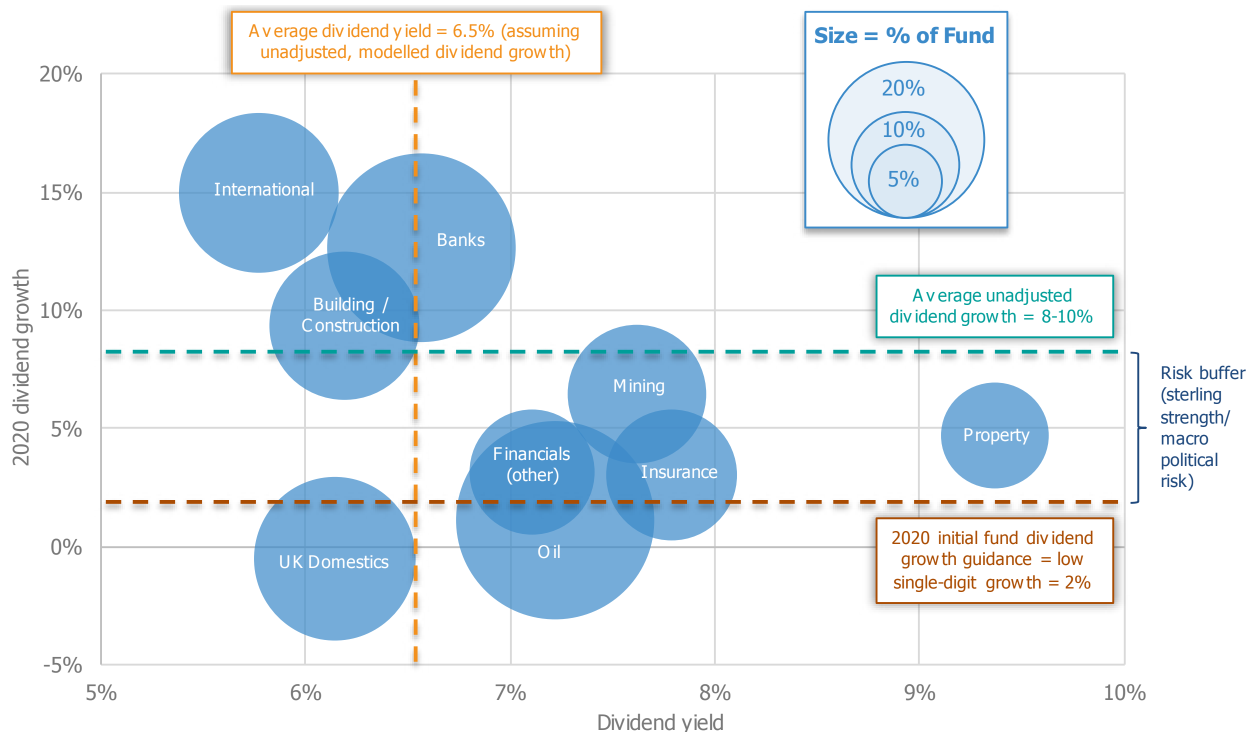


Source: Citigroup/JOHCM as at 28 June 2019.

A deeper dive

Let's take a look at the dividend picture in more detail starting with the overall dividend cover of the market and the Fund.

By sectors



Source: JOHCM August 2019.

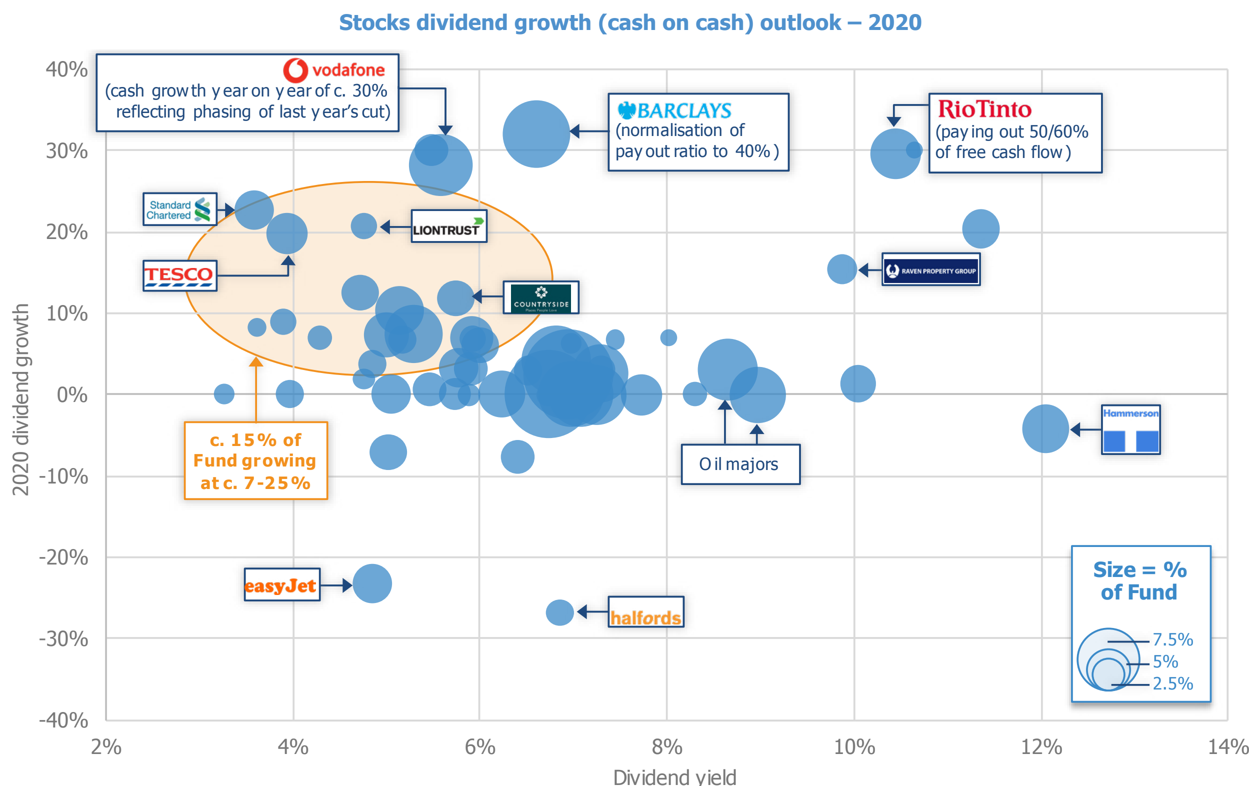
Based on our initial analysis, the chart highlights the Fund would be on a 6.5% average dividend yield in 2020 (which is the final yield if the dividend grew in line with the unadjusted, i.e. pre-risk buffer, figure of 8-10%) and our average dividend growth estimate of 9%. The chart also portrays the dividend outlook through a sector prism. It plots dividend growth versus dividend yield while the size of the circles indicates the size of the Fund's weightings in these sectors.

The banks sector will be one of the main drivers of this dividend growth. From the chart, we can see that the Fund has broadly 20% in banking stocks, while the average yield of our banking stocks is 6.6% and our estimate of their average dividend growth is a chunky 12.5%. Pay-out ratios in the banking sector are rising as the gap between statutory and normalised earnings has closed. Even now, though, pay-

out ratios for the UK banks stand at a modest 40%, down on their long-term pay-out averages that prevailed before the financial crisis necessitated balance sheet repair and more cautious dividend policies.

Elsewhere, this chart highlights our expectations for strong dividend growth in our more international names (e.g. DS Smith and National Express), within our numerous building and construction holdings (e.g. Bovis Homes Group, Morgan Sindall and brickmaker Forterra) and in our mining positions (e.g. Rio Tinto), the latter being helped by the return of capital discipline to the sector and a sharp drop in capex. On the flip side, the chart also shows the lacklustre dividend growth outlook in aggregate for our UK domestic names (e.g. ITV, Halfords and Lookers).

By individual stocks



Source: JOHCM August 2019.

This final chart examines the dividend outlook for individual stocks and is where the real detail resides. There are two main takeaways here.

Firstly, there is a cluster of stocks, representing about 15% of the Fund's overall capital, that we estimate will enjoy dividend growth of between 7-25% in 2020, including Standard Chartered (+23% dividend growth), Tesco (+20%), Countryside Properties (+12%) and Forterra (+12%). This swathe of stocks should be a solid underpin to the Fund dividend growth we expect next year. All have dividend cover over two times, so we are confident in the sustainability of these distributions, even with a modest lowering of cover in some cases, such as Tesco.

Secondly, there are three large cap positions (Vodafone, Barclays and Rio Tinto), constituting 10% of the Fund's total capital, that will also provide a significant contribution towards the overall Fund dividend growth in 2020. Barclays is normalising its pay-out ratio to 40%, in common with other UK banks as noted earlier, while Rio Tinto will pay out 50-60% of its rising free cash flow. The mention of Vodafone might seem surprising given its high profile dividend cut in May, but it important to note that we are looking at calendar year dividend payments here. As the final dividend took the full brunt of the cut (the earlier interim was unscathed), there is a rebalancing effect at work in 2020. Our underlying forecasts for Vodafone's dividends are in line with the company's new policy and therefore consistent with market consensus.

Summary

- Dividend growth for 2019 upgraded to c. mid-single-digit growth (after +18% in 2018)
- The gap between the unit price and dividend yield is at its highest ever – either the dividend will fall materially (the gap suggests -40%) or the Fund is significantly undervalued – we argue it is the latter
- Since inception the Fund has seen the dividend fall in only 1 out of 15 years, which was in the financial crisis and then by only c. 7%
- Versus the financial crisis the leverage in the Fund is significantly lower, the dividend cover is a lot higher (c. 2x), and Fund holdings are further away from normalised earnings (i.e. underearning)
- Bottom-up estimates for Fund dividend growth for 2020 are robust (8-10%). Factoring in the risk of sterling strength and macro / political uncertainty, we are confident the Fund dividend will grow in 2020. Initial guidance including a risk buffer is for low single-digit growth

We hope this detailed update has provided some visibility on the outlook for the Fund's dividend for 2020. As you can see, we are confident in the Fund's ability to build on its long-term, market-leading record of income growth.

Thank you for your continued support of the Fund.

Discrete 12-month performance (%) to:

	31 Aug 2019	31 Aug 2018	31 Aug 2017	31 Aug 2016	31 Aug 2015
JOHCM UK Equity Income Fund – A Acc GBP	**-10.94**	**6.71**	**19.59**	**6.60**	**-0.66**
FTSE All-Share TR Index (12pm adjusted)	0.18	5.71	13.49	13.45	-3.41

Past performance is no guarantee of future returns. Source: JOHCM / Lipper Hindsight. NAV per share calculated net of fees, net income reinvested, 'A' accumulation share class in GBP. Performance of other share classes may vary and is available on request. Inception date: 30 November 2004. Index return is net income reinvested, adjusted for 12pm.

Past performance is no guarantee of future performance. Source: JOHCM/Bloomberg unless otherwise stated. Fund launch date 30 November 2004. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Any forecasted dividend yield quoted is prospective and not guaranteed. 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. 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. Source: JOHCM/Bloomberg/ FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE" ® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.