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# Extinction? Rebelled.

After a tough few years for UK investors, value investors, FTSE 100 companies and latterly a tough period for UK Dynamic returns, Alex discusses the rapid changes going on in the world of UK investing

JOHCM UK Dynamic Fund

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"Is there ever a portfolio question to which the answer is Vodafone?" mused a broker to me recently. As an investor in Vodafone, I laughed nervously but kept quiet and moved on to something he might find far more interesting. Back to this in a moment.

As a business transformation investor focused on the UK we rarely get to invest in disruptive technology. Our usual market is companies that are more established, going through tough periods, but which - under new management and armed with new strategies - are becoming better versions of themselves.

To the casual observer these companies are often viewed as dinosaurs, soon to be facing the risk of extinction as the trading environment changes. Doubtless it was in that context that the broker had mused over why JOHCM UK Dynamic would own a position in Vodafone.

It is perhaps sad but true, that the FTSE 100 is probably one of the best hunting grounds for us. The index is packed full of established companies that generate cash flow but do not necessarily excite with their growth prospects or innovation. This runs in contrast to the FTSE 250 where growth and innovation are typically far easier to find, leading to outperformance.

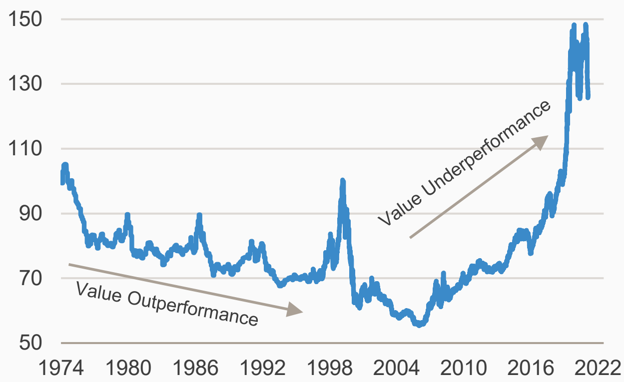
**Figure 1: FTSE 100 vs. 250 Price Performance**


Source: Morgan Stanley as at 4 January 2022.

Over the last 20 years the dizzying cocktail of breakneck technological shifts, breath-taking monetary easing and more latterly innovative investment products that allow access to investment themes far more easily than ever before, has led investor preferences in a particular direction. A growth direction. And we can all recite the well-rehearsed argument that the UK doesn't do growth particularly well.

"But hey" we say, "we are pretty good at value, ever heard of that"? By 2019, the marked and progressive shift away from value investing as a style since the nadir of the 2008-09 Global Financial Crisis had been brutal by any definition. Nowhere was this felt more than in the UK, where, alongside all the global challenges to the value style, a succession of uniquely British events made the UK just seem un-investable to many. Top this off with a global pandemic and a brutal de-rating became a merciless capitulation. Value investing in the UK – dead as a dodo.

**Figure 2: Growth vs. Value**




Source: Citi as at 28 January 2022.

The pandemic brought misery and loss to the world in so many ways and rest assured we think about our own Fund's travails within that most horrible of human contexts. Nevertheless, even in purely financial terms, for our own Fund and its investors the pandemic was unkind. Having peaked at 316p on December 27th the Fund NAV bottomed in March 2021, at 180p erasing c. 25% of the accumulated outperformance over the past 12 years. More frustratingly for our clients, whilst the

Fund recovered from its absolute lows, successive waves of the pandemic meant that the path was not smooth and in relative terms the nadir was later in the year. So, was this our own extinction event?

Our belief in strategic adaptability meant that early on we were convinced that the same stocks that had led the Fund into the crisis would lead the Fund out of it. As value-biased transformation investors we couldn't invest in the post-pandemic growth winners anyway. But even if we could, we had reservations over the assumptions needed to make the majority of these valuations work.

Whilst sentiment reached a nadir not long before the vaccine news in September, from an investment perspective, something started happening a little earlier. The nature of conversations with management teams started to shift, progressing first from panic to stability, and then on to thinking about the future. Corporates were starting to learn and adapt. The rebellion was on.

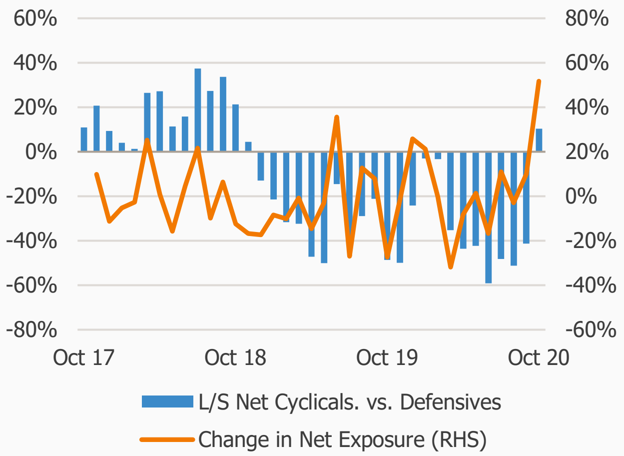
We write extensive quarterly slide packs for our clients, and it is always interesting going back to reflect on what we were thinking previously. The Q3 2020 pack will stay with us for a long time. When writing it we remember our mild depression linked to the Fund performance and loss of client monies, but also the palpable excitement about changes afoot.

**Change number 1** – The insiders started buying: Insider interest in our high conviction, and at this point fairly deep value stocks was picking up materially. But more than that, other interesting investors were showing up on the share registers of our companies. Among housebuilders, Steve Morgan of Redrow fame bought a stake in McCarthy & Stone. Cevian Capital, a long-term 'active ownership' fund, took a stake in media firm Pearson.

**Change number 2** – Sentiment turned: After 18 months hedge funds, often early into narrative shifts, were going net long cyclicals versus defensives (SEE FIG 3). This was a very interesting move to us, not least because we were starting to see market buyers of our stocks for the first time in a while.

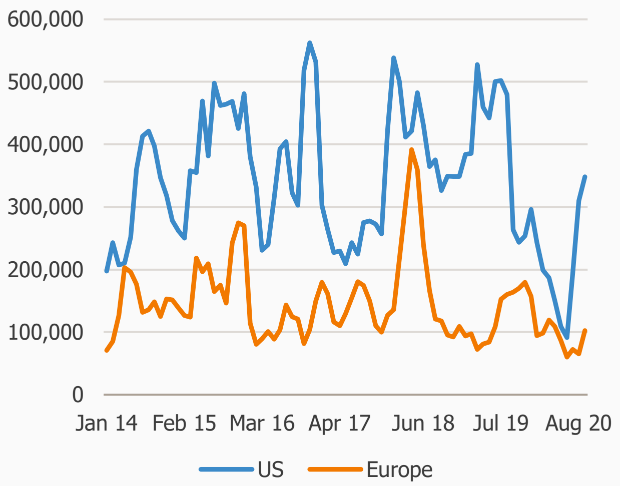
**Change number 3** – The opportunists came: M&A activity was picking up globally (SEE FIG 4) but we thought that, given the amazing valuation arbitrage on offer in the UK at the time, UK M&A activity in particular was likely to accelerate (SEE FIG 5).

**Figure 3: L/S Momentum – Net Cyclical / Defensive exposure**



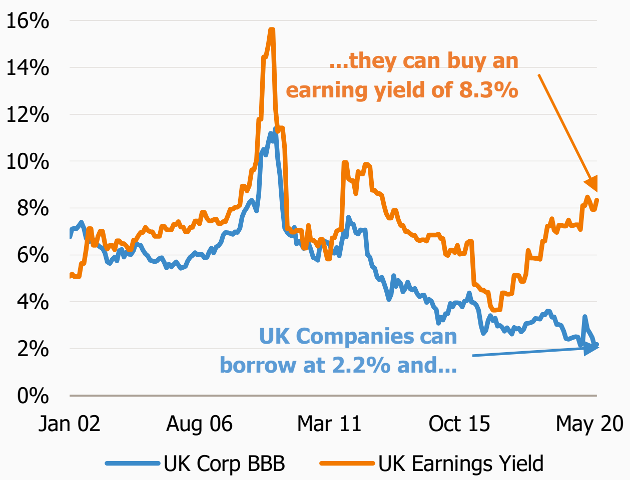

Source: MS EU Equity Derivatives as at 1 October 2020.

**Figure 4: M&A activity picking up**




Source: Citi as at 30 August 2020.

**Figure 5: UK activity likely to accelerate**




Source: Citi as at 30 August 2020.

When we wrote that M&A slide we had at that point received only one takeover – an industry merger between translation & intellectual property specialist RWS and our investment in language service provider SDL?– which had long been thought likely. What happened next though was way beyond our expectations. Out of a portfolio of c. 45 stocks, over the next 12 months a further 9 of the Fund's investments were bid for and 8 of these were sold to new owners. Prior to this the Fund had never previously received more than 2 bids within a 12-month period! The rebellion was deepening.

In the main these were real asset businesses being bought. Typically they were trading at or near historically low valuations. Moreover, as owners of assets with long useful lives deployable over lengthy periods to generate consistent cash flows, these businesses had infrastructure-like characteristics - a trait we often look for.

It did not escape our attention that some of these companies could also be seen as amongst our most threatened: by the pandemic, the energy transition, or by technological disruption. Yet they were piquing the interest of long-term and highly sophisticated investors: Lone Star for McCarthy & Stone; TDR and I Squared for Aggreko; The Wellcome Trust for Urban & Civic; Blackstone for St Modwen; CD&R for Morrisons; The Rothermere family Trust for DMGT.

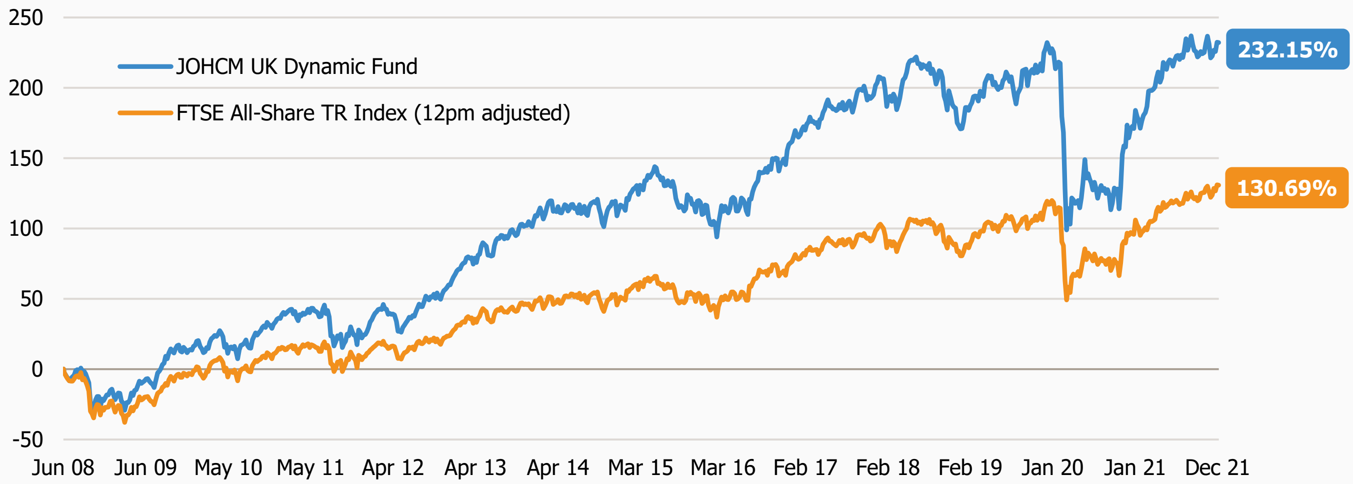
The boom in interest for our type of stocks helped the Fund recover its poise and hit a new absolute high last year. Extinction thwarted.

One of the nice problems from all the M&A activity over the last 18 months was a significant amount of capital to re-invest. We did not want that to be the case of course – we were against at least 4 of the 10 bids that were put in front of us – but there are always other opportunities.

The first place we always look when we have capital to allocate is our existing portfolio. Stocks we know and like, where we have spent weeks, months and years analysing and understanding the drivers of the company and motivations of the board. Only then do we look outside.

When we compare position sizes within the Fund at the beginning of 2021 to the end of the year we see that 6 of the top 8 upward movers were FTSE 100 stocks. Our capital allocation decisions had naturally drifted toward FTSE 100 names and to such an extent that by the end of 2021 the Fund's exposure to FTSE 100 companies was the highest for a number of years.

**Figure 6: Percentage growth of the Fund (since launch) versus benchmark (%)**

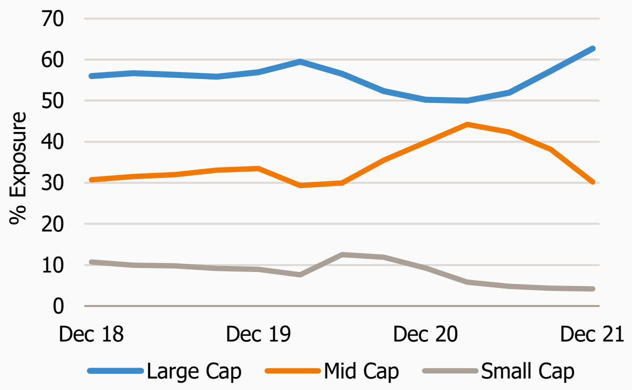



**JOHCM UK Dynamic Fund – 5-year net discrete performance (%)**

| 1 year to 31 Dec 2021 | 1 year to 31 Dec 2020 | 1 year to 31 Dec 2019 | 1 year to 31 Dec 2018 | 1 year to 31 Dec 2017 |
|---|---|---|---|---|
| 22.56 | -17.62 | 20.82 | -10.30 | 16.03 |

**Past performance is not necessarily a guide to future performance. For further information on risks please refer to the Fund's KIID and/or the Prospectus. The value of an investment can go down as well as up and investors may not get back the amount invested.** Source: JOHCM/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as at 31 December 2021. 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. Note: Data representative of JOHCM UK Fund (U.K.) onshore OEIC.

**Figure 7: JOHCM UK Dynamic Fund split by FTSE market capitalisation**

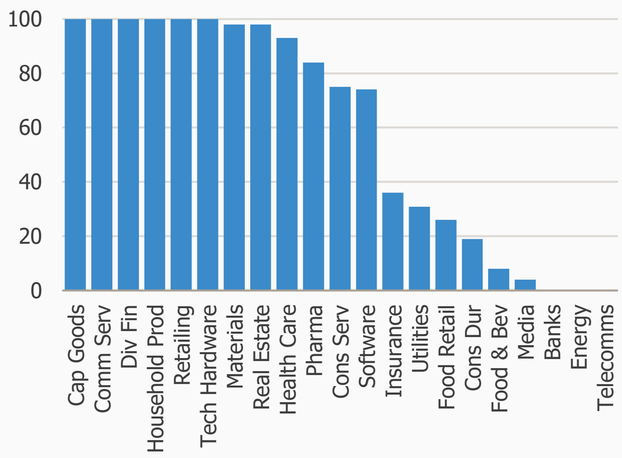



Source: JOHCM as at 31 December 2021.

We do not take explicitly top-down calls and neither do we particularly invest in companies so challenged that their very existence can be questioned. So why was this happening? To answer this we need to think about what we do and the environment we were in.

Quaint as it may seem in a world of thematic investing and factor tilting, we still believe that the price you pay for an asset will be a key determinant of the return you make from it. And the FTSE 100 was, in parts, ludicrously cheap. Whether it was WPP on 10x earnings, ITV on 8x, or it was HSBC, Aviva and Landsec all on 0.7x book, there was not just value, but deep value. Returning to our Q3 2020 slide pack, this had as much to do with investor preferences and fears as it did with the company outlook. We are re-drawn to this slide which showed the amazing dispersion of sector valuations in the FTSE at the time.

**Figure 8: Percentile of P/Book vs. 10-year range in UK**




Source: Morgan Stanley/MSCI.

But cheapness alone is not good enough. Whilst we do not use the word value as a pejorative term (as many seem to), we do think value needs to be attached to three things in order to get the best out of it: management change, strategic change and hidden growth.

This gets to the heart of business transformation – change. Companies (and markets) are forever changing yet often the accompanying investment narrative is slow to catch-up and the valuation backward looking as the pain of recent experience leaves lasting scars. This is why some stocks, regions, indices or even styles can become so mistrusted and fall so out of favour. And when we looked, these companies had deep scars but were changing fast and the market was not yet not yet picking up on it.

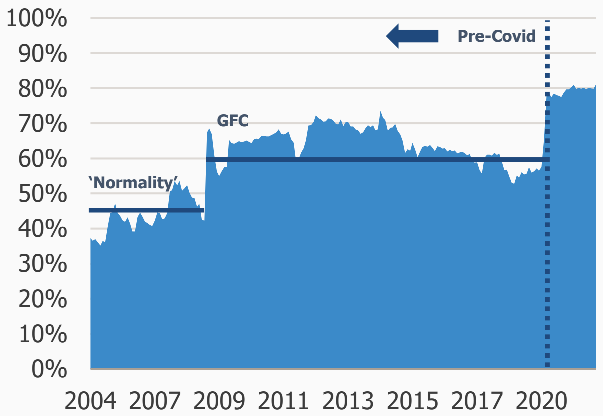
But not all change is equal. The capacity for reinvention is critical. We look for established businesses with market position, real cash flows and critically, large pockets of value where there are not threats but opportunity. If a business is faced with threats, better to have the established position, cash flows, and asset base to be able to do something about it.

Last but not least we look for value-creating management teams. Business transformation does not happen in isolation; there must be an agent for change, and that agent has to have full stakeholder support and exhibit real commitment to better capital allocation.

Returning to our 2021 capital allocation decisions, in all cases for these larger capitalisation FTSE 100 companies there were big, company-defining changes to capital allocation going on - in full view of the markets - by new management teams that were specifically employed to make these strategic shifts. Given their unarguably strong market positions and cash flows, we felt all these companies had a strong capability to reinvent.

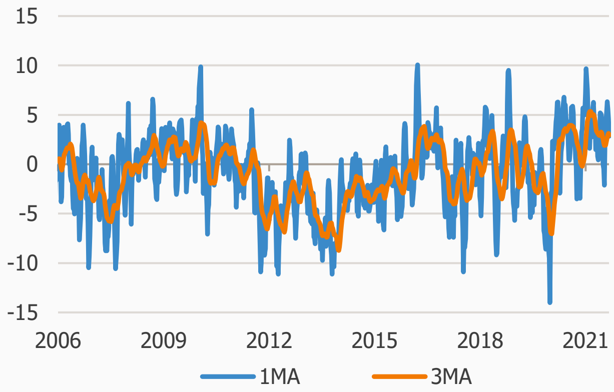
We are not naïve enough to believe that the market will look at these companies in the same way that we do however - focusing on their strategies and hypothesizing about what they will become, rather than obsessing about their factor or macro exposures. In fact it has been a horrible by-product of successive financial crises, quantitative easing, febrile geopolitics, investment trends and then a pandemic that investors have increasingly gone the other way over the last 15 years.

**Figure 9: Macro driving global equity variability**




Source: Citi Research as at 31 December 2021.

**Figure 10: Relative earnings revisions are improving**




Sources: FTSE, IBES, Morgan Stanley Research

But eventually everything changes and what doesn't kill you makes you stronger. Things started to change in the outlook for FTSE 100 stocks as 2021 progressed. What started as an existential threat to life as we knew it progressed to being seen as the supply shock it clearly was but with a monetary response more fitting to the worst demand destruction ever witnessed. The pandemic and the global response has quite simply been inflationary.

And so the supply shock, demand recovery, energy crisis and resulting inflation narrative shift is where the FTSE 100 rebellion story started for the masses. As large global asset allocators trawled around for things to buy that might protect them from inflation, their eyes, spurred on by strategists' siren calls, alighted on the UK.

What did those eyes see? Yes, an index full of old-world energy, pharmaceuticals, materials, banks, insurance companies and telecom stocks that might just benefit from this new inflation narrative - and in a world where value just might not be a dirty word anymore.

But they saw so much more. They saw large, established and highly cash generative companies with real asset bases and real market positions being aggressively managed for change to fight the successive and often existential threats they might face.

They saw companies, often with new boards, committed to dealing with their issues, allocating capital accordingly and making revolutionary strategic decisions that call into question the very basis on which we have thought about and valued these shares for many years. They have rebelled against their own extinction, becoming better, less challenged versions of themselves. Results are most definitely therefore improving.

And they now have an added sense of urgency. Nowadays nothing is too big in stock markets to not feel and succumb to the pressure for change and improvement. And when the alternative is to give in to private equity interest (for them to do the job for them) or have an activist shareholder call the agenda, many boards have rightly chosen to chart the new course themselves. For doing so they should be applauded and backed.

This is not just a dead cat bounce as value revives for a period. One of the most interesting and common themes from some of the management teams of this cohort has been the sustainability of the recovery in trading they are seeing.

These sustainable revenue improvements have been driven not only by the rapid strategic actions that all have taken both pre and post pandemic, but by the post pandemic world itself. It has been fascinating to hear in the last few months from WPP, ITV, Landsec and Vodafone management that these are lasting improvements being seen. The pandemic has not been and will not be an extinction level event. Not for the FTSE 100, not for value investing, not for the UK and not for UK Dynamic.

So, returning to Vodafone. If you follow the conventional narrative then it's the most challenged and vulnerable dinosaur in the UK Jurassic Park. Some investors may still wonder, if the answer is Vodafone then what's the portfolio question? If you're one of them then I suggest you read this article again.

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