

Global Value and Income Dispatch

Q3 Review: Bifurcation and what the averages don't tell you...

Highlights

We saw opportunities in cyclicals, which significantly underperformed defensive equities.

Bifurcation has been shaping the opportunity set in credit as well.

We are happy to provide or harvest liquidity – whenever someone is selling or buying for non-economic reasons.

Quality bubbles inflated in equities (only to begin popping in early in Q4); 10-year yields returned almost to their 10-year lows in treasury markets; high yield spreads had a brief panic in August before returning to near their 2019 tights, and when all was said and done Q3 came and went with only modest changes in market averages.

The turmoil increasingly is below the surface, and averages told less of the story as we saw sharp bifurcations across asset classes.

Q3 2019 returns & indicators

MSCI World Index	0.66%
Bloomberg Barclays US Agg	2.27%
ICE BofAML BB-B Global High Yield Constrained	0.56%
EUR vs. USD	(4.17%)
JPY vs. USD	(0.17%)
Gold	4.47%
US 10-Year Yield (06/28/19)	2.01%
US 10-Year Yield (09/30/19)	1.66%

Source: Bloomberg, as of 09/30/19.

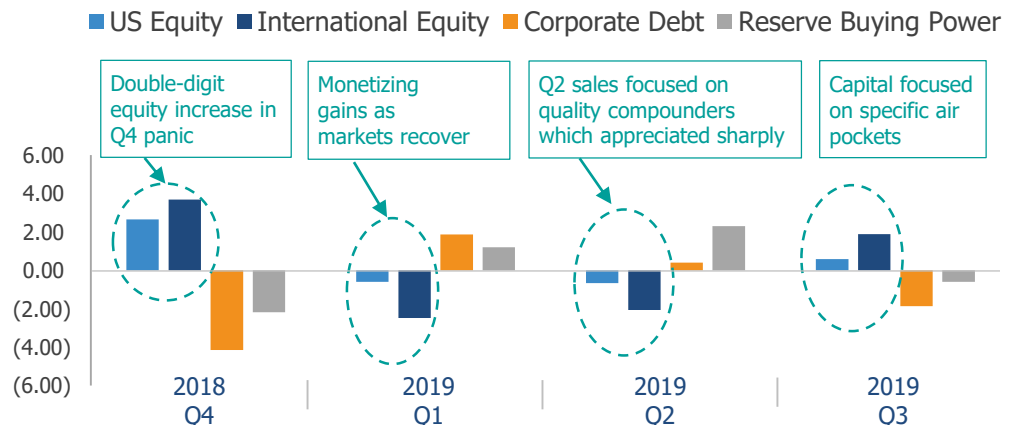
Portfolio Executive Summary – a tale of “two autos”

For the first time this year net capital flowed into equities, as investors chased stable, “high quality” businesses to almost extreme valuations. **Businesses with more volatile and cyclical revenues were shunned**, and in some cases they even seemed to price in a moderate recession.

We don't know whether a true recession is in the cards (it could be), but we love to get paid for taking risk. We finally felt this was the case among some of these unloved cyclicals. We took advantage by deploying capital into European industrial automation businesses, including one supplier of “**automotive automation**,” which could be the most hated industry group outside of Hong Kong real estate (yes, we bought a bit of that too ... for what we think was 30 cents on the dollar).

We are NOT getting particularly well compensated for credit and duration risk, and so our fixed income holdings have been moving up in quality and shorter in maturity. It is time to **be careful and selective in credit and not chase yield**.

Capital Deployment – Trailing 4 Quarters



Source: JOHCM, Bloomberg, as of September 30th, 2019. Represents estimated capital shifts net of asset class performance.

Portfolio positioning

Equity exposure crept back up towards the 50% level, but did not quite get there ending the quarter at 48% and change. Opportunities were fleeting and concentrated in specific areas (cyclicals, real estate) primarily within Europe and Asia. Equity purchases were funded with credit sales and reserves.

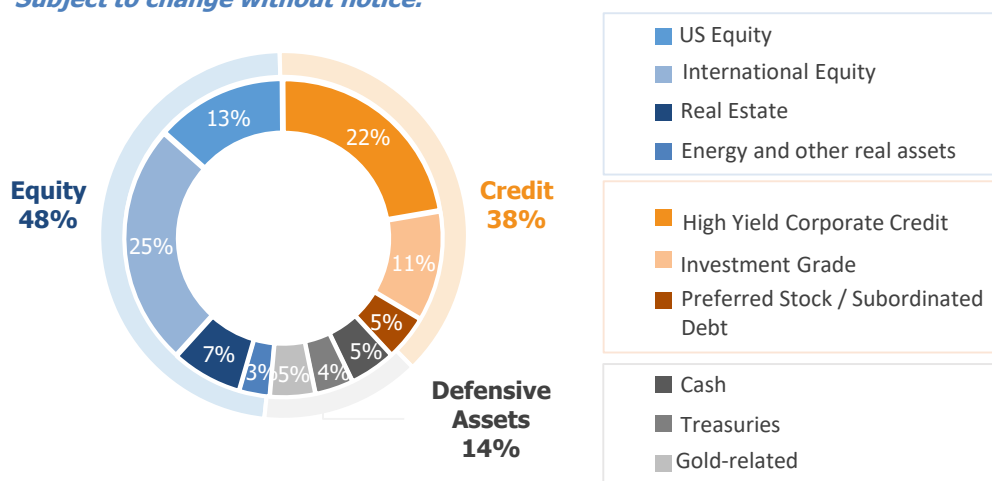
De-risking credit helped offset the increased exposure to higher beta cyclicals on the equity side.

Our credit exposure continued to improve in quality, with almost 45% of our fixed income rated investment grade and roughly 85% rated BB or higher. Duration has continued to shorten ending at 3.26 years.

The increased exposure to cyclicals means our equities are somewhat higher beta. De-risking credit a bit has helped offset this from a risk management point of view.

GIB strategy by asset class and region (as of 9/30/2019)

Subject to change without notice.



Source: JOHCM, as of September 30th, 2019.

Bifurcation in Equities – a fear rally?

One way to see the market bifurcation in equities is to compare the S&P Low Volatility and S&P 500 Value indices.

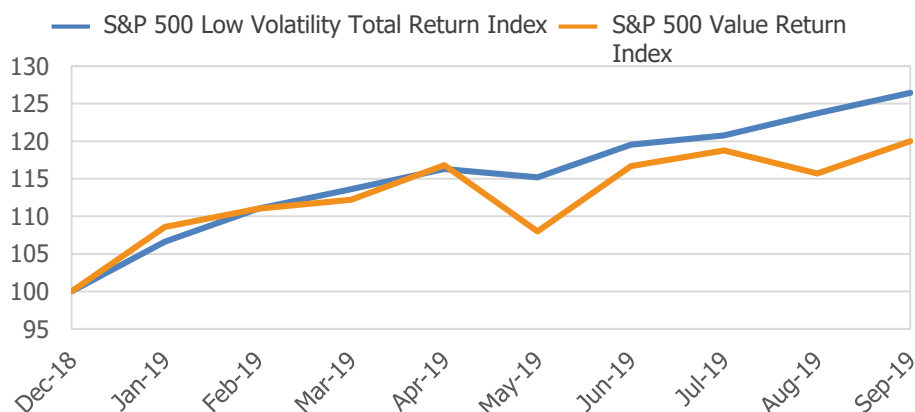
During the first quarter of 2019, both low-vol and value equities recovered similarly from the December 2018 market lows.

However, in April this dynamic changed. Since then, low-vol equities have significantly outperformed the more cyclical and volatile value category. Equities are generally viewed as risk assets, but in the most recent quarter it was purchases of the “safest” of equities that drove markets into positive territory.

Positive equity market returns in Q3 can be viewed as a “fear rally.”

For lack of a better term, we are calling this a “fear rally.” We find it quite unusual for risk-off sentiment to lead the risk-on asset class of equities higher. But then again, these are unusual times and markets.

S&P 500 Low Vol versus Value



Source: Bloomberg, as of October 28th, 2019

As is increasingly the case, momentum strategies seem to have piled in behind this trend and pushed valuations to extremes. In some cases buys are paired with short positions in “anti-momentum” securities. This likely added to the selling pressure in cyclicals.

Within credit, carnage has been particularly severe in the energy industry.

Bifurcation in credit – what lies below the surface

To a casual observer, overall credit spreads might not seem to have moved much since April. At the same time we have been speaking about being less well compensated for taking risk in credit and moving up the quality spectrum.

This is because **bifurcation has been shaping the opportunity set in credit as well**. Since April, lower quality CCC-rated bonds and higher quality BB bonds have moved in very different directions. The latter have rallied while the former have sold off. The carnage has been particularly severe in the energy industry (~15% of the BofA US HY index). Fear of slowing economic growth as well as a strong energy supply picture have made energy a favorite sector within which to express negative views.

We are focused on capital preservation, and so we tend to focus more on investment grade and the higher quality echelons of high yield debt. Bifurcation has made the areas where we traffic more expensive, prompting us to reduce risk, even as pricing for the overall asset class seems to have changed only moderately.

CCC – BB Spread difference continues to widen amid flight to quality



Source: Bloomberg, as of October 29th, 2019. Spread of ICE BofaML US HY CCC Index and BB Index.

The fact that we saw a similar market bifurcation in both equities and credit gave us greater conviction to deploy capital

What does bifurcation do for us?

The ability to look across different markets from a bottom-up basis is one of the key benefits of an integrated, cross-capital structure investment process like ours. When we see similar themes in different markets, it can increase our level of conviction to deploy or harvest capital.

The fact that we saw a similar market bifurcation in both equities and credit gave us greater conviction that price movements were driven by broader flows rather than security specific risks.

In this case, we felt we were getting paid more to take incremental risk in equities. While more extreme price moves were limited to specific market areas featuring cyclical and volatility, they could indeed be sharp. Certain companies within the automation and automotive industries we discussed above saw their share prices decline by as much as 30% in recent months.

This created opportunities to invest at attractive valuation levels in companies offering solid yields that are supported by free cash flow. Market cap flexibility proved useful, as some of the best opportunities were small and mid cap.

We remain very happy to provide or harvest liquidity – across asset classes geographies and capitalization ranges – whenever someone is selling or buying for non-economic reasons.

Bigger picture implications – signs of the (factor) times

Increasingly market participants are shifting capital based on their views of market factors, such as momentum, growth, value, low volatility, and quality – just to name a few.

Often, the factors bets are done in long-short portfolios, where the securities ranking the best on a certain factor are bought and the worst are shorted. This dynamic can really amplify market bifurcation. In Q3, investors were buying low-vol and likely shorting high vol (which are often cyclical and traditional value stocks). Thus it wasn't so much a bet against value stocks, but more that they just happened to be in capital intensive and cyclical industries. If you will, they were in the wrong factor at the wrong time.

Historical research, by the likes of Fama and French and others, suggests that some of the factors mentioned above are linked to human behavioral biases. As a result these factors in theory generate excess returns or risk premia.

The problem is that when everyone knows this, the factors can get "crowded" as more and more capital pours into them. In the end, this invariably eliminates the excess return.

Momentum is perhaps a bit different in this regard, since it benefits from crowding for a while; however, in the end, the reversals, when momentum breaks can be all the more brutal.

Understanding these factor flows and how they evolve can help bottom-up investors look in the right places

It may prove to be very useful to have market cap flexibility in coming years, as mid and small cap equities could be impacted the most by these non-economic flows and offer the best opportunities when trading flows become one-sided, as we saw in Q3.

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