JOHCM Funds

October 2020

Global Value and Income Dispatch

Q3 review: The rise of tangible capital?

Highlights

Current equity exposure sits at the upper end of neutral

We expect to continue to employ defensive equities and preferred shares to manage through this low rate environment…

…however, Income portfolios must beware to avoid excessive sector or style biases

The 3rd quarter continued the trend of growth outperforming value in equity markets.

There are signs that this trend may changing. In the years ahead the world will need copious **tangible capital** to de-carbonize and improve infrastructure.

Well-positioned income investors can profit both from the need for tangible *and* intangible capital, if they don't focus blindly on yield.

Q3 2020 returns & indicators

MSCI World Index	7.93%
Bloomberg Barclays US Agg	0.62%
ICE BofAML BB-B Global High Yield Constrained	4.68%
EUR vs. USD	4.34%
JPY vs. USD	(2.35%)
Gold	5.89%
US 10-Year Yield (3/31/20)	0.66%
US 10-Year Yield (6/30/20)	0.68%

Source: Bloomberg, as of September 30, 2020.

Portfolio Executive Summary

Two key dynamics influenced capital shifts in our portfolios over the past quarter:

1) a shift into high yield "**Cushion Paper**," within credit and
2) the continued focus on **de-carbonization**-linked investments within equities.

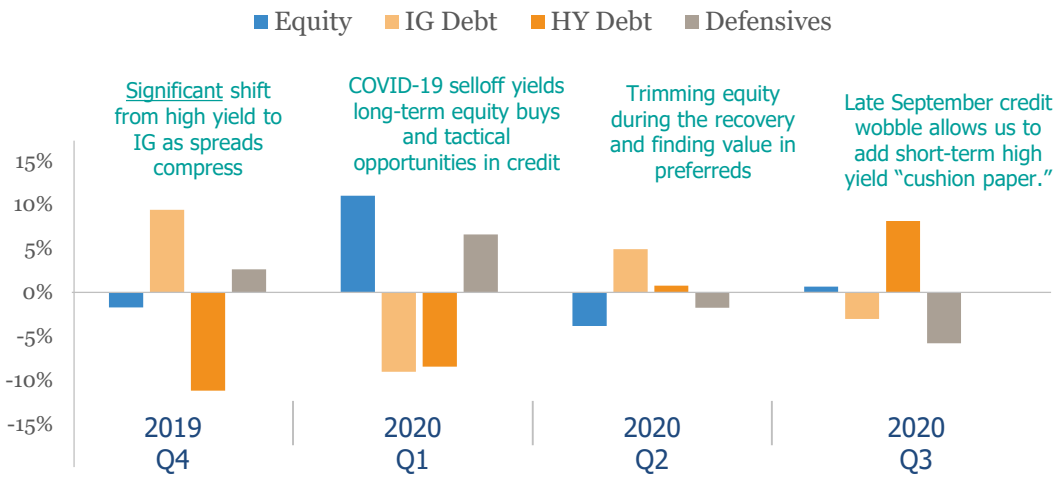
Cushion paper is a term for shorter duration high yield bonds that are likely to be called in the next couple of years. With credit spreads widening towards the end of the quarter, these became attractive.

De-carbonization is a key structural theme. Governments are increasingly aligned, and we see transformational opportunities for some providers of the physical capital than will be needed to move supply chains off fossil fuels.

We are also wary of the emerging **New Fiscal-Monetary Paradigm.** With no bad actor to punish, authorities are engaging in unprecedented stimulus. The pandemic will pass. Perhaps faster than expected, per the vaccine makers.

When the pandemic passes, we may finally see the rebirth of inflation. Income portfolios in particular must prepare for this risk.

Capital Deployment – Trailing 4 Quarters



Source: JOHCM, Bloomberg, as of September 30, 2020. Represents estimated capital shifts net of asset class performance.

Portfolio positioning – defensive equities rather than bonds

We found value and income in preferreds, as investors focus more on plowing capital into the traditional debt

Equity exposure has stayed in the mid 50s, ending the quarter at 54%. We tend to view equity exposures between 50% and 55% as being neutral for our strategy, so **current equity exposure sits at the upper end of neutral**.

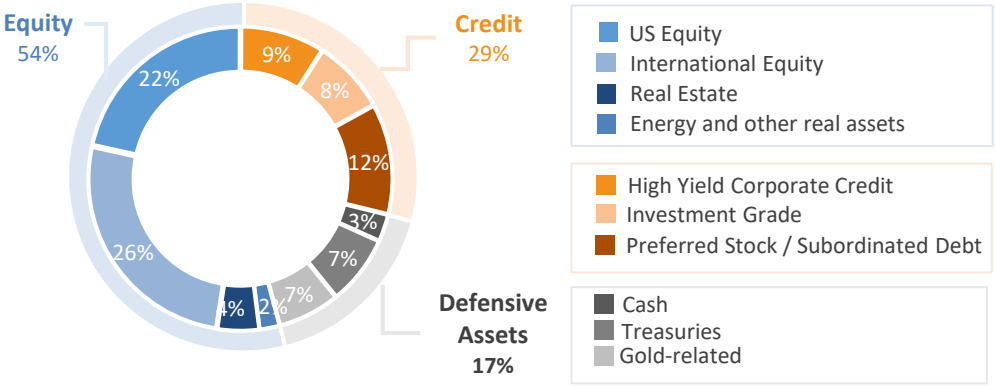
Despite the recent additions of cushion paper, high yield exposure remains almost 10% lower than late 2019 levels and almost 20% below where we began 2019.

With bond yields depressed by central banks we have **pivoted more to defensive equities**, such as consumer staples and utilities to generate income.

While the overall yields we earn here, are lower than what we were able to collect from credit back in 2018, consumer staples have pricing power that can offset inflation should it re-emerge. **Utilities could see multi-decade growth** from de-carbonization initiatives, that could accelerate under a Biden presidency.

Current Allocation (as of 9/30/2020)

Subject to change without notice.



Source: JOHCM, as of September 30, 2020.

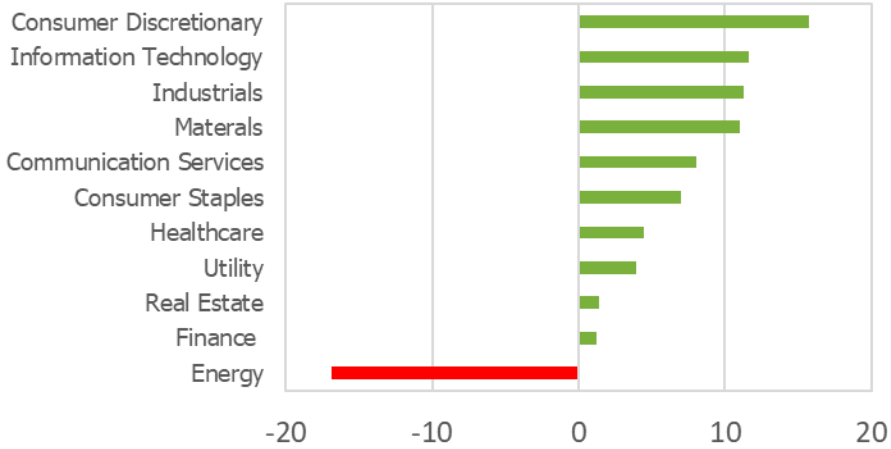
Within credit, preferred shares continue to have a much higher allocation than in prior years. We found value and income in preferreds, as investors focus more on plowing capital into the traditional debt that central banks have been purchasing.

In could be some time before base rates (i.e. treasury yields) go back up, and so **we expect to continue to employ bond surrogates** (such as defensive equities and preferred shares) to manage through this low rate environment for income and appreciation, until better fixed income opportunities emerge.

Q3 saw a continuation of tech and internet leadership

Along information technology, the consumer discretionary sector, which is powered by its inclusion of Amazon, continued its run of momentum.

MSCI World Indices (% change)



Sources Bloomberg, JOHCM as of xxxxx.

However, Q2 also saw signs of speculative excesses

We have taken notice of the fervor with which certain work-from-home and speculative automotive shares added billions of market caps in days.

Whether it was Robin Hood-style retail investors, overly exuberate algorithms, or option whales creating the dynamic, **it is generally a cautionary flag when speculative excess can be seen in markets.**

it is critical to be aware of any sector or style biases which can present in your income portfolio

None of this is to suggest that a crash is coming or that the businesses that are subject of the speculations might not have good long term business prospect.

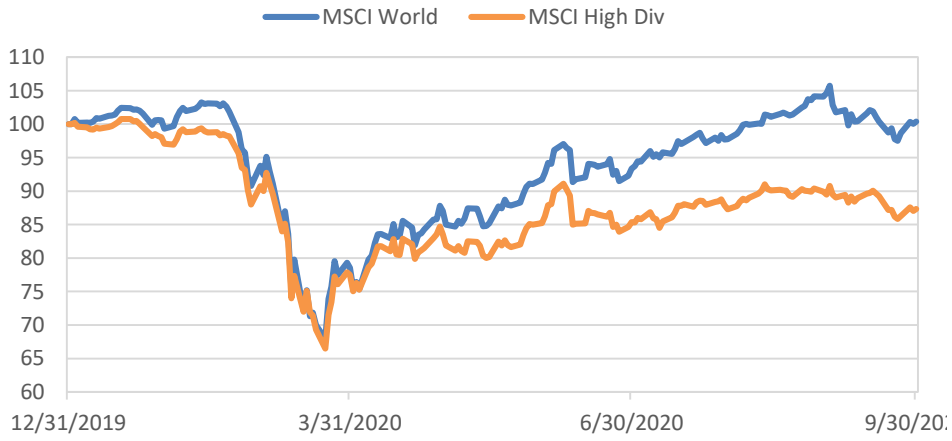
All we would say is … be careful. As income and cash flow minded investors, it is – to us – paramount that the source of corporate cash flows is durable and that the valuation thereof is not excessive.

The Income Challenge (cont.) – beware of sector biases

As we discussed in the prior quarter, financials and energy are over-represented among high dividend shares, so simply buying high income risks a significant bias to these sectors. This would have been painful in the past year given the poor performance of these sectors.

Another approach is overlay a quality screen to income shares. This is the approach adopted by the MSCI World High Dividend index and tends to favor consumer staples businesses and healthcare stocks.

Unfortunately, here too, one misses out on what have been some of the more dynamic, technology businesses. This can be seen in the chart below, highlighting the difference between the MSCI High Dividend Index and the more tech-heavy MSCI World.



Sources Bloomberg, JOHCM as of June 30, 2020. High Income defined as MSCI World index constituents with more than 3% trailing yield.

It is critical to be aware of any sector or style biases which can present in your income portfolio when using a passive or static approach.

Balanced income approach – ignore growth at your own peril

To summarize the prior page, the income approaches that we come across most frequently are:

1) **Yield maximizing** – which tends to overweight financials and energy, and
2) **Low Volatility Overlay** – which tend to cluster around staples.

When the focus is on generating optically high-income levels, it is difficult to include growing income streams, since these can often reduce the overall yield.

As 2020 has shown, these income streams are not only important from a capital appreciation perspective, but also as a risk management consideration. The growth factor has been the dominant driver of returns.

So what is the answer?

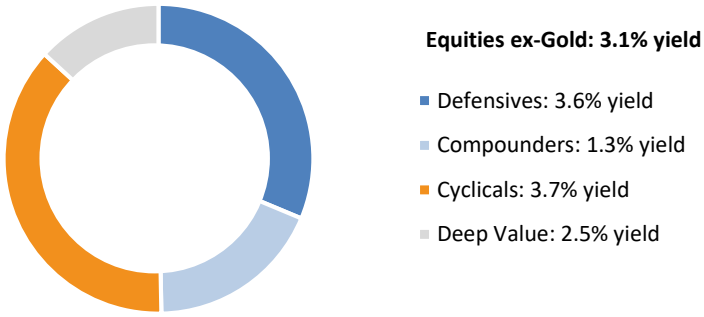
We track our exposures across different stylistic buckets. Growth-oriented investments are typically included in our "Compounders" bucket, which is roughly 20% of our overall equity exposure.

When we think about balance we want to pay heed not just to sectors, but to look more broadly at different clusters of risk and factor exposure.

As can be seen in the chart below, the yield on these investments is indeed lower than what we can earn on our cyclical and defensive investments, as well as our deep value investments, where income levels are temporarily reduced.

As our equity holding pie chart illustrates, there is a balance in our portfolio between ***on one hand*** economically sensitive cyclicals and recovery oriented deep value and ***on the other hand*** more stable defensives and lower yielding compounders.

Equity holdings and LTM yield grouped by style



Sources Bloomberg, JOHCM as September 30, 2020.

As the chart below illustrates, **each of these clusters has an important role to play in the <u>current</u> environment** to try to contribute to a portfolio that generates stable income, but is also resilient to various shocks ranging from recession to inflation. Our holdings of hedge assets such as cash sovereign debt and gold further this goal.

We feel that such a portfolio provides a resilient base from which a flexible income-oriented manager such as ourselves can seek to take advantage of air-pockets and opportunities to deploy capital.

Risk buckets serve unique roles in a modern income portfolio

With the upcoming US election and prospects for a vaccine, investors may be in tore for shocks and more regime changes

Defensives	• Stable businesses that generate consistent income • Growth prospects can be limited • Consumer staples, healthcare, utilities, telecom services
Cyclicals	• Earnings streams that are economically sensitive • Potential inflation hedge for defensives and bonds • Industrials, materials, business services, financials
Compounders	• Strongly positioned in secular growth industries • Often lower income due to higher multiples • Software, semiconductors, automation equipment
Contrarian /Deep Value	• Generally idiosyncratic or counter-cyclical investments • Yields can range from low to very high depending • Restaurants, hotels/travel, office real estate,

Closing thoughts

- With the upcoming US election and prospects for a vaccine, investors may be in tore for shocks and more regime changes
  - ✓ A flexible approaches can evolve to the opportunity set, while static approaches may face structural biases.
- New Fiscal-Monetary raises the risk of extreme outcomes and potential inflation.
  - ✓ Income investors face a particularly broad range of concerns.
- Traditional fixed income doesn't offer very *much* income today
  - ✓ Alternatives such as equity, preferred and hybrid income may be need to earn carry and protect against capital loss should rates rise.