Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: April 2018

Active sector bets for the month ending 31 March 2018

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.55	3.12	+5.43
Banks	15.82	11.14	+4.68
Construction & Materials	5.75	1.46	+4.29
Oil & Gas Producers	16.53	12.50	+4.03
Mining	10.03	6.38	+3.65

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.11	-5.11
Pharmaceuticals & Biotechnology	2.72	7.63	-4.91
Equity Investment Instruments	0.57	4.61	-4.04
Beverages	0.00	2.91	-2.91
Personal Goods	0.00	2.38	-2.38

Active stock bets for the month ending 31 March 2018

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
ITV	3.30	0.24	+3.06
BP	7.03	3.99	+3.04
Aviva	3.87	0.87	+3.00
Lloyds Banking Group	4.88	2.03	+2.85
Standard Life Aberdeen	2.93	0.43	+2.50
DS Smith	2.55	0.20	+2.35
National Express Group	2.34	0.07	+2.27
Rio Tinto	3.82	1.80	+2.02
Glencore	3.67	1.81	+1.86
Vodafone Group	4.05	2.27	+1.78

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.10	-4.10
GlaxoSmithKline	0.00	2.97	-2.97
Diageo	0.00	2.56	-2.56
Prudential	0.00	2.09	-2.09
Unilever	0.00	1.99	-1.99

Performance to 31 March 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-1.96**	**-5.31**	**271.10**	**£3,479mn**
Lipper UK Equity Income mean*	-2.37	-6.28	159.29	
FTSE All-Share TR Index (12pm adjusted)	-2.18	-6.30	165.32	

Discrete 12-month performance (%) to:

	30.03.18	31.03.17	31.03.16	31.03.15	31.03.14
JOHCM UK Equity Income Fund – A Acc GBP	**7.25**	**24.33**	**-6.74**	**7.26**	**16.30**
FTSE All-Share TR Index (12pm adjusted)	1.36	21.88	-4.42	6.87	8.66

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. * Initial estimate for the Investment Association's UK Equity Income sector.

Economic developments

March brought further evidence to support our thesis that UK real wages are starting to inflect upward as wage growth accelerated to 2.6%. We continue to believe that this measure will move to 3% by the end of 2018 as a result of the increased tightness in the labour market: the percentage of the population employed (75.3%) has never been higher; the inactivity rate is the lowest ever; and the number of job vacancies is close to a record high. Widespread survey data, numerous comments from the corporate sector and further evidence that the public sector 1% pay cap is loosening (e.g. the NHS three-year pay deal) also suggest rising wage pressures. At the same time, inflation continues to fall (to 2.7% on latest data), as the Brexit sterling depreciation effects start to fall out of the data. We expect inflation to trend down towards 2% over the next 12 months. Despite this very clear picture on real wage trends, the media and market narrative remains focused on real wage pressure, which is last year's story.

Brexit negotiations took a step forward in March with agreement on the transition period and follow the first breakthrough at the end of last year. Between these forward steps, the rhetoric surrounding negotiation continually increases, causing the market to focus on a more negative outcome. As we have articulated before, we believe the UK will reach an agreement that will be better than the negative consensus. It is in Europe's interests to do so as well as the UK's, and the evidence to date and more recent commentary from a number of European leaders suggests this will be the case. The progress in March led the pound to rally towards recent highs. We expect the combination of Brexit progress, real wage increases and general stability in UK GDP growth to lead to a further rise in UK interest rates in the next few months.

It is interesting in the context of the debate around the health of the UK economy that there were inbound bids from Continental European companies for two UK FTSE 250 stocks during March (**Hammerson**, discussed below, and Fenner).

In Europe, it was noticeable that some forward-looking data, such as the manufacturing PMI survey, rolled over from high levels. This is probably a direct result of the strong euro (versus the US dollar).

In March, there was a further interest rate rise in the US, the sixth rise since the current tightening process began in December 2015. In his first meeting as Federal Reserve Governor, Jerome Powell struck a measured tone in the subsequent press conference, although the Fed's view of economic growth, inflation and the number of likely further rate rises this year all increased slightly from the previous month. Economic activity indicators in the US remained robust during March, with the first impact of the tax cuts starting to show. The US 10-year treasury yield, whilst

weakening towards the end of the month due to the wider market sell-off, remained close to the highs established during February.

The rise in global interest rates, which is a clear theme now, coupled with Trump's tariff announcement, unsettled markets. This is no surprise as the complacency in markets around the impact of rising rates on equity valuations has been surprising up until now. As other central banks also continue to tighten in response to the strongest synchronised global growth for a decade, it feels likely that we should periodically expect equity market volatility as market participants adjust to this new regime. The tariff announcements would be a bigger negative if they lead to a series of retaliatory moves.

The oil price rose c. 5-8% in March as a result of tension in the Middle East and concern that changes to White House staff (the exit of Secretary Tillerson and National Security Advisor McMaster) would lead to the demise of the Iran agreement. This move, which took the price of Brent crude back above US$70/bbl, will reinforce global inflationary trends and add further pressure for interest rate increases.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) posted a decline of -2.18%. The Fund performed slightly better than the market in returning -1.96%. Year to date the Fund is down 5.31%, again slightly better than the FTSE All-Share Total Return Index (down 6.30%).

Looking at the peer group, the Fund ranked third decile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked first decile over three years, 10 years and since launch (November 2004) and first quartile (second decile) over five years.

The market fall and associated volatility led to a rush towards stocks perceived as defensive. Names we own that fit within this bucket, such as **AstraZeneca** (up 6% relative) and **National Express** (up 12% relative), performed well, but the net effect of the market tilt hurt the Fund's relative performance. The underperformance of the mining sector was also a headwind.

There were four bids for FTSE 350 stocks during March, two of which, as highlighted above, were from European companies. The bid targets were **Hammerson** and **Laird**, both owned in the Fund, and Shire and NEX Group (a bid which consummated), neither of which are held in the portfolio.

Starting with Hammerson, while the 615p per share approach from French shopping mall operator Klepiere represents a 40% premium to the undisturbed share price, it is not an attractive offer. Nonetheless, the approach does highlight the value in the business, and we would be supportive of a transaction towards the 700p per share level were such an offer to be forthcoming. Whilst 700p would still constitute a discount to the current net asset value (776p), our test is where the share price could credibly move to on a 2-3 year timeline rather than the net asset value, a level at which, in our view, the shares are unlikely to ever trade.

The Laird agreed bid, at a premium of c. 70% to the undisturbed share price, was not unexpected given the stock's low valuation coupled with the technology Laird owns, particularly its 'connected vehicle solutions'. We are surprised an industry player has not counterbid.

Both of these bids helped relative performance, albeit the approach for Shire, which is a large index constituent, partially offset these positives. The bids for Laird and Hammerson are the first offers for stocks held in the Fund for 20 months, an unusually long period.

Other noteworthy contributors included a number of our building / construction holdings – **Bovis** (up 15% relative), our brick-maker stocks **Forterra** and **Ibstock** (both up 8% relative) and **Costain** (up 8%). All of these moves were driven by good results. **Huntsworth** and **Vitec** were also strong following results. **Mckay (**up 15% relative), one of our small cap property stocks, was boosted by the announcement it had forward-let its new development in Lombard Street to St James's Place. This will lead to earnings per share, dividend per share and net asset value upgrades.

Whilst the majority of our stocks have produced solid results and, as discussed below, have also surprised positively on dividends on an aggregate basis, two stocks fell (both c. 15% relative) on their results: **TP ICAP** and **Kingfisher**. The market has punished stocks harder than normal (and

harder than should be the case) for results that contained the slightest negative chinks. We cover Kingfisher in more detail below. Other areas of weakness were banks whilst **ITV** also continued to perform sluggishly.

Portfolio activity

We made a number of changes to the Fund during March, adding one new stock (**WM Morrison**) and adjusting a larger-than-normal number of weightings, reflecting the volatility in the market.

We have been 'shadow boxing' supermarket group Morrisons for the past 12-18 months. During this period, we established it was fundamentally attractive, for the reasons described below, but it was not a buy from the Fund's perspective: it did not yield enough to meet our strict yield criterion and was too expensive. The stock had fallen c. 10% over the 4-5 months ahead of its full-year results in mid-March and fell a further 10% in the wake of the annual numbers. This created a more attractive entry point from a valuation perspective, with the stock trading on a free cash flow yield of c. 8%. The management also articulated a new dividend policy alongside the results, a move that we had largely anticipated, which indicated that a supplemental dividend would be paid, likely every year. On this basis, the dividend yield is over 5%.

The fundamental attractions here are numerous. The management team have recovered the position well from the situation they inherited. They have chosen the longer road of rotating a large part of the cost reduction into lower prices, which will drive competitiveness and future volume growth rather than delivering the instant gratification of large step changes in margin. This creates a higher quality, firmer foundation for the business. Furthermore, Morrisons is the only UK food retailer that is vertically integrated into food manufacturing, which should confer higher margins. It has also cleverly done a number of wholesale agreements (e.g. with McColls), which should likewise add sales and profit over the fixed cost base. Morrisons has no pension deficit, is lowly geared and has the highest value of freehold property versus market cap compared to its sector peers.

The addition of Morrisons to the portfolio also fits in with our continued careful move over the past year into domestically focused assets. We part funded this by a modest reduction in our **Sainsbury's** weighting – we believe this stock remains very cheap but it has continued to disappoint slightly in terms of its sales performance over a fairly long period of time. We also modestly reduced our holding in **Hollywood Bowl**, which is our most expensive domestically focused asset.

Kingfisher, as noted above, sold off during March. We used this share price weakness to add materially to our position. The market focus on the results was narrow and chiefly on the negatives, namely on the recent weakness in its UK business and on the working capital investment to reduce disruption risk as the ONE Kingfisher transformation programme is rolled out. There was little market focus on the positives - improved price competitiveness in the French businesses, continued execution of the 'ONE' programme, confidence that the latter will yield the £500m EBIT uplift targeted - and no focus on the very low valuation. The UK B&Q business, which is only c. 20% of our valuation but gets all the attention, should benefit from the potential withdrawal from the UK and closure of Homebase by its Australian owners, Bunnings. This withdrawal could happen in mid-2018 following a strategic review, which follows the announcement Homebase is losing more than £100m annually. Our view of a pickup in UK real wages also adds to our investment case. We funded the position increase in Kingfisher with a reduction in some of our construction names that have performed very well e.g. **Costain**, **Forterra**, **Ibstock** and **Bovis**.

In the mining sector, we trimmed our position in **Rio Tinto** and added to **Glencore**. This continues the move we have been making to move the Fund's end commodity exposure towards base metals like copper, cobalt and nickel, the beneficiaries of the move towards electric vehicles, and away from iron ore.

In financials, we continued to add to **Standard Chartered**, which weakened as a result of the Trump tariff changes. This stock is now trading on 0.8x 2018 net tangible book value. We also added to **Raven Russia** following good results, **Hammerson** (before the Klepiere approach noted above), **Paragon** and **TCAP.**

Dividend update

We indicated last month that we would provide an update on the Fund dividend following the end of the full-year results season.

Year-to-date results have been strong and, in aggregate, dividends have exceeded our forecasts. There have been strong performances across a wide number of sectors and stocks: miners **Anglo American** and **Rio Tinto**, **Aviva**, which increased its payout ratio, **Raven Russia**, **Ibstock**, **Morgan Sindall** and **Vitec** were amongst others exceeding our dividend forecasts. Partly offsetting this has been the negative impact of a stronger pound on UK dividend flow, an effect we had and continue to budget for, and the decision by **Lloyds Banking Group** to move from an ongoing supplemental dividend to a share buyback.

The net effect of these developments is positive. As a result, we are able to increase our guidance for Fund dividend growth for 2018 from c. mid-single digits to the slightly higher range of 5-7%. This remains a prudent view of the current run rate and allows for the risk, noted above, of a further strengthening of sterling (particularly against the US dollar). We will provide a further update at the end of Q2.

Assuming growth at the mid-point of this guided range means a dividend per unit of 17.2p (on the A accumulation class), which would mean the Fund yields 4.6% for 2018.

The discrete Q1 2018 dividend will be up by c. 7.5%.

Outlook

It is becoming clearer by the month that the path to policy normalisation has categorically begun in the US, the UK and Europe. A further rise in US interest rates during March, coupled with indications that we will see an increase in the UK in May, were very encouraging evidence that this transition to a more normal interest rate environment continues. Higher wages and higher inflation, the main drivers of interest rate normalisation, also saw more evidence of upward movement during the month, as discussed above.

The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, it has undoubtedly pushed valuations of many assets and individual instruments to elevated levels that will be hard to justify if the cost of capital rises. As expected, markets are finding life tougher at a headline level as this adjustment in bond yields feeds through. The shape of the market's performance has modestly helped the Fund's relative performance, but the general downward direction of the market and higher volatility have also led to a number of our holdings falling to levels that mean that the valuation signal is now flashing green. Consequently, there are few stocks in the Fund that we are concerned about from a valuation risk perspective. The chart below shows the price-to-book ratio of the Fund against its history and the FTSE All-Share index.

The Fund remains on a low price-to-book, both in comparison with its history and the wider market, having only been sustainably cheaper in 2009 immediately after the financial crisis. The Fund's long-term performance is highly correlated to its dividend growth and the resulting absolute level of the dividend. The delivery of 13.4% growth in 2017, which continues a track record of strong growth since the Fund's launch, and our confidence in 2018's dividend outlook is an important driver of the unit price. As we note above, we are increasing our guidance for 2018 Fund dividend growth to 5-7%, which would mean the Fund's prospective yield for 2018 is c. 4.6%. This yield, strong dividend growth and low valuations embedded across the portfolio, allied with the shift in monetary policy, leave us optimistic in our outlook for the Fund's relative and absolute performance.

Further information

If you would like further information about the Fund, please call our Investor Relations team on +44 (0) 20 7747 8969, email us at info@johcm.co.uk or visit our website at www.johcm.com

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