JOHCM UK Equity Income Fund

Monthly Bulletin: April 2019

Active sector bets for the month ending 31 March 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.34	3.06	+6.28
Banks	15.26	10.02	+5.24
Oil & Gas Producers	17.78	13.87	+3.91
Construction & Materials	5.40	1.59	+3.81
Mining	10.21	6.78	+3.43

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.62	-7.62
Equity Investment Instruments	0.26	5.16	-4.90
Tobacco	0.00	4.31	-4.31
Beverages	0.00	3.69	-3.69
Personal Goods	0.00	2.54	-2.54

Active stock bets for the month ending 31 March 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Glencore	4.64	1.56	+3.08
Barclays	4.15	1.16	+2.99
Lloyds Banking Group	4.92	1.96	+2.96
BP	7.79	4.86	+2.93
Aviva	3.61	0.71	+2.90
DS Smith	3.06	0.18	+2.88
Standard Life Aberdeen	3.14	0.28	+2.86
ITV	3.01	0.21	+2.80
Phoenix Group	2.68	0.16	+2.52
Paragon Banking Group	1.96	0.05	+1.91

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	3.66	-3.66
GlaxoSmithKline	0.00	3.45	-3.45
Diageo	0.00	3.31	-3.31
British American Tobacco	0.00	3.20	-3.20
Unilever	0.00	2.14	-2.14

Performance to 31 March 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**0.91**	**8.08**	**267.70**	**£3,433mn**
Lipper UK Equity Income mean*	1.63	8.55	167.71	
FTSE All-Share TR Index (12pm adjusted)	2.67	9.15	180.78	

Discrete 12-month performance (%) to:

	29.03.19	30.03.18	31.03.17	31.03.16	31.03.15
JOHCM UK Equity Income Fund – A Acc GBP	**-0.91**	**7.25**	**24.33**	**-6.74**	**7.26**
FTSE All-Share TR Index (12pm adjusted)	5.93	1.36	21.88	-4.42	6.87

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

Markets reacted aggressively to the Federal Reserve’s “policy pivot” as Chairman Powell appeared to rule out any further interest rate hikes this year amid signs of slowing economic activity and a persistent undershoot of inflation, despite the strong US labour market. With inflation struggling to meet, let alone beat, the central bank’s 2% central target, the Fed also announced that it would slow down its monthly reduction of asset holdings. This policy shift, combined with some modest downgrades to its GDP forecasts, was enough to lead investors to question whether the central bank had tightened too fast during 2018. Consequently, markets have begun to price in the possibility of rate cuts at some stage in the next 12 months: the two-year US treasury yield fell 35bps to 2.2%. Clearly, parts of the US economy have slowed progressively since the rate tightening phase began, particularly those related to housing activity, and some business confidence surveys have weakened. However, the data is somewhat inconsistent. As such, a period of reflection from the Fed is probably the correct policy response. Inevitably, the sharp moves in bond yields and consequent inversion of yield curves have led to commentary that this is a likely precursor of an impending recession. Whilst the economic cycle is extended in terms of timeframe, it has been an unusually sluggish cycle despite loose monetary policy. As such, it is more difficult than normal to predict its path. At least the Fed has given itself some monetary firepower to react if activity were to disappoint to the downside, unlike central banks elsewhere in the world.

The Brexit drama rolls on and has absorbed many column inches in the UK. Interestingly, despite the barrage of commentary on every twist and turn in Parliament, the sterling/euro exchange rate was effectively unchanged at €1.165/£ over the month of March. This probably reflects the fact that both a ‘no deal’ outcome and an ultimately softer Brexit agreement have both risen in probability over the course of the last couple of weeks. It also highlights that sterling remains a modestly valued currency and that domestic economic activity has slowed but not collapsed so far in 2019.

Evidence is building that the looser monetary and fiscal policies in China are beginning to have a positive impact. The Chinese manufacturing PMI for new orders had its first rise in eight months, and some of the business confidence indicators such as the Cheung Kong Graduate School of Business Overall Conditions Index hit its highest level since December 2017. These stronger lead indicators suggest that we should expect firmer manufacturing PMI data in the coming months, and this process began in March with a reading of 50.5, the first expansionary number for six months. It is noteworthy that these improvements have occurred despite a lack of meaningful progress on the trade dispute with the USA. Any improvements in China would be very welcome in Europe, where industrial activity (which is heavily reliant upon exports to China and autos) has fallen heavily in recent months. The German manufacturing PMI fell below 45 this month, its lowest level since 2012.

Performance

Equity markets were up modestly in March, with the FTSE All-Share Total Return Index (12pm adjusted) returning 2.67% during the month. The Fund, up 0.91%, underperformed the market. Relative performance trends were volatile, with performance continuing to be heavily influenced by Brexit news flow. This is likely to remain the case in the near term. Year to date the Fund is up 8.08%, versus the FTSE All-Share Total Return Index, which is up 9.15%.

Looking at the peer group, the Fund ranked third quartile/seventh 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 over five years.

The oil price continued to move higher in March, underpinning our oil holdings. **BP** has shown better form of late whilst **Petrofac** bounced strongly (up 15% relative[*]) following the SFO investigation-related falls of the previous month. **Diversified Gas & Oil** also performed well after announcing another acquisition (see below). Elsewhere, the mining sector was more mixed, although **Rio Tinto** performed well. Its share price was supported by its large portfolio of iron ore assets - iron ore prices have been strong since the tragic events at Vale's mine in Brumadinho, Brazil.

Sluggish Brexit progress meant that our domestic names were largely weak. **Barclays**, **ITV**, **Hammerson** and **U & I** were noticeably poor, albeit there were some pockets of strength such as **Forterra** and **Morgan Sindall** after both reported good results.

The fall in bond yields noted above led financials to weaken with banks and life insurance stocks particularly affected. In contrast, the majority of the defensive sectors (where the Fund is lightly weighted) performed well.

Portfolio activity

We added one new stock to the Fund in March, advertising agency **WPP.** This stock has more than halved from its 2017 highs as cyclical effects, structural challenges and management changes have taken their toll. The result is a very cheap stock (P/E of 8x and a yield of 7.5%). New management has taken decisive action to simplify the business and reset its technology backbone to deal better with the structural changes that are happening in the market. Targets have been set to return the business to organic revenue growth, with margins in the mid-teens within three years. This seems sensible and, in our view, would lead to a share price c. 50% higher if delivered. Historically, we have always viewed the balance sheet as too highly levered, but this will be resolved by the completion of the ongoing sale of the Kantor market research business. It is unusual to see global market leaders with a new management team proactively addressing the known issues on such low valuations.

At the end of the month, we committed to a placing in **Diversified Oil & Gas**, which will fund in April (adding c. 30bp to our current position). The placing finances (with associated debt) the acquisition of further oil-producing assets in the northeastern US. The combination of the low purchase price (4x EBITDA) and the operational leverage of the acquired revenue over the current fixed central cost base means the transaction is very accretive to free cash flow and dividend per share (by c. 20%). The stock yields c. 9-10%. To make way for this addition we trimmed **Royal Dutch Shell** slightly and marked **Petrofac** to c. 100bp. In the mining sector, we also continued to slightly fade **Rio Tinto**.

Turning to portfolio sales, we reduced our position in **National Express**. This has been one of our best performers, both operationally (particularly versus its sector peers) and in terms of share price over the last few years. It has also benefited from being a quasi-defensive and a predominantly overseas earner. Whilst not expensive in an absolute sense (c. 12x P/E), it looks fuller value when compared with the rest of the Fund while the yield has fallen below 4% as the shares have outperformed since we purchased it in 2013. The position size reduction to c. 125bp overweight

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

reflects these points. We also trimmed **Countryside Properties**, which is now yielding less than 4%.

In the financials sector, we cut **HSBC**. As we commented early in the year, the combination of a higher valuation than other stocks in the sector, coupled with falling bond yields (and the likely associated revenue downgrades) would make it harder for the shares to outperform significantly. It remains part of our overall banks position where the skew is clearly focused on the domestic banks, with both **Barclays** and **Lloyds** in our top five active positions.

Fund dividend

With the results season now largely complete, the Fund's dividend growth for 2019 is clearer. Our previous guidance of low to mid single-digit growth year on year remains intact. This growth rate should be seen in the context of a strong 2018 when Fund dividend growth was +18%. It remains a prudent estimate of the current run rate, reflecting our view that sterling will strengthen in the event of any resolution to Brexit.

The theme of the results season has been, in the main, a reasonable delivery of results. However, the cautious environment caused by the fall in global markets in Q4 2018 (which has now reversed) coupled with ongoing political risks (primarily Brexit and China / US trade concerns) has 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). This cautiousness can also be seen in many of our holdings (**Glencore**, **Aviva** and **Ibstock** among others) operating to more conservative net debt to EBITDA / target solvency ratios. Some of this will unwind as the political trajectory becomes clearer and these safety buffers are used. These pressures were built into our original Fund dividend growth forecast.

The Fund's Q1 dividend went ex-dividend at the end of March. For the 'A' Accumulation class, the dividend per share was c. 4p – up c. 15% year on year. Based on current forecasts, growth will slow in Q2, be slightly negative in Q3 before moving back into positive territory in Q4. Quarterly movements are not indicative of any trend as they are distorted by the changing mix of stocks in the Fund and when each goes ex dividend.

Based on our current guidance of low to mid-single-digit growth, the dividend for 2019 would be 19.84p per unit ('A' accumulation share class), which would represent a forward dividend yield of 5.4%[*].

Outlook

Only four months ago, markets were anticipating continued monetary tightening from the Federal Reserve and were fearful that its actions might tip the global economy into a major slowdown or recession. Governor Powell's more balanced stance recently has calmed these fears and allowed investors to rediscover their risk appetite somewhat. As highlighted above, there are a few signs that economic activity in key countries (such as China) have started to stabilise or recover a little. If this continues, it would assist the Fund's relative performance.

In the UK, the path of Brexit will become a little clearer in the next few days. We will see either a deal agreed or a long delay. We see a 'no deal' exit as less likely given the clear reluctance of the House of Commons to entertain this outcome. An agreed deal would, we believe, unleash a powerful rally in sterling and UK domestic assets. A long delay would likely be seen as a modest positive (versus the current scenario), as it would categorically take a 'no deal' scenario off the table and push the issue further down the road.

The UK economy remains at a crossroads. Business confidence is understandably low and has manifested itself in deferred investment decisions and lower investment overall. We see this in many of our meetings with company managements. It can also be seen in capital allocation and dividend decisions, as discussed above. However, UK consumers are in a more positive position and frame of mind and continue to drive modest growth for the overall economy. The public finances are also in a much better position than expected, which gives scope for looser fiscal

[*] This is not guaranteed and figures have not been audited.

policy. The Chancellor has kept this flexibility in his back pocket pending the outcome of the Brexit negotiations.

As ever, we remain focused upon valuations. In this regard, we remain very optimistic about our portfolio. Assuming low to mid single-digit dividend growth in 2019, which we have reconfirmed today, the Fund's yield remains high at 5.4% prospectively, which looks highly attractive for a diversified portfolio of around 60 stocks.

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

Past performance is not necessarily a guide to future performance. Dividend yield quoted is prospective and is not guaranteed.

Investors should note that there may be no recognised market for investments selected by the Investment Manager and it may, therefore, be difficult to deal in the investments or to obtain reliable information about their value or the extent of the risks to which they are exposed.
The Investment Manager may undertake investments on behalf of the Fund in countries other than the investors' own domicile. Investors should also note that changes in rates of exchange may cause the value of investments to go up or down.