



JOHCM UK Equity Income Fund

Monthly Bulletin: April 2020

Active sector bets for the month ending 31 March 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.90	3.26	7.64
Mining	10.97	6.21	4.75
Financial Services	8.94	4.19	4.75
Food & Drug Retailers	6.21	2.16	4.05
Oil & Gas Producers	13.78	9.77	4.02

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.16	-10.16
Equity Investment Instruments	0.00	5.89	-5.89
Tobacco	0.00	4.24	-4.24
Beverages	0.00	3.81	-3.81
Gas, Water & Multiutilities	0.00	3.03	-3.03

Active stock bets for the month ending 31 March 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Legal & General Group	3.89	0.66	3.23
Phoenix Group	3.39	0.19	3.21
Standard Life Aberdeen	3.45	0.30	3.15
BP	6.89	3.75	3.14
Aviva	3.62	0.61	3.01
WPP	2.95	0.02	2.93
DS Smith	3.13	0.20	2.93
Tesco	4.21	1.31	2.90
Lloyds Banking Group	4.19	1.36	2.82
Barclays	3.73	0.94	2.79

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
HSBC	0.00	5.45	-5.45
AstraZeneca	0.00	5.42	-5.42
GlaxoSmithKline	0.00	4.23	-4.23
British American Tobacco	0.00	3.50	-3.50
Diageo	0.00	3.45	-3.45

Performance to 31 March 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	-25.30	-36.52	159.20	£1,770mn	£2,132mn
Lipper UK Equity Income mean*	-18.65	-28.45	111.91		
FTSE All-Share TR Index (12pm adjusted)	-15.89	-25.94	127.27		

Discrete 12-month performance (%) to:

	31.03.20	31.03.19	31.03.18	31.03.17	31.03.16
JOHCM UK Equity Income Fund – A Acc GBP	-29.51	-0.92	7.25	24.33	-6.74
FTSE All-Share TR Index (12pm adjusted)	-19.06	5.93	1.36	21.88	-4.42

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

A dramatic month saw one of the fastest stock market falls in history followed by unquestionably the swiftest and largest central bank and government support packages ever seen in many countries around the world. As has been widely discussed, the unusual element of this economic crisis compared to others before it is that for many industries revenues have literally stopped altogether. This has necessitated the scale of the support offered.

Clearly there will be a global economic contraction during 2020, but the key dynamic centres upon the duration and the depth of the downturn. Many market participants have strong emotional views on this, but we continue to assume that the virus crisis will be a finite one predominantly covering a number of months of 2020. Precisely anticipating the dates upon which social distancing measures and industrial lockdowns begin to be relaxed is prone to error, as there are so many variables at play that we do not need to list here. The uncertainty around how quickly economic activity will rebound is also hard to accurately predict, but the early signs from China are encouraging at this stage, with most factories appearing to have returned to close to full production, partly reflected in a healthy recovery in the manufacturing PMI to above 50 (expansionary territory) at the end of March. Whether it takes a much longer timeframe for consumer activity to revert to a more normal pattern is a factor that will be closely watched all around the world.

Before too long the debate around the timing of the easing of the restrictions on personal movement will begin to focus upon the trade-off between future economic growth and saving lives. Unpalatable as this is, President Trump, speaking on 23 March, will not be alone in voicing these issues: "We cannot let the cure be worse than the problem." How different politicians react to this terrible moral dilemma will have a major impact upon the depth and duration of the downturn in their respective regions. But it will be easier in a command economy such as China than in liberal Western democracies.

In the shorter term, central bank intervention has had a meaningful impact on many financial markets. The initial strength of the US dollar has subsided, with sterling/dollar only moving 3.5% over the month having breached a 10% move two weeks ago. Government bond yields have fallen back, as central banks desired, despite a spike higher mid-month. Similarly, credit spreads, whilst still elevated, are meaningfully below the levels seen earlier in March. As well as the impact of Covid-19, credit spreads had also widened significantly after the failure of OPEC+ to reach a new agreement on oil output production cuts. Oil prices have broadly halved over the month, although it should be noted that two-year oil price futures have fallen much less, suggesting that the current low price is likely to prove to be somewhat temporary.

Normally in these monthly commentaries we would discuss issues such as the highly expansionary, infrastructure-orientated UK budget, or reflect upon statistics such as the 73,500 new UK mortgage approvals in February, the highest since 2007. However, recent events have rendered these less significant than before, although the debate around the wider use of fiscal policy has been magnified very quickly. With even the Germans set to move into a budget deficit, it could be that this current crisis brings about a permanent shift in the balance of monetary and fiscal policy. Beyond the Covid-19 crisis, a series of other issues will need to be debated too, including the appropriate size of state intervention and spending, government budget deficit plans, de-globalisation, personal taxation rates and many more. However, these topics are for another day.

Performance

The market, represented by our benchmark, the FTSE All-Share Total Return index (12pm adjusted), fell sharply during March, driven by news flow surrounding the Coronavirus. The Fund significantly underperformed the market over the month in returning -25.30% versus -15.89%. The indiscriminate selling around the middle of the month led to many dislocations in share prices, particularly in the small- and mid-cap space. These will take time to smooth out.

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

As indicated above, the downward move in bond yields highlights an extreme 'risk off' sentiment, which was also evident across equity markets. Defensives performed strongly and cyclicals, banks and, to a lesser extent commodity sectors, fell materially. This provided a major headwind to the Fund's performance. The polarisation between growth and value has now exploded way above the TMT bubble and the level seen last August. The gap is now unprecedented. We showed this, and the performance of different types of stocks on both sides of the style divide, in our recent webcast, which can be found [here](#) under the 'Live and Recorded' section.

The main negative impacts on performance over the month were amongst financials and UK domestics. Many of the latter – where our main exposure is building / construction-related – have temporarily closed. Whilst many will come out the other side of the pandemic strong, and in some cases stronger (due to competitors failing), the immediate market focus is on the cash cost per month of closure and related downgrades. Financials were hit by the second derivative impact of these shutdowns and worries regarding higher provisioning, as well as lower income as a result of the fall in interest rates noted above.

On a more positive note, our food retail names (which cumulatively are c. 7% of the Fund) performed well and other semi-defensive names like **Vodafone**, the packaging stocks and **Hipgnosis** also held up well.

Portfolio activity

We sold **HSBC** in March. We have been gradually reducing our position over the last 12 months (with most of the sales conducted between 1-1.1x book value) on valuation grounds and because of the increasing challenges affecting the business (lower rates, unrest in Hong Kong, restructuring, etc.). In the first part of the month HSBC outperformed materially due to the large, (perceived) safe and liquid nature of the shares. We think this will unwind as the resultant relative valuation comes to the fore.

Other reductions included selling our residual position in **Forterra**. The proceeds were reinvested into several names, discussed below, that had fallen more in value (compared to Forterra). We also reduced our position in **Hammerson** as the effects of Covid-19 place pressure on its revenues. It also means the sale of part of its premium outlets business (which would have dramatically changed its balance sheet position and the valuation agenda) is now unlikely. However, the stock continues to trade at a fraction of its net asset value and has strong recovery potential as and when consumer activity resumes. Elsewhere, we had to reduce our position in some of our defensive positions as the scale of the relative performance took them materially above our 300bp active position focus point. **Tesco** fell into this category.

In terms of additions to the Fund, we made a number of changes to the portfolio using the proceeds from the abovementioned sales, alongside positive inflows to the Fund (c. +£30-40m) over the month. The common theme amongst the additions were strong balance sheets, stocks that have disproportionately fallen and those companies that will potentially benefit from the current unfortunate set of circumstances.

An example in the latter category is **TP ICAP**. It was already improving as a business under new leadership, with investment in technology and its data businesses. The Coronavirus has led to a surge in trading volumes, with certain banks like Goldman Sachs reporting record weeks; TP ICAP will have benefited from this. The Fund's position has nearly doubled in size.

Stocks whose share prices have fallen disproportionately include certain miners (specifically **Anglo American** – down c. 50% this year from its peak in January to low in March), housebuilders **Countryside** and **Vistry**, which both importantly have Partnership Housing businesses (shares down 45% and 60% from YTD highs), a number of financials (**Legal & General** – down 55% this year from its high to lowest point) and certain small caps (**Norcros** and **Tyman**). We added to all these names.

We are focused on ensuring our holdings are going to be well-positioned coming out of the crisis in terms of balance sheets, but also with the ability to take market share given trends around them. Later in this report we have included four examples of stocks held in the Fund that we believe will be well placed as and when conditions normalise, to give a feel for this dynamic.

Fund dividend

As we discussed on our recent webcast ([available here](#) under 'Live and Recorded'), the impact of Covid-19 will be material to the Fund's 2020 dividend. A number of countries, such as Germany, have asked all companies receiving state funding to suspend dividends whilst others (e.g. some Scandinavian countries) have asked banks to suspend dividends. In the last two days there has been an acceleration in cancelled, suspended or deferred dividends across the UK market, with all UK-quoted large banks mandated to suspend dividend payments for 2020 (including the 2019 final dividends) by the PRA.

As we go through this year, we will provide as clear guidance as we can on the potential range of outcomes for the Fund dividend in 2020. The final resting point is subject to material uncertainty driven mainly by the nature of Covid-19, the aforementioned regulatory overlay and the unknown length of the lockdown in the West.

It will be just as important to understand what element of the 2020 drop in income will be permanent and what element will turn out to be a temporary reduction. In this regard we would make two points: 1) the degree of fiscal and monetary stimulus is unprecedented, which should create a strong rebound when the lockdowns are removed; and 2) in our discussions with management teams, which as we have said elsewhere, largely went into this with solid balance sheets, the consistent message has been that the removal of dividends is a temporary measure linked to preserving liquidity and reducing the risk profile as they navigate through the lockdown period. A number of companies have made this clear in their public statements (e.g. **Galliford Try** and **WPP** amongst others).

Prior to the outbreak Covid-19 the Fund dividend was in good shape. Our 'live' forecast at that point was 8-9% annual growth in 2020. This is the starting point before Covid-19 adjustments are made.

The Fund went ex its Q1 dividend on 31 March – this dividend was 3.24p (Accumulation 'A' share class). This is down c. 20% year-on-year. Prior to the pandemic taking hold, the Q1 dividend was forecast to be down c. 5%, with the decline a function of the differing mix of the portfolio in relation to ex-dividend dates year-on-year. The incremental fall of 15% is due to Covid-19 as three dividends – **McCarthy & Stone**, **Galliford Try** and, more materially, **Hammerson** – were cancelled. The Q1 dividend is the smallest quarter, representing c. 20% of the total Fund dividend paid in 2019.

For 2020, as indicated above, the final outcome will depend on how long the lockdown lasts for, the extent to which governments and regulators mandate dividend suspensions in the UK, and the trajectory of the recovery following the lockdown. Both of these have high degrees of uncertainty around them. The final landing point will depend on what large sectors determine to be the right course of action vis a vis dividends. On our webcast last week, mentioned above, we gave an estimate that the dividend distribution for the Fund for this year could be down between 20-40%. Since we made this estimate, the extent of cancelled and deferred dividends has risen further, and so there is a high probability that the number could be worse than this. However, a critical factor will be when and how lockdowns are relaxed, as this could lead to a rebound in economic activity in H2 2020 and the subsequent payment of some of the deferred dividends referred to above.

We think the permanent reduction in income will be materially less than where 2020 lands, for the reasons outlined above. We will provide monthly updates on the trajectory of the 2020 dividend and our expectation as it builds of what the 2021 Fund dividend could look like (and hence what the more important permanent reduction will be).

The chart below, which we have consistently shown, compares the Fund unit price to the dividend trajectory. It shows the Fund dividend would have to fall permanently by more than 50% for the lines to recouple. We think the permanent fall will turn out to be materially less than this.



Source: JOHCM/Fund Analytics/StatPro as at 30 March 2020.

Stock examples – exiting Covid-19 with strength

We have discussed a number of stocks elsewhere in this report but here we have included four portfolio holdings (c.10% of the Fund) from different parts of the market to show how each is positioned to recover. All four have strong balance sheets, low valuations, and we believe could see gains in their respective market shares.

Eurocell is a good example of a Fund holding that was well positioned pre-Covid-19 (taking market share, expanding its branch network). It has reduced the cash costs of running its business through the lockdown to £3m p.a. (post government assistance – mainly rates and furloughing employees). It had a robust balance sheet, with net debt-to-EBITDA of c. 1x before the outbreak. At the start of April it conducted a placing, raising £17m (10% of its pre-existing market cap) to ensure it could transition through a long shutdown (into 2021), but, more importantly, to continue to make capital investment (e.g. a new distribution centre) that will enable it to accelerate its market share gains as markets reopen.

Eurocell currently has c. 15% market share, with an aspiration pre-pandemic of c. 20% over five years. With one competitor entering administration two weeks ago and others close to a similar position, this market share could be achieved much more quickly. The stock is c. 1% of the Fund, and we over-participated in the placing relative to our holding in the stock. We believe Eurocell will prosper in the years ahead.

Galliford Try is valued broadly in line with its net cash balance despite being a de-risked £1.3bn revenue business that should make £25-£30m of EBIT. 85% of its workload is government related – it was well placed before the Covid-19 outbreak given expansionary fiscal policy. And it will be well placed after the pandemic subsides given likely increased fiscal spending to level up ‘north to south’, get Britain moving again post-lockdown and likely further investment in the NHS. Construction terms and conditions are likely to improve meaning risks will be lower. Galliford cancelled its dividend of 1p per share (worth just £1m), but indicated it would consider adding this dividend to its final dividend later this year once the Covid-19 situation is clearer.

DS Smith is one of Europe’s leading corrugated packaging manufacturers, with strong positions in the collection and recycling of paper and board. The crisis is likely to further accelerate the rising structural growth of e-commerce and the need for sustainable and recyclable packaging solutions, including the switch away from plastic. Whilst DS Smith has net debt-to-EBITDA of around 2x, the fact that around 70% of its sales serve the FMCG industry, with food around 50%, means that its earnings will be less affected than most companies in the industrial space. Furthermore, it has significant headroom in its existing banking facilities (over £1bn). Its dividend has historically been 2-2.5x covered. With its earnings relatively insulated against the shutdown, an unchanged dividend would leave the shares yielding round 6% at the current share price.

Phoenix Group is the largest life and pension consolidator in Europe. The group has historically been run in a risk-averse manner, seeking to hedge out as many market risks as possible. Indeed, it is currently slightly overhedged on its equity exposure. And whilst the company has some sensitivity to rising credit spreads, Phoenix would also be a positive beneficiary of falling longevity. Its solvency has improved during the last few weeks NOT fallen as a result of this hedging. In 2019, the group generated £707m cash, and in 2020 it is expected to generate £800-900m. Operating expenses and debt interest reduce these numbers by around £200m p.a., leaving the group on a free cash flow yield of around 16% in 2020 at the mid-point of its guidance. Furthermore, Phoenix expects to generate at least £3.2bn in cash over the next four years and a further £8.8bn after 2024. The company distributes around half of the cash generated in dividends each year while the stock currently yields over 8%. The completion of the ReAssure deal during 2020 will further enhance a number of these financial characteristics.

Outlook

As is well known, markets dislike uncertainty more than anything else. And the nature of this crisis, makes anticipating the trajectory of the path through the fog more difficult than usual. However, as stated above, we still assume that there is likely to be a recovery during the second half of the year following the heavy fall in economic activity. Other commentators have a much more cautious view than that, and they may be right if severe social distancing measures remain in place for many months. However, it seems more likely that these measures will be progressively lifted over time as antibody testing and immunity increases and as the debate about the economic cost versus the human cost intensifies.

Clearly corporate performance is being severely affected by this event. In addition, political and regulatory pressure has risen materially, particularly in respect of shareholder distributions. We are proud of the Fund’s dividend growth record since its launch in 2004, but 2020 will see a significant fall, as highlighted above. However, the highly unusual nature of the social and business lockdowns means that we will look through short-term earnings and dividend shortfalls and keep focused upon the 2021 valuation agenda, in particular. In some cases, this will mean adding to our positions in stocks that have suspended dividend payments, if we believe the shares have material upside and will return to paying dividend distributions in 2021 or the latter part of 2020. We believe that is the best strategy to maximise returns for our unitholders and was a strategy we successfully adopted in 2008/9.

Prior to this crisis developing, the UK economy in particular was showing clear signs of an economic acceleration after the clarity of the election result. With the country entering March at full

employment, if the crisis does turn out to be contained in terms of its duration, it is entirely possible that the economy returns to growth sooner than many commentators fear. The cost of the crisis in terms of the larger debt burden will need to be addressed in due course. Other economies will recover at different rates depending upon their own specific circumstances, with China probably leading the way, ironically. Furthermore, we also should not lose sight of how poorly value-orientated strategies had performed prior to this crisis, with the starting point valuation on many of our core stocks and holdings very undemanding, even before the heavy falls seen in March. As we experienced in 2009, many of these stocks and other potential new names will have substantial recovery potential over the next few months if the uncertainty begins to fade.

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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