Professional Investors Only

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Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: April 2021

Active sector bets for the month ending 31 March 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.80	3.47	+7.33
Industrial Metals and Mining	14.52	8.11	+6.41
Media	8.04	2.88	+5.16
Household Goods and Home Construction	6.22	1.80	+4.42
Banks	11.63	7.86	+3.77

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.56	-7.56
Closed End Investments	0.00	6.62	-6.62
Beverages	0.00	3.41	-3.41
Travel & Leisure	0.70	4.09	-3.39
Tobacco	0.00	3.37	-3.37

Active stock bets for the month ending 31 March 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.78	0.70	+3.08
Legal & General	3.81	0.74	+3.07
Phoenix Group	3.22	0.17	+3.05
Barclays	4.45	1.43	+3.02
Vistry Group	3.09	0.11	+2.98
Anglo American	4.51	1.54	+2.97
WPP	3.43	0.49	+2.94
BP	5.47	2.61	+2.86
Glencore	4.21	1.35	+2.86
ITV	3.05	0.20	+2.85

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Unilever	0.00	4.50	-4.50
AstraZeneca	0.00	4.17	-4.17
HSBC	0.00	3.83	-3.83
Diageo	0.00	3.03	-3.03
Royal Dutch Shell	1.96	4.80	-2.84

Performance to 31 March 2021 (%):

	1 month	Year to date	Since inception	Fund size (m)	Strategy size (m)
Fund – A Acc GBP	**5.94**	**12.90**	**288.50**	**£2,099mn**	**£2,484mn**
Lipper UK Equity Income mean*	4.81	6.66	176.08		
FTSE All-Share TR Index (12pm adjusted)	3.73	5.40	192.64		

Discrete 12-month performance (%) to:

	31.03.21	31.03.20	31.03.19	31.03.18	31.03.17
JOHCM UK Equity Income Fund – A Acc GBP	**49.88**	**-29.51**	**-0.92**	**7.25**	**24.33**
FTSE All-Share TR Index (12pm adjusted)	28.76	-19.06	5.93	1.36	21.88

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

Once again, the stand out feature this month was the further rise in government bond yields, with the US 10-year Treasury yield rising by another 30bps to 1.73%. Rises in European yields (including the UK) were more subdued, due to further short-term lockdown measures on the Continent. The increase in US yields was partly attributable to the growing evidence of a rapid recovery as mobility restrictions are eased, of which more detail below. However, we believe that many market participants have failed to recognise the significant change in policy from the Federal Reserve. This reduces the emphasis on controlling inflation at the expense of targeting full employment, in an attempt to tackle income and wealth inequality, which has had even greater focus during the pandemic. This radical shift in priorities is best encapsulated by a series of speeches given by Lael Brainard, a member of the Fed's Board of Governors since 2014:

"Monetary policy will remain accommodative in order to achieve inflation above 2% for some time."

"Maximum employment is a broad based and inclusive goal."

"We will not tighten monetary policy solely in response to a strong labour market. Pre-emptive tightening risks an unwarranted loss of opportunity for many of the most economically vulnerable Americans. It may curtail progress for racial and ethnic groups that have faced systematic challenges in the labour force."

Lael Brainard – Peter McColough Series on International economics, New York, 2 March 2021.

It is very clear that both the Fed and the Biden administration's priorities are aligned in an overtly socialist manner – to address income and wealth inequality head on via fiscal policy, as seen with emergency support cheques and infrastructure spending bills, as well as materially relaxing inflation targeting priorities. Given this backdrop, we are very likely to see inflation expectations continue to rise and medium and longer-dated bond yields push higher.

At the same time, the widespread evidence of a strong economic recovery adds further fuel to this debate. With unprecedented levels of government fiscal support, accommodative central banks, the progressive relaxation of Covid restrictions in the US and UK and enormous quantities of forced savings and pent up demand, we have seen a series of very strong economic indicators over the last few weeks. In the US, the Philly Fed survey registered its highest reading since April 1973, with the new orders balance +27.5pp. The Conference Board consumer confidence survey saw its biggest increase in 18 years. Most of the real time data points suggest very strong activity levels in recent weeks, particularly in areas such as airlines, hotels and hospitality, particularly in the southern states.

With vaccination progress in the UK similar to the US, we have seen many similar readings. Consumer confidence hit its highest level in 12 months; retail sales were actually up 2% in February despite the lockdown; the March composite PMI was 56.6; employment, as measured by PAYE tax receipts, has grown by 200,000 in the last three months; mortgage approvals were +19% in February; UK Government borrowing for the current fiscal year is running £70bn better than the Office of Budget Responsibility's projections, helped by high tax receipts. All of the above, combined with feedback from management meetings with a number of our more domestically focused companies, suggest to us that the economy is operating much more robustly than the official GDP data suggests, and that we will continue to see post-event upgrades to those figures. Indeed, despite the country being in hard lockdown in February, the economy looks likely to have been flat or even grown modestly during that month, with very strong momentum building into March and beyond. The archaic way that the UK calculates GDP continues to make the situation look worse than it is; for example, the "fall" in education output (due to schools being shut) in January contributed to 1% of the 2.9% contraction in January GDP.

Elsewhere in the world, the delays in vaccinations and extended lockdown restrictions are likely to push the Continental European economic recovery into the second half of 2021, although the March PMIs still registered growth. China's PMI data also remains above 50, with accelerating growth from the services sector, a blueprint for other parts of the world.

Performance

Market dynamics were conducive in March and the Fund performed very well across the month, with a return of 5.94% compared to an index return of 3.73%. Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector for February and is similarly placed year to date. On a longer-term basis, the Fund is ranked third quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

We have previously talked about a confluence of three factors driving Fund performance. Firstly, the macro environment (this includes the recovery in GDP, inflation risk, bond yields rising, pent-up demand as a result of lockdowns and Covid-19 restrictions easing). This is driving the rotation from high valuation stocks to lower valuation names, from tech to the rest, from growth to value. Secondly, nearly every stock in the Fund being on the front foot, coming out of Covid strongly with consensus forecasts materially too low. Thirdly, ultra-low valuations after years of 'value' underperformance. These points were all evident in the performance trends in March.

Perhaps the most interesting is the second point, which was very noticeable in the month as we went through the results season. The majority of the reports were positive, either beating expectations or highlighting strategic developments that were positive. To give readers a feel for this, we have placed in the Appendix a sample of the news we had in the first week of the month. This covered six stocks (c.10% of the Fund) and included six beats (two which were unscheduled upside warnings) and two updated dividend policies, which exceeded expectations. The vast majority of the Fund has now reported results across the last six weeks, and the picture has been very positive. This is driving Fund performance, with stocks like **Vistry** (up 25% relative to the Fund's benchmark), **DFS** (up 16% relative), **ITV** (up 12% relative and **Sthree** (up 10% relative) being good examples. Many of the stocks at the forefront of this theme are domestic UK names, which feeds into the comments above regarding the improving economic picture in the UK.

Elsewhere our financials largely did well, helped by the improving macro picture as well as good results. **Barclays** (up 10% relative), **Aviva** (up 7% relative) and **Standard Chartered** (up 5% relative) stood out. On the negative side **Standard Life Aberdeen** fell after a strategy update. Whilst very credible, the strategy is back end-weighted in terms of financial delivery, and the market took a 'wait and see' approach. The 10% fall (in relative terms) is actually equivalent to a more than 20% fall when we strip out the quoted stakes the company owns and excess capital – all of which stayed relatively constant across the month. Our non-life insurers were also weak, with **Conduit** and **Randall & Quilter** both down 5% relative.

Drax (up 10% relative) performed well as the market started to understand the strategic pivot the company has made away from coal and gas towards biomass and clean energy. It was also included in a clean energy index which moved it up.

The one area of weakness in the Fund after a strong run was the oil and mining sectors. **Petrofac** performed poorly after further negative news relating to a historic regulatory matter.

Portfolio activity

With market dynamics continuing to shift in March, we made a number of adjustments to the Fund. We finished selling **National Express**, which we had re-acquired in the post-Covid placing in Q2 last year. After a weak period following the placing (its shares halved at one point), it has rallied strongly and is now 33% above the placing price and nearly 70% above our average entry price. The stock is now fully valued and we sold it on valuation grounds. The fundamental recovery should be very strong and it will move back onto our watch list, should the share price fall. The stock contributed over 50bp of relative performance during this period of ownership.

Several of our top active positions were strong, which meant we had to reduce to keep the holdings around the 300bp mark; Vistry, Barclays, ITV and Aviva all fell into this bucket. These large active positions performing well is one of the reasons the Fund is continuing to recover. All four of these names, despite enjoying share price rises, continue to look too cheap in our view. Aviva, for example, is on a P/E of 7x, a yield close to 6% and is expected to return c. 20% of its current market cap back to shareholders over the next two years, while Barclays remains on a steep discount to book value at c. 0.6x.

Following the sale of National Express and **SSE** (see last month's update for details), there are no stocks in the Fund that are flashing red on a valuation basis. Reductions in weights elsewhere were therefore stocks that have less upside than the Fund's average. Stocks that fit into this category include **Tyman** and **Countryside**. We also continue to gently trim **Lloyds** at its new post-Covid highs, moving the proceeds into **Natwest Group** and also Standard Chartered and **Paragon**, which were weaker in the month.

We have a strong pipeline of new ideas that we have fully assessed from a fundamental perspective. Four of these are clear 'buys'; we are just waiting for the right entry price. We will highlight these over the next few months as we are able to start new positions – although this will depend on their share price trajectory. Each of the four stocks currently in this 'waiting room' bucket are market leaders in their industries, have strong management teams, good balance sheets and have, by our calculations, between 40-100% upside.

Within the Fund there were a number of laggards which we added to, namely **Diversified Gas & Oil**, the food retailers in the early part of the month, the banks noted above and Standard Life Aberdeen.

We also added to last month's new addition, **National Grid**. During the month it announced it would accept a one notch debt downgrade (which is very sensible given the cost of debt), rather than change the dividend policy or raise additional equity. This removed the near-term downside risk we discussed last month. It also announced three major transactions involving the sale of gas distribution assets and the acquisition of electricity distribution assets. This is a positive pivot from an ESG and green energy perspective. It is now just under 1% of the Fund. We also continued to add to our other recent addition **Bellway**.

Fund dividend

There has been some scepticism around the prospect for dividend growth in 2021. For example, the widely quoted Link Asset Services Dividend Monitor indicated in January a best case of c. 8% growth and a worst case of a small fall in 2021 versus 2020.

In contrast, in January, we indicated we were forecasting growth of 37% in 2021 on a cash dividend paid basis. We are now at the end of the 2020 full-year reporting cycle and have updated our dividend forecasts at a stock level. Whilst we will not change our formal guidance at this stage, we can say that our detailed analysis suggests a slightly higher growth rate. This is positive.

Some context to the drivers of this are:

- The mining sector has outperformed our dividend forecasts as rising commodity prices, no material capex increases and modest debt all contributed to higher dividends. This is likely to remain a trend;
- Banks, in contrast, delivered in line with our forecasts for capital return, but two of our holdings (Barclays and Standard Chartered) decided to pay an element of the capital return via buybacks (due to their boards' view of low valuations), which reduced the dividend element;
- **Morrison's** paid its normal dividend, but indicated consideration of the special dividend (which had become a semi-annual event over the last few years) would become an annual event (which pushes the related cashflow to 2022);
- A small number of UK domestics that did not repay furlough decided, as a result, they should not pay a dividend for the 2020 final (which financial performance would have justified) but would wait for the 2021 interim.

All of these factors are either positive or are merely a delay as opposed to a permanent diminution in dividend flow. The latter will, in our view, boost dividend growth in 2022 and beyond.

There is another dynamic at work. As the Fund has started to perform better, we are selling stocks on value / yield grounds and rotating into new names with higher yields (e.g. National Grid). This process creates dividend growth at a portfolio level. In the life of the Fund, prior to Covid-19, we estimated this added 2-3% p.a.

The trajectory of the recovery in the Fund's dividend will be affected by a more material calendar effect than normal in 2021. With most of our companies having a December year end, they have been declaring their 2020 fiscal year final dividends in Q1 2021, during what should be the last material phase of the pandemic before vaccinations take effect. Consequently, the normalisation will partly occur in 2022 when the 2021 finals are paid. This is compounded by the fact that for many companies two thirds of their annual dividend is paid at the final stage. Therefore, the difference between what companies declare as their fiscal year 2021 dividends and what they physically pay during 2021 is likely to be abnormally large.

The 37% growth forecast mentioned above is based on the expected cash dividends to be received in 2021. If we look at our fiscal year 2021 forecast dividends (which include the final dividends which will be paid in the first part of 2022) versus fiscal year 2020, we currently (as we did in January) expect around c. 60% growth.[1] The Fund dividend growth should therefore continue to be strong in 2022 and 2023.

Within the year, we expect the calendar Q1 dividend to fall year-on-year (c. 24%), before growing strongly from Q2 onwards (including a more than doubling of the Q2 dividend year-on-year). Based upon the growth of 37%, the Fund dividend yield for 2021 is projected to be 3.7% and using the 60% growth, including the full calendar effect, it would be 4.3%.

Outlook

Recent conversations with unit holders and other interested parties have centred around the key debate – have we now seen the value rally, driven by vaccinations or is there more to come? Hopefully, in this paper, we have given ample evidence to suggest that the shift in stock market leadership away from growth/momentum styles towards more valuation-aware processes has much, much further to run. Central to this debate is the issue of inflation. Many market participants believe that any pick-up in inflation will be largely driven by the lapping of a weak economy 12 months ago, and as such will be short-lived before longer-term structural dynamics driven by technology and demographics return to dominate. Whilst this is a possibility, we see it as much more likely that inflationary pressures are much more longer lasting than that.

As we pointed out in the first section, the Fed has radically changed its policy priorities, driven by a strong desire to reduce income and wealth inequality. Such a change is a huge regime shift from the last 30-40 years and will also be supported by the Biden administration's levelling-up agenda.

[1] The main reasons for the decline in our forecast from 69% growth (stated in our July dividend paper) to 60% growth now are: (a) a strengthening of sterling (versus the US dollar) – this has moved from c. £1/$1.27, to £1/$1.36, reducing growth by c. 2-3%; and (b) the decision by all food retail companies to repay rate relief, which in the case of WM Morrison meant no special dividends (which have been an annual feature for the last few years) in 2021; this has a 2% impact, albeit a one-year impact as this should flow back in 2022.

Similar principles are at play elsewhere in the world, including the UK, where higher minimum wages and more generous pay settlements for key workers or employees in the gig economy are evident for all to see.

Furthermore, as the de-globalisation trend gathers pace, driven by the consequences of Covid-19, such as the risk of companies having geographically extended supply chains, by rising populism increasing the pressure for onshoring, and by specific events such as the Suez blockage or the UK/European spat over vaccine supply, the pressure on businesses to onshore activities will rise, which will have inflationary consequences.

At the same time the confluence of very large fiscal expansions, unprecedented amounts of pent up demand and forced saving and the progressive unlocking of economies, is likely to see a very sharp improvement in economies during the rest of 2021 and, in places, demand outstripping supply, with obvious consequences for the direction of prices. We are already seeing that in many commodity markets and that upward price pressure is now moving into the industrial/ manufacturing sector, too.

Lastly, as we have discussed before, all central banks and western governments would welcome a period of higher inflation as it would also help to reduce the real value of their debt burdens. With central banks likely to let economies “run hot” for some time, it is no surprise to see the medium and longer end of the bond market moving the most so far, but, in time, it is likely that the whole curve will move higher to reflect rising inflationary expectations.

These conditions are likely to periodically provide challenges to the overall level of stock markets, where many sectors have dined out on ever lower discount rates to justify ever higher multiples. However, for our pool of stocks, these conditions should prove extremely favourable, particularly for financials, commodity stocks and a number of other real economy sectors such as construction and media. Furthermore, with dividend payments on a clear path back to normalisation and with the UK market looking modestly priced compared to other international peers, and with a robust domestic economic recovery already under way, we believe the prospects look bright for our strategy.

Appendix – positive stock newsflow

Across March we had around half of the Fund’s holdings report results or provide trading updates. In this section we have placed comments we made internally when c. 10% of the Fund (six stocks) reported in the early part of the month. We had six beats (two were unscheduled upside warnings) and two updated dividend policies which exceeded expectations. This snapshot will give a feel for the positive dynamics being reported across the Fund.

The six stocks reporting in that period are listed below with a brief description of the news to give a feel for the momentum, valuation and upside potential.

Norcros – a small-cap building product supplier. It warned to the upside in an unscheduled update. Like-for-like sales were up 17% for the four months to the end of February, remarkable considering this was prior to the spread of Covid-19 last year. How did it achieve this? As a result of two of our key themes: 1) it is a market share gainer due to its strong brands; and 2) it benefited from the Covid-19-induced spending shift as consumers focus more on their homes. In our view, both these trends will endure. It has also de-levered across the Covid period and is now close to being debt neutral. It is likely to focus on acquisitions which will be very accretive. The stock is on a P/E of 9x forecasts that remain too low.

Aviva – a large-cap insurer. Its full-year results were positive, and it announced the sale of its Italian business. This follows on from the sale of its Singapore, France and other operations executed since the new CEO took over in May last year. This has led to the gearing being reduced and lays the grounds for a £2-3bn buyback in H2 2021/2022. Results were better than expected. The analyst presentation was strong, with the focus on what is left in Aviva after the asset sales. The stock trades on a P/E of 7x and a yield based on our dividend per share forecasts of c. 6%.

Morses Club – a small-cap lender. It warned to the upside in an unscheduled update. The recovery from Covid has been quicker than expected. It also confirmed it would be paying a dividend in the current fiscal year. The stock is on a P/E of less than 10x on forecasts that are likely too low.

Galliford Try – a small-cap builder. Its profits were slightly higher than expected, and it announced a new, better dividend policy. The stock trades at less than its average cash position, never mind the profits it will produce and PFI stakes it owns.

Tyman – a small-cap (close to mid-cap) global building products manufacturer. Results were 10% better than forecast, with profits only down 5% in 2020. Again, this was an amazing achievement given Covid, with evidence of market share gain coming through. The company was also at the more indebted end of the Fund (c. 1.8x net debt to EBITDA) as we came into the pandemic, but ended the year at a very comfortable c. 1x net debt to EBITDA. It also reinstated its dividend. Forecasts on a constant FX basis were upgraded by 7%, but this was offset by an FX downgrade (the latter impacts the parts of the market the Fund does not own due to the move in sterling, which is a large relative performance help). This is the most expensive of the stocks in this appendix as the share price has fully recovered – up 50% on our average purchase price but still on a P/E of only 12x, which is hardly expensive, in our view.

Vistry – a mid-cap housebuilder. Its full-year results were strong with earnings beating expectations, and it ended the year with net cash. Year-on-year sales in 2021 are up on last year (again comparing to pre-Covid), with prices up and momentum accelerating. The CEO acquired 500,000 shares following its results. The stock trades on a P/E of 7x forecasts that are too low. The company also announced a new dividend policy of 1.75x cover, which is better than we expected.

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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The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

Investments fluctuate in value and may fall as well as rise. Investors may not get back the value of their original investment.

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

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