Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: May 2023

Fund Overview

- The Fund aims to generate long-term capital and income growth through active management of a portfolio of UK listed equities.
- Established income investors James Lowen and Clive Beagles abide by a strict dividend yield discipline, which leads to an emphasis on higher-yielding stocks and promotes a naturally contrarian style.
- The Fund will typically have significant exposure to small and mid-cap stocks, often giving the portfolio a different holdings profile to many other income funds.
- Benchmark: FTSE All-Share Total Return Index.

Active sector positions as at 30 April 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.13	2.69	6.44
Construction and Materials	7.62	1.55	6.07
Household Goods & Home Construction	6.66	1.11	5.55
Banks	13.53	8.76	4.77
Industrial Metals and Mining	10.60	6.26	4.43

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.82	-10.82
Personal Care, Drug and Grocery Stores	0.00	7.85	-7.85
Closed End Investments	0.00	5.93	-5.93
Beverages	0.00	3.68	-3.68
Tobacco	0.00	3.48	-3.48

Active stock bets as at 30 April 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix	3.21	0.18	3.03
Barclays	4.04	1.05	2.99
Vistry	3.09	0.11	2.98
Bellway	3.10	0.12	2.98
Aviva	3.45	0.49	2.96
NatWest	3.48	0.59	2.89
DS Smith	3.04	0.16	2.88
Glencore	5.32	2.46	2.86
Standard Chartered	3.43	0.62	2.81
ITV	2.79	0.13	2.66

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
HSBC	1.78	4.80	-3.02
Diageo	0.00	3.34	-3.34
Unilever	0.00	4.63	-4.63
Shell	2.35	7.10	-4.75
AstraZeneca	0.00	7.21	-7.21

Performance to 30 April 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**0.98**	**2.02**	**334.20**	**1,645**	**1,957**
Lipper UK Equity Income mean*	2.27	4.17	215.97		
FTSE All-Share TR Index (12pm adjusted)	2.52	5.41	247.24		

Discrete 12-month performance (%) to:

	30.04.23	30.04.22	30.04.21	30.04.20	30.04.19
JOHCM UK Equity Income Fund – A Acc GBP	1.97	6.50	41.22	-25.85	-4.38
FTSE All-Share TR Index (12pm adjusted)	5.57	8.67	22.59	-14.76	2.34

Past performance is no guarantee of future returns. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus. 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

In many respects, markets continued to stabilise after the short-term disruption caused by the issues in the US banking industry in March. UK 10-year bond yields rose 25bps, back to the level they were prior to Silicon Valley Banks' (SVB) unravelling and across Continental Europe they increased by 10-15bps. The geographical outlier in many respects was the US, where 10 year yields remained flat at 3.47%, and it's noteworthy that they are 25-30bps lower than the UK 10 year equivalent. Investors will have their own views as to why that is, but in many respects, it may well reflect a growing view that the US economy is less likely to be in the vanguard of global growth than it has been in the last decade. Q1 GDP was close to 1% annualised, but the inflationary picture is somewhat mixed, with input costs declining as witnessed by the weakening PPI goods print of 3.2%, its lowest level for two years, but a stronger core PCE (personal consumption expenditure) reading of 4.6%. There are tentative signs that the worst of the falls in housing activity may be behind us, with new home sales up 9.6% month-on-month. However, the Conference Board's consumer confidence index fell 3 points to 101.3, the lowest reading since August 2022.

In contrast, economic data in the UK and Europe has generally continued to be a little firmer than expected. Whilst Eurozone GDP growth was only 0.1% quarter-on-quarter, it was much more robust in Southern Europe, where it was 0.5% in Spain and Italy. European consumer confidence readings were at their highest levels since the invasion of Ukraine, helped by resilient labour markets and softening gas prices. Inflation readings have been mixed, with some countries exhibiting a modest acceleration this month which is likely to keep the European Central Bank (ECB) on the hawkish side.

In the UK, the Citigroup economic surprise index hit a one year high driven by various positive readings, like those seen in Europe. These included GFK Consumer confidence hitting a one year high, the CBI's April Industrial trend survey showing business optimism 3 points higher and investment expectations at +14 vs +8 last quarter. The services PMI Index hit an 11-month high, backed up by some robust trading updates from many bellwether consumer exposed stocks in the UK, such as Whitbread and **EasyJet**. Activity in the housing market has continued to recover, with March transactions 26% higher than February and although retail sales volumes were down 0.9% month on month, the extraordinarily wet weather clearly had a negative impact. Volumes were still 0.6% higher over Q1. The UK labour market is exhibiting some interesting developments. Whilst unemployment has risen slightly to 3.8%, more people have re-entered the labour force, particularly those over 50 and students. This increased participation rate is exactly what the economy needs to expand and will also help limit wage inflation, with the rolling 3-month growth rate slowing to its lowest level for a year, despite all of the industrial action. Employment growth has actually increased by 1.25% in the last three months.

Inflation in the UK has come down less quickly than expected, with CPI staying above 10% this month, driven mainly by food price inflation of almost 20%. However, next month will see the 40% increase in gas and electricity prices drop out of the annual comparator, and as such, it will fall to between 7-8% in April, with a likely resumption of real wage growth by the end June.

Chinese economic data has generally been strong as the economy re-opens. However, this has been more obvious in the consumer part of the economy, with the PMI Service Index at 57.8, a three year low and retail sales rising 10.6% year-on-year. However, the recovery has been more subdued in the industrial complex, with industrial production climbing only 3.9% year-on-year and this slower pace of recovery has been part of the reason that some commodity prices have been softer in April, with iron ore down around 15%.

Performance

Markets started to regain poise in April, following a difficult month in March dominated by news flow around SVB and Credit Suisse. The UK FTSE All Share was up 2.52% and the Fund, whilst up 0.98%, underperformed the market. Year-to-date, the Fund is up 2.02%, whilst the FTSE All Share is up 5.41%. Looking at the peer group, the fund is ranked 4th quartile within the UK Equity Income sector year to date. On a longer-term basis, the fund is ranked 1st quartile over three years, 3rd quartile over five years, 1st quartile over 10 years and remains the best Fund in the sector since inception in 2004.[1]

Despite a better tone at the overall market level, there was still a 'risk' off mentality at a sector/stock level, which lasted until the last few days of the month. Defensives we do not own, like Astra Zeneca and Diageo, were a headwind to the Fund's relative performance.

Banks, to varying degrees, started to recover from March's events. **Barclays** was up more than 10% relative, helped by strong Q1 results, and in Insurance, **Phoenix** started to perform better. There are many performance anomalies across the financial sectors which we expect to iron out as things settle down (**TP ICAP** and **Paragon** were weak – see comments in *Portfolio Activity* section).

Drax performed well despite not being included in the UK government's Track 1 list for carbon capture. Management provided a strong trading update, the announcement of a share buyback and the message that they are engaged with the government to be fast tracked later this year on carbon capture were positives.

Domestic stocks troughed in September 2022 and continued to make progress during April. Bellway (up 12% relative) and Kier (up 11% relative) were notable features. In the financial sector, there remain anomalies, particularly amongst small caps across domestic sectors. Currys continued to be sluggish. We have written to the board to suggest they sell ID Mobile, its mobile virtual network operator with more than one million customers. This business is not core to the retail operations and, in our view, is worth c.£300m (which is half of the total market cap of the business). Such a move would highlight value in the core, strengthen the balance sheet, and remove the crisis of confidence around the stock.

The main drags on performance during the month were the mining sector, with Central Asia Metals and Anglo American particularly weak (down 20% and 10% relative, respectively). Most of the oil sector was also sluggish.

[1] Source: Lipper

Portfolio activity

Sell ideas remain challenging, given the market's valuation dynamics, which we discuss elsewhere in this report. Most of the reductions this month were 'housekeeping' in nature. We marked **Phoenix**, which started to pick up towards the end of the month to 300bps, our maximum overweight position.

As noted above, certain domestic stocks have also started to perform well. Two of our three contracting stocks began to outperform – **Costain** and **Kier** – both moved above our target weights and were marked accordingly. In the housebuilding sector, **Bellway** has recovered strongly, up 50% since the Truss budget and we top sliced slightly to keep that weight in check. Bellway, at c.0.8x book value, remains cheap. It also launched a new share buyback during the month. We also lowered our target weight in **Conduit**, reflecting its strong share price performance and the continued recovery in sterling, which reduces the value of this US dollar asset. Finally on reductions we top sliced **First Group**, which performed well.

We noted last month we had added one new stock, which we now highlight, having built it to a c.40-50bps position. We will continue to build this holding, **Marks & Spencer's** (MKS), as we see results and capital allocation decisions made. We sceptically approached our assessment of MKS given its history and our (negative) preconceptions given that history. What is under the bonnet, once assessed, is very different. The market capitalisation of MKS is materially lower than a straw poll would think, just c.£3bn. Part of this is driven by the more comprehensive valuation points we make about the UK market in this report and part is driven by the perception issues just noted. Under the bonnet, it is clear (a) the new management has made a noticeable and material impact strategically and operationally (we would encourage very interested readers to watch the 90 minutes capital markets event by the new team from Q4 last year), (b) the over-spacing issues have been addressed; when the current plan is finished there will be just 180 mainline (non-food) MKS stores in the UK, (c) both sides of the business are taking market share – from Waitrose in Food, from John Lewis and the historic closures of Debenhams, Arcadia etc on the clothing side, (d) there are clear margin targets on both sides of the business that are realistic, (e) the balance sheet is now strong, (f) forecasts, in our view are too low and (g) we expect the Company to reinstate the dividend in the next 6-12 months. Our normalised earnings are c.30p a share compared to a share price of around 160p. MKS also own 50% of Ocado UK, which is not in this earnings number.

There were several laggards which we also added to; **DFS**, which in its most recent communication highlighted a market share of 40%, **Ibstock**, which has not rallied with the housebuilders, recent addition **Energean** and a number of mining names, including **Central Asia Metals**.

Finally, we added to **Paragon**, which is a long standing position. We attended a group event with management during the month, which highlighted the strength of the balance sheet and funding position (no SVB related impacts), the upside to the business when they are permitted by the PRA to use their internal model for capital calculations (due in 2024), the growth prospects across the business lines and the valuation; close to book value vs a return on capital profile of 15-16%, a P/E of 6 and a yield of 6%.

Outlook

Whilst concerns about escalating problems in the banking sector diminished during the month, investors are still very cautious on future economic developments. Whilst equity markets overall have proven resilient, the leadership within developed markets has been dominated by defensives, which we continue to find surprising. Higher interest rates should drive multiple compression for many of these sectors and we do not believe that process is anywhere near complete. In contrast, valuations elsewhere in sectors that have a degree of exposure to the economic cycle look very undemanding. These low multiples may reflect confusion about the direction of leading economic indicators. Whilst the broader economic picture in the USA continues to weaken and is potentially challenged by higher rates and leverage, in the UK and Continental Europe, economic performance has been more robust than had been feared six months ago and are we likely to see inflation rates fall over the summer.

However, we believe investors are far too focused on trying to anticipate each twist and turn of global macro developments and are in danger of missing how startlingly low many stocks' multiples are in the UK stock market. The decline of UK valuations relative to global peers has been well discussed in many places over the last few months and April has seen a resurgence in corporate activity for UK listed stocks, with private equity and industrial operators taking advantage of the embarrassing multiples on offer. Unless the valuation gap closes, we can only see an acceleration in the number and potential scale of the companies leaving the UK quoted arena at high premiums to current share prices. Why should BP trade at a more than 40% discount to Exxon? Why are the UK banks set to return 40-50% of their market capitalisations in shareholder returns over the next three years and yet trade on 4-6x earnings and large discounts to book? Why do mid and small cap stocks like Redde and Lookers trade on 6-7x earnings despite delivering a series of upgrades over the last 18 months? Why do building contractors like Kier, who are well placed to benefit from the UK's infrastructure and low carbon boom trade on 4x earnings? More broadly, why does a well-diversified fund such as ours, with 60 discrete holdings, sit on the second highest dividend yield in its near 20 year history, despite having lower leverage across the portfolio than we have seen before and the highest dividend cover? We continue to ask these questions, which many market participants seem oblivious to. We feel optimistic about the future returns on offer from our Fund.

Further information

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