Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: May 2024

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 2024:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction and Materials	9.70	0.43	9.27
Life Insurance	9.21	2.17	7.04
Banks	15.24	9.65	5.59
Industrial Metals and Mining	9.82	6.64	3.18
Retailers	4.17	1.51	2.66

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	11.35	-11.35
Closed End Investments	0.00	6.14	-6.14
Personal Care, Drug and Grocery Stores	1.46	7.02	-5.56
Aerospace and Defence	0.00	3.77	-3.77
Beverages	0.00	2.89	-2.89

Active stock bets as at 30 April 2024:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
NatWest	3.67	0.68	2.99
Barclays	4.20	1.27	2.93
Aviva	3.40	0.53	2.87
Phoenix	3.01	0.15	2.86
ITV	2.98	0.11	2.78
Standard Chartered	3.34	0.62	2.72
DS Smith	2.75	0.19	2.56
BP	5.96	3.62	2.34
WPP	2.69	0.35	2.34
Legal & General	2.81	0.58	2.23

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
HSBC	2.65	5.30	-2.65
GSK	0.00	2.79	-2.79
Unilever	0.00	4.23	-4.23
Shell	1.71	7.78	-6.07
AstraZeneca	0.00	7.37	-7.37

Performance to 30 April 2024 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**4.73**	**10.53**	**398.60**	**1,604**	**1,894**
Lipper UK Equity Income mean*	2.79	5.34	240.44		
FTSE All-Share TR Index (12pm adjusted)	3.19	6.73	278.59		

Discrete 12-month performance (%) to:

	30.04.24	30.04.23	30.04.22	30.04.21	30.04.20
JOHCM UK Equity Income Fund – A Acc GBP	14.83	1.97	6.50	41.22	-25.85
FTSE All-Share TR Index (12pm adjusted)	9.03	5.57	8.67	22.59	-14.76

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

The prospect of divergence in economic policy between the Federal Reserve (Fed) and the Bank of England (and the European Central Bank (ECB)) came firmly into view this month. In the US, investors have progressively removed the anticipated interest rate cuts during 2024 as most measures of inflation have proven to be stubbornly persistent. This month, the CPI nudged higher again to 3.5%, and the measures of Personal Consumption Expenditure were also modestly higher than expected. Interestingly, this happened at the same time as US GDP decelerated and the US savings ratio fell below 4%, suggesting a degree of exhaustion by US consumers. Lastly, the US's composite PMI reading fell back to 50.9, its lowest level for five months. So, despite evidence of slowing economic activity, the Fed may well have to sit on its hands for a while unless inflationary pressures reverse swiftly. Consequently, US 10-year bond yields rose by around 40bps to 4.6% during the month.

In contrast, the inflation rate in the UK continues to decelerate, falling to 3.2% in March, although this was marginally higher than expected. This is less than half the rate in September, with goods inflation below 1% compared to a peak of 15% in October 2022. Services inflation has been slower to decline, recording 6% this month, principally driven by continued wage inflation of a similar magnitude. Next month, UK CPI will fall significantly again towards 2% as the 12% reduction in OFGEM's price cap kicks in. Consumers and businesses have begun to respond to the lower inflationary environment, with consumer confidence hitting another 2-year high with the 5 point increase in the reading for Future Major Purchases, a standout feature of the survey. The Lloyds Business Barometer sits very close to a 2-year high and the UK's Composite PMI survey came in at 54, a level which usually indicates quarterly GDP growth of c.0.4%. Strikingly, the UK registered the highest PMI reading of any of the G7 countries, closely followed by Italy and Japan, with the US the only country showing a slowdown. UK Corporates have also begun to see a more positive tone, with the well-respected Next CEO stating that the UK consumer outlook was the most positive since 2019, whilst the NatWest CEO last week stated that "confidence is definitely better and that is translating into customer activity". With the UK savings ratio sitting at around 9.5%in sharp contrast to the US's less than 4%ratio , it is easy to see why businesses see an improving outlook.

This nascent pick up in UK economic activity provides the Bank of England with a conundrum. Inflation returning close to target next month allows, in principle, the process of monetary easing to begin, but with all lead indicators suggesting a resumption of growth has already started, there may be some temptation to sit on their hands. However, part of the reason activity has started to pick up is because consumers and businesses are expecting some interest rate cuts in the next few months and a failure to deliver those could stall the recovery. As such, we anticipate split opinions across the nine MPC members, which has been reflected in speeches made by individuals such as Ramsden and Pill this month which had different tones. The economy probably only needs a couple of rate cuts to trigger a meaningful acceleration in consumer spending, but the window of opportunity to deliver those cuts is relatively narrow.

The ECB is also likely to differentiate itself from policymakers across the Atlantic, with Lagarde firmly stating that "we are not Fed dependent." PMI surveys are also picking up across the Continent but in a more subdued fashion as the manufacturing sector continues to see patchy demand from China in particular. As such, monetary easing may well commence before the end of the second quarter.

Performance

The UK stock market's strength continued in April (with the FTSE All Share up 3.19%). Within this overall positive trend, the change in market leadership that has been evident since November continued, benefiting the Fund. The latter was up 4.73%, outperforming the market by 1.49%.

Year-to-date, the Fund is up 10.53% compared to the market, which is up 6.73%.

Looking at the peer group, the Fund was ranked in the 1st decile within the UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked 1st quartile over three years, 2nd quartile over five years, 1st quartile over 10 years and is the best Fund in the sector since inception in 2004.[1]

The leadership change has been driven by a confluence of positive factors - lower inflation, a modest uptick in UK economic activity, an acceleration in M&A activity and strong company results. This shift has led to a performance reversal of the previously strong defensive sectors, which we believe are still overpriced and where earnings blips are starting to occur. Conversely, cyclical sectors, such as the financial and commodity sectors (i.e., where the Fund is present), are now outperforming.

The valuation gap was so large that the moves since November should be seen as the foothills of the potential that could feed through over time.

The Fund benefited from M&A activity this month. The BHP bid for **Anglo American** led to a sharp rise in the latter (up 39% relative), whilst **Tyman** rose (up 28% relative) following its agreed bid from Quanex. The third bid the Fund received was for **Hipgnosis**, which was up 50% relative. We'll discuss our view on each of these in the next section. Last month's bid for **DS Smith**, fell after Mondi pulled out of the process, leaving DS Smith and International Paper to continue with the planned merger uncontested. Overall, these factors contributed to an increase of more than 100bps in fund performance.

The banking sector continued to perform well, particularly **Barclays** and **Natwest**, after delivering well-received quarterly results. Mining, across the sector, performed well, with the continued increase in copper price. The other notable performance trend was seen in small caps; **Severfield** (up 22% relative) rose following a strong trading update that lifted forecasts and became the latest stock to join the share buyback list and **Costain** (up 10% relative) moved to a post-Covid high.

On the other side of the ledger, our two bus/rail companies underperformed; **First Group** disappointed after the Labour Party indicated they would gradually nationalise the rail operating companies as the contracts end. We already baked this into our valuation framework. Similarly, **Mobico** (formerly National Express) posted weak results following their failure to provide a timely delivery of their stated strategy to sell the US Student bus operation to de-lever the balance sheet.

[1] Source: Lipper

Ashmore was also weak as EM debt weakened as US rate cut expectations moderated. Housebuilders – which had arguably run to far earlier this year – were weak. We sold c.60% of our housebuilding holdings and rotated to other stocks in Q1. The insurance sector, even adjusting for ex dividends (which are large), was also sluggish.

Portfolio activity

As the Fund's absolute and relative performance moved forward, April was another active month for portfolio activity.

M&A was a notable feature during the month, as we highlighted above.

The competitive situation around **Hipgnosis** has allowed the stock to move above its original IPO price. As we have indicated previously, this stock had become an issue due to various factors (poor board governance, accounting issues, etc). We worked hard with other shareholders last year to replace the Board, who, once in place, created the platform for the sale of the assets. As the shares traded at a small premium to the latest offer, we sold around 60% of our holding. The takeover approaches have recovered the loss we had made on the stock. This example has some lessons (e.g. a focus on board strength) but also highlights how active engagement/focus can recover lost value.

We have several active M&A situations in the Fund. We'll make the following brief comments on two that were added to the list in April.

Tyman received an approach from the US-listed Quanex. While we were pleased to see an approach because it highlighted the value we see in the stock, we think the offer is c. 50-75p too low. An optimal exit price would be 450-475p per share in our view, which equates to c.12x normalised EPS, which we believe is fair for a market leader. We also note that a large part of the offer comes in the form of paper in Quanex, where flow back is likely to erode some of the headline value.

Anglo American received an approach from BHP valued at a c.20% premium, involving a convoluted structure to demerge the two listed South African businesses before the takeover. Coincidently, we met with the CEO and Financial Director of Anglo American in our offices a few hours before the news broke. As part of the preparation for that meeting, we did, as we do for all meetings, detailed valuation work, so the details, the drivers and the sensitivities were at the top of our minds when the news broke later that day. In our opinion, there are two issues with the BHP bid: 1) The valuation of the bid at c.£25 is (materially) too low. Anglo American has 7-8 world-class assets, which are relatively easy to benchmark/value. Copper represents c.50% of the value of Anglo American, with our central case sum of the parts 3000-3500p. This highlights the value gap compared to the offer. 2) The complex structure requires the spin-off of the two listed South African subsidiaries (Anglo Platinum and Kumba) before the takeover happens. The flow back from this will erode value. We would prefer that any bidder acquire the whole company and then restructure any assets not required over the medium term.

We decided to sell **Inchcape**. This high-quality business had a good trading update and sold its (non-core) UK retail business during the month. As we reviewed the full-year results material, it was clear average debt levels were higher than period-end debt levels, which, in our view, could and has impacted capital allocation decisions.

We also trimmed **Costain**, which has been strong, towards its target weight (c. 80bps). A number of stocks in the banking sector performed well, as noted above, and moved above our 300bps active position maximum and were trimmed – **Barclays** and **Natwest**.

The encouraging outcome of April is that despite the positive performance trend, many stocks are still firmly in 'add' territory. This included the insurance sector, which, in contrast to banks, remained sluggish (**Aviva**, **Phoenix** and **Conduit**), certain small caps (**Galliford Try**), **Marks & Spencer**, **ITV** and **First Group**.

We continued to build our holdings in the fund's two new additions – **Centrica** and **Morgan Advanced Materials**. The rationale for these additions was covered in detail last month (SEE HERE). Morgan Advanced Materials held a Capital Markets event during April, which upgraded revenue growth aspirations and gave a clear roadmap to a 15% margin. Combined, these would place the stock on a PE of c.5x.

In the oil sector, we switched part of our holding in **Diversified Energy** into **Energean** to equalise the weights.

As implied above, one of the issues is the capital tightness in the Fund. There are still materially more stocks to add to than to reduce, and every stock in the Fund has material upside. We constantly 'value review' all stocks the Fund owns to ensure the latter is the case. This month, one of the stocks we did a detailed review of was **Vodafone**, where there have been multiple transactions (selling assets, e.g. Spain, Italy), a change in dividend policy and improved disclosure around the non-operating assets they own. There is a lack of clarity in sell-side analysis due to the number of moving parts over the next few years. Looking at the proforma group, valuing the operating businesses on a 10% free cashflow yield and adding the value of the non-operating assets in – which at €10bn (mainly the tower assets) – is material, gets a target price of c. 110p (60% upside) – we added to our holding.

Outlook

In many of our interactions with investors over the last 18 months, we have had very little disagreement with our thesis that the UK market was cheap. However, a persistent refrain was 'What is the catalyst to change it?'. Well, in the last few months, catalysts have been stacking up like a line of aircraft waiting to land at Heathrow Airport:

- **Divergence of central bank policy** – rate cuts look more likely in the UK (and Europe) than the US in the next few months; this is particularly interesting given how much lower valuations are in the UK than in North America;
- **UK April PMIs were the strongest amongst the G7** countries and are moving higher as it is clear that inflation is returning towards 2%;
- **Not only has M&A activity picked up significantly in the UK**, but it is predominantly led by international corporates buying UK-listed stocks in the less popular, value-orientated sectors such as mining, paper and packaging, real estate, housebuilding, building materials and retail;
- **Companies are carrying out significant corporate actions** upon themselves to highlight and release value; ITV (selling Britbox International) and TP ICAP (announcing IPO of the data business) being two prime examples;

- **Whilst the Mansion House compact and the British ISA will not lead to wholesale asset allocation changes** by domestic investors, the greater focus upon the very low allocations to UK equities by tax-advantaged wrappers and funds is likely to lead to further policy action, with the Labour Party particularly engaged on this issue;
- **Momentum** – in the last two months, UK equities have shown they can go up, even when the US market is going down; this naturally attracts more interest.

There's a sense that the UK market's prolonged period in the investment wilderness is finally over and the example of Japan shows how dramatically appetite can change if the catalysts are there. However, we would encourage our investors to look at their current UK allocation and ensure it is invested in funds with a genuine 'Value' bias. Sadly, style drift has been a significant feature of the UK market over the last 5-7 years, and most funds have morphed into a ‘GARP/Quality’ growth style, which is unlikely to outperform in this new environment.

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