Professional Investors Only

J O Hambro Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: August 2017

Active sector bets for the month ending 31 July 2017

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction & Materials	7.29	1.51	5.78
Banks	15.89	11.37	4.52
Oil & Gas Producers	15.66	11.18	4.48
Financial Services	6.42	2.71	3.71
Life Insurance	8.34	4.75	3.59

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	6.11	-6.11
Pharmaceuticals & Biotechnology	3.43	7.55	-4.12
Equity Investment Instruments	0.46	4.37	-3.91
Beverages	0.00	2.84	-2.84
Personal Goods	0.00	2.60	-2.60

Active stock bets for the month ending 31 July 2017

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Rio Tinto	4.76	1.78	2.98
BP	6.55	3.60	2.95
Aviva	3.85	0.91	2.94
Standard Life	3.19	0.36	2.83
Lloyds Banking Group	4.74	2.00	2.74
Barclays	4.18	1.47	2.71
DS Smith	2.89	0.20	2.69
National Express Group	2.56	0.06	2.50
ITV	2.61	0.27	2.34
Brewin Dolphin	2.20	0.04	2.16

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.78	-4.78
GlaxoSmithKline	0.00	3.09	-3.09
Diageo	0.00	2.54	-2.54
Unilever	0.00	2.18	-2.18
Prudential	0.00	1.97	-1.97

Performance to 31 July 2017

	1 month (%)	Year to date (%)	Since inception (%)	Fund size
JOHCM UK Equity Income Fund	**2.01**	**10.10**	**265.30**	**£3,270mn**
Lipper UK Equity Income Mean*	0.26	6.82	164.59	
FTSE All-Share TR Index (adjusted)	0.62	7.43	168.70	

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 July 2016, the entire stock of Swiss government bonds were trading at negative yields, reflecting investors' collective nervousness about deflationary pressures across Continental Europe. Consequently, the significance of the fact that the key benchmark 10-year bond yield moved back into positive territory during the month should not be ignored. It reflects a growing sense of confidence in the European economic recovery, as well as markets readying themselves for a progressive withdrawal of monetary stimulus across the Western world.

In that regard, Janet Yellen's carefully chosen words about balance sheet "normalisation" indicate that the liquidity punch bowl will be steadily withdrawn during the second half of 2017 and beyond, so long as the economy continues to expand on its current trajectory. The Federal Reserve is clearly not going to be sidetracked by softer inflationary pressures in the short term.

In the UK, it is somewhat bizarre to hear Mark Carney and others bemoaning the high rates of growth in the likes of consumer credit and car loans; having resolutely stuck to their near-zero interest rate policy for a decade, what did they expect to happen? Once again, it is clear that the economy would be functioning in a much more orderly and predictable fashion if interest rates were higher. Shorter-term economic activity in the UK continues to be hard to read. Undoubtedly the election result and protracted Brexit negotiations have raised levels of uncertainty and in places that has led to consumers and corporates reining in their spending. Elsewhere, however, activity levels have held up – for example, the recruitment agencies Hays and SThree have both reported an improvement in recruitment demand in the last couple of months. With sterling continuing to trade close to its lows relative to the euro, the competitiveness boost should not be ignored, providing an escape valve against the other uncertainties. However, this currency weakness continues to push shorter-term inflationary pressures higher.

Commodity prices have risen in response to strong demand from Asia, including China. A lot of commentary in this area focuses upon the iron ore price, which rose significantly in July. The price of iron ore can be quite volatile and tends to respond to short-term steel demand changes in China. In many respects, however, the copper price is a more useful barometer as its end uses are more varied both by product and region. In that regard, it is noteworthy that the copper price rose around 10% during July and is trading at its highest level for around three years. Furthermore, the current price is well above levels seen in Q4 2016, when the prices seen then were dismissed as no more than Trump reflation euphoria. Oil also managed to recover some ground during the month, despite plenty of media coverage of the impending growth in electric vehicles. Once again, robust global demand is probably the main reason for the resilience.

On the political front, Mr Trump's administration continues to stumble from one crisis to another, with little meaningful legislation getting passed and a revolving door of personnel. Thus far, equity markets have managed to shrug off any impact, although the uncertainty may have contributed to the weak performance of the US dollar. The risks of a premature end to the Trump administration appear to be rising.

Performance

Against a market that was flattish in July, with the FTSE All-Share Total Return Index (12pm adjusted) posting a modest 0.62%, the Fund performed strongly in returning 2.01%.

Year-to-date the Fund is up 10.10% versus the benchmark return of 7.43%. Looking at the peer group, the Fund is ranked first decile within the IA UK Equity Income sector over one year to 31 July 2017. On a longer-term basis, the Fund is ranked first decile over ten years and since launch (November 2004), and first quartile over three years and over five years.

The strength of the Fund was driven by a very good start to the interim results season (see below), coupled with negative developments in the tobacco sector (where we have zero exposure) at the end of the month, which boosted relative performance.

The tobacco news revolved around the US Food and Drug Administration (FDA) announcing a consultation process to limit the levels of nicotine permitted in cigarettes in order to reduce consumption and therefore fatalities and healthcare costs. This is a major negative regulatory change, which follows a raft of smaller negative developments (e.g. tax rises, plain packaging, restricting use of flavours and higher age restrictions, amongst others), which had largely gone unnoticed by the market and had minimal impact on share prices. As we have discussed before, tobacco stocks (and the wider consumer staples sector) have become priced to perfection, driven by lower bond yields and the search for dividend yields perceived to be safe. Analyst commentary following years of strong share price performance has become too positively skewed. It is interesting in this context that the initial reaction to the US news by analysts was arguably rose tinted, trying to suggest that the US FDA developments would be positive because it would accelerate the move to new tobacco technologies. Whilst this may partly be the case, it certainly won't be seamless. With high levels of debt and high debt-adjusted valuations, we expect the sector to remain under pressure.

The interim results season thus far has been positive for the Fund. Highlights include **Morgan Sindall** pre-announcing stronger-than-expected results and cash flow (the stock is up 123% relative over one year), **Thomas Cook** (up 18% relative over one month), **Huntsworth** (up 26% relative over one month), **HSBC** (up 5% relative over one month) and **Segro** (up 7% relative over one month). The share price performances we have seen from some of our small cap names in recent months (Morgan Sindall being the best example) show the undervaluation in this part of the Fund, something we have been highlighting for the past year.

Elsewhere, the mining sector was strong (up 11% relative), driven by rising commodity prices. This has put the valuations of the sector and the stocks we own, which were already low, on even more attractive short-term valuation metrics. Our housebuilders **Bovis** and **Countryside** also performed well, as did **Standard Life** as it nears the consummation of the **Aberdeen Asset Management** deal in mid-August.

On the negative side, two stocks stood out, **AstraZeneca** and **Countrywide**. AstraZeneca fell following disappointing results of the Mystic trial, which was assessing one of its major lung cancer drugs. The failure of this trial was partly offset by more encouraging news from another element of its lung cancer drug pipeline. We had materially cut back our position in AstraZeneca over the last six months as the shares rose from 4,200p at the start of the year to c.5,500p, and we were around 100bp overweight, as opposed to our previous overweight position, which was closer to 200bp. Whilst the news was disappointing, this is not a one drug company; there is a broader pipeline that will come through over time and the potential for a bid has increased due to this news. We therefore did not adjust our weighting after the news. We do not own GlaxoSmithKline, which is a major part of the index (c.300bp) – GSK's share price fell 10% following an uninspiring update which laid bare some of the underinvestment of former CEO Witty's years in charge. From a relative perspective, this largely offset the AstraZeneca share price fall. Countrywide had disappointing results, reflective of sluggish housing transaction volumes. However, there were some encouraging signs within the detail of the results regarding the company's move to a new digital-based framework.

Portfolio activity

We mentioned last month that we were in the process of adding a fifth stock to our oil/mining exposures, which we would highlight this month. That stock is **Anglo American**. The addition of this stock, coupled with increases to **Glencore** which we have made over the last six months, means the Fund is now c.3% overweight the mining sector. **Rio Tinto** remains our largest active position in the area. Anglo American, like Glencore, has gone up a lot from the share price lows made at the end of 2015, but it is important to focus on the new strategy and the current valuation

metrics when assessing the stock from an investment perspective. Anglo American was over indebted at the end of 2015. Since then, higher commodity prices and disposals have created a position where it is potentially underleveraged: net debt to EBITDA will be close to 0.7x at the end of this year. This trajectory is why, at the interim results last week, the company surprised the market in coming back to the dividend list ahead of schedule, with a reasonable 40% payout ratio. Anglo's commodity mix is more balanced than Rio Tinto's, with less iron ore and more copper, which, as highlighted above, has moved appreciatively higher recently. We also like the long-term new supply (which is limited) and demand dynamics of the copper market. The other change recently has been the board structure. Anglo American has a new chairman and a new finance director. The chairman, John Parker, has a strong track record of value creation. The stock, which has moved up since we added it, still trades on a free cash flow yield of 15% on current spot prices and yields close to 6%. The oil sector has not rallied with the oil price, so we also added to our exposure in **BP** and **Royal Dutch Shell.**

We made a number of adjustments to our current holdings over the month. In financials, as we have noted in the last two updates, **Standard Life** and **Aberdeen Asset Management** have performed strongly. We have taken profits to keep our aggregate overweight close to our maximum focus point of c.300bp. We also slightly reduced our holding in **Brewin Dolphin,** which reached new absolute highs following a good trading update. Domestic-focused financials were sluggish, and we selectively added to names like **Paragon** and the UK banks.

Elsewhere, we continued to add to **Bovis**, which was a new addition about three months ago and is now 125bp of the Fund. We also added to **Northgate** on continued share price weakness following poor results in June. In the bus/rail sector, we switched some of our position in **Go Ahead** into **National Express,** which has a more overseas-centric business mix. The final two changes of note were the continued reduction of **Vodafone**, where we have used the recent price increase to reduce our weighting reflective of longer-term concerns regarding its ability to monetise its growth drivers, and a reduction in **Costain** following good share price performance.

We continue to focus on balance sheet strength across the Fund. The chart below shows that since the launch of the Fund in 2004, we have significantly reduced the average leverage of the companies we hold in comparison to the market. We are significantly below the index on this metric. Many of the new stocks we have added recently have net cash (Bovis and Countryside being good examples), and we rarely look at new stocks with net debt to EBITDA of more than 2x.

Average debt/equity for the JOHCM UK Equity Income Fund vs the market

Source: Style Research

The importance and potential danger of debt was highlighted again during June with the issues at Carillion (which the Fund does not own). Debt concerns, ongoing poor cash flow and management issues led to a 70% fall in its share price over the month. This also highlights the importance of intra-sector stock analysis – our main holdings in the construction sector are **Morgan Sindall,** which we note in the section above, and **Costain**. Both of these have large net cash positions and continue to perform well.

Outlook

The path to policy normalisation has categorically begun in the US and is moving nearer in the UK and Europe. The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, without doubt it has pushed valuations of many assets and individual instruments to elevated levels that will be hard to justify if the cost of capital rises. With this in mind, an element of caution may be appropriate as we approach the autumn.

Within the equity markets, we strongly believe that this overvaluation is most apparent in consumer staples and other perceived defensive sectors such as utilities and pharmaceuticals. Conversely, we believe that many of the areas that we are exposed to will respond well to a change of stock market leadership, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also still selective opportunities in the UK domestic arena too, despite the challenging macro. We continue to be encouraged by the dividend growth that our companies are exhibiting and believe that the 2017 dividend yield of the Fund of around 4.25% is attractive relative to other asset classes.

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.co.uk.

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