



## JOHCM UK Equity Income Fund

Monthly Bulletin: August 2019

### Active sector bets for the month ending 31 July 2019:

#### Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	10.15	3.42	+6.73
Banks	14.37	9.83	+4.54
Life Insurance	6.73	3.63	+3.10
Oil & Gas Producers	16.77	13.84	+2.93
Construction & Materials	4.46	1.63	+2.83

#### Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.01	-8.01
Equity Investment Instruments	0.20	5.22	-5.02
Beverages	0.00	3.80	-3.80
Tobacco	0.00	3.71	-3.71
Personal Goods	0.00	2.73	-2.73

### Active stock bets for the month ending 31 July 2019:

#### Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	7.70	4.62	+3.08
Aviva	3.75	0.67	+3.08
Barclays	4.17	1.13	+3.04
ITV	3.16	0.18	+2.98
Standard Life Aberdeen	3.19	0.31	+2.88
DS Smith	3.07	0.19	+2.88
Lloyds Banking Group	4.45	1.60	+2.85
Phoenix Group	2.98	0.16	+2.82
Glencore	4.01	1.26	+2.75
Paragon Banking Group	2.11	0.05	+2.06

#### Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	3.94	-3.94
GlaxoSmithKline	0.00	3.55	-3.55
Diageo	0.00	3.42	-3.42
British American Tobacco	0.00	2.87	-2.87
Unilever	0.00	2.30	-2.30

## Performance to 31 July 2019 (%):

	1 month	Year to date	Since inception	Fund size
<b>JOHCM UK Equity Income Fund – A Acc GBP</b>	<b>-0.95</b>	<b>6.73</b>	<b>263.10</b>	<b>£2,999mn</b>
Lipper UK Equity Income mean*	1.26	11.90	177.07	
FTSE All-Share TR Index (12pm adjusted)	2.28	15.54	197.22	

### Discrete 12-month performance (%) to:

	31.07.19	31.07.18	31.07.17	29.07.16	31.07.15
<b>JOHCM UK Equity Income Fund – A Acc GBP</b>	<b>-9.50</b>	<b>9.83</b>	<b>26.45</b>	<b>-5.06</b>	<b>7.53</b>
FTSE All-Share TR Index (12pm adjusted)	1.33	9.17	15.33	4.06	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

The Fed succumbed to the market's demand for monetary easing by cutting interest rates by 25 bps at the end of the month, justifying the move on US-China trade uncertainty and a further breakdown in the efficacy of the Phillips curve. The call may have been a marginal one as some domestic economic indicators in the US have shown some strength in the last few weeks. Core durable goods orders were up +2% month on month in June and related to this, the Philadelphia Fed Manufacturing Index rose to a one year high. Furthermore, June retail sales comfortably exceeded expectations as did the non-farm payroll data, albeit recovering from a weak print in May. However, housing indicators have been more subdued and business confidence remains fragile due to the trade uncertainties. Markets continue to believe that the Fed will make further cuts in 2019, although interestingly, 10-year bond yields in the US slightly rose over the month to 2.06%.

In contrast, bond yields in Europe fell further during the month, in many cases into deeper negative territory. Manufacturing data points suggest a weak operating performance and PMI outlook surveys remain generally soft with the latest German reading hitting a new low for the year. These data points saw Draghi describe the economic outlook as "worse and worse" and left the door open for more (but unspecified) stimulus in the coming months. In the UK, the CBI Industrial trends data paints a similar picture with a notable fall in the export component of order books (mostly to continental Europe).

The election of Boris Johnson as Prime Minister has partly caused weakness in sterling during the month, with around a 3% fall against the dollar in the latter part of July. The chances of a hard Brexit at the end of October have clearly risen in the market's view and at present, the currency represents the principle mechanism for displaying this fear. At \$1.215 we have returned to the same level that was seen in late 2016 in the aftermath of the referendum result. Whilst sterling looks materially undervalued on a purchasing power parity basis, it looks set to remain so until there is some kind of Brexit resolution. Less commented upon thus far, has been the plans for the new UK Government to inject fresh economic stimulus into the economy before the October deadline. We have commented before that this probably should have happened before now, given how much the budget deficit has fallen by over the last few years. Whilst the exact details are yet to be released, a blend of stamp duty adjustments, accelerated infrastructure spend, and both personal and corporate tax cuts are both affordable and welcome to an economy with very low business confidence at present. For now, the UK remains a nation of full employment and accelerating wage growth and this is still producing somewhat schizophrenic data points in the consumer economy as individuals weigh up their shorter-term relative economic prosperity with a cloudier and more uncertain future. Given the political roadblocks to a Brexit resolution, a general

election at some stage can not be ruled out, but predicting the outcome is fraught with difficulties, with the decline in popularity of the Labour Party under Mr Corbyn in recent months, countered by the rise of the Liberal Democrats, adding to the complexity of the picture.

## Performance

Markets continued to move higher in July, with the Fund's benchmark, the FTSE All-Share Total Return Index (12 pm adjusted), returning 2.28%. The Fund was modestly down in absolute terms returning -0.95%. It continued to struggle in relative terms due to the continued leadership of growth, earnings momentum and low volatility stocks. Year to date the Fund has returned 6.73% against the benchmark return of 15.54%.

Looking at the peer group, the Fund is ranked fourth quartile/tenth decile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked first decile over 10 years and since launch (November 2004), first quartile over three years and third quartile over five years.

The main drivers of the underperformance were the portfolio's voids, which continued to perform strongly. It was another month in which the perceived compounders were robust, with the tobacco and pharmaceuticals sectors up strongly. We discuss in more detail below how stretched and polarised this has left the market. At some stage, this will surely reverse. However, for now, momentum is dominating flows and valuation is getting little attention from the investment community.

Corporate activity in names we don't own also impacted the portfolio this month. For example, the proposed acquisition of Refinitiv by the London Stock Exchange in a highly leveraged transaction, which helped create high earnings enhancement and a strong share price reaction. UK corporate activity continued at a strong pace in July after reaching a 10-year record in the previous month.

In terms of Fund holdings, the oil/mining sector performed poorly despite sterling weakness, good results from **BP**, and relatively flat commodity prices. Banks, excluding **Barclays** (which performed reasonably), were also sluggish, as were certain property names. Elsewhere, small caps also generally struggled.

Unusually, given the relative performance gap, the Fund only had one profit warning during the month – **Lookers**, which cost c. 10bp. Results in general tended to be robust with **Vodafone** up 15% relative\* after delivering a stabilisation in revenue trends and a new strategy to monetise its Tower assets. ITV was another highlight as it showed good strategic progress in the early part of the results season. Elsewhere, results from **Forterra** and **Liontrust** were also strong. Both of these stocks grew their dividends by 20%+, with the former mainly driven by a modest increase in the payout ratio and the latter by strong earnings (driven by record inflows, in particular into their ESG franchise). This dividend dynamic underpins what is likely to be another year of robust dividend growth for the Fund.

## Portfolio activity

We sold two stocks in June, **lbstock** and **Kingfisher**. lbstock was a very successful position, driven by the fact we added materially to it during the post Brexit-vote period when it (and similar shares) dislocated badly. The stock contributed 62bp of relative performance. Kingfisher, where poor management and execution led to a series of downgrades, cost 38bp relative.

Elsewhere we continued to trim a number of positions that are fairly fully priced – namely **HSBC** and **National Express**. The former is within 5-8% of our target price which is materially below the upside elsewhere in the Fund. Lower interest rates and the unrest / uncertainty in Hong Kong also means the risk of management missing its strategy targets is a real possibility. National Express continues to perform well as its recent results highlight. We also re-marked Vodafone to a 200bp overweight after the sharp rise in its share price noted above.

Additions were focused on three stocks we have been building weightings in, over recent months: **Tesco**, **WPP** (a new addition earlier this year) and **Countryside**. The first two are on a free

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\* Relative to the Fund's benchmark, the FTSE All-Share TR index (12pm adjusted).

cashflow yield of 10% whilst the latter, which has the strongest position in the Partnership Homes market with a 10 year pipeline, is on a P/E yield cross over at 6.5x / 6.5% respectively.

We also added to **Hammerson**. Its shares are now trading at 210p. This compares to an historic NAV of just below 700p and our trough NAV estimate of c. 550p. The market cap is now c. £1.7bn. Within its asset mix, as well as UK, French and Irish property, it holds a position in Value Retail, which is effectively Bicester Village in the UK, and similar centres across Europe. This is a fast-growing (c. 11% like-for-like growth in H1 19), valuable asset. This on its own is worth £2.6bn – 27% of gross asset value. The company is much less geared than other stocks in the sector that it is often compared to, such as Intu. Leverage is 37% (compared with 57% at the latter). The company has also just sold a major French asset (c. 5% of gross asset value sold for <5% discount to book value). We also expect the company to monetise part of its Value Retail stake for close to book value or a premium to book value. These numbers show how materially undervalued this stock is, which is a common characteristic across the Fund's holdings.

## Outlook

Earlier this week, we sent out an update to our piece “Mind the Gap” (the original piece was published at the beginning of the year) highlighting the growing polarisation in valuations between value and growth stocks. This is available below in the Appendix. In July there has been a further dramatic differential in performance between these two broad groups of stocks both in the UK and across Europe. The effect has been more pronounced in the UK as a weak performance by sterling has exacerbated the outperformance of many of the UK's “growth” companies which have an overseas bias to their earnings. The shift by the Fed to an easing of monetary policy has provided more fuel to the outperformance of the growth style as investors use an ever lower discount rate to value these stocks. Furthermore, investors appear willing to allow stocks of this type to lever themselves up even more, almost with no limit, despite the relatively subdued global economic environment. This looks highly dangerous to us and is likely to end badly, but predicting precisely when is very difficult.

In contrast, many of the constituents of the “value” style bucket have very modestly levered balance sheets and often have asset value support at or above the current market valuation. For now, markets are disinterested in these sorts of stocks as they are seen to be either too cyclical, too dull and/or at risk of disintermediation from technological change. Whilst we are not blind to many of the challenges some of these stocks face, we believe that a number of them will not only survive the current environment, but will in fact thrive and grow stronger. We will continue to focus upon valuation rather than momentum, an approach that has served us well over the last two decades, even though it has reaped little reward in the last 12 months. We recognise that our underperformance over recent periods has been significant and we appreciate our investors' patience and the faith that they have shown in our approach. As and when market leadership changes, we believe the scope for a commensurate degree of outperformance is present and we would hope to recover the lost ground.

## Appendix

*‘Mind the gap (again). Beware the bubble in growth/low volatility stocks* – available using the link below:

[JOHCM UK Equity Income Fund: Mind the gap \(again\)](#)

## 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](mailto:info@johcm.co.uk) or visit our website at [www.johcm.com](http://www.johcm.com)

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