Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: August 2020

Active sector bets for the month ending 31 July 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.10	3.23	+6.87
Mining	14.06	7.66	+6.40
Media	7.94	3.45	+4.49
Food & Drug Retailers	6.50	2.05	+4.45
Banks	9.27	6.65	+2.62

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.63	-10.63
Equity Investment Instruments	0.00	6.61	-6.61
Tobacco	0.00	3.87	-3.87
Beverages	0.00	3.86	-3.86
Personal Goods	0.00	2.99	-2.99

Active stock bets for the month ending 31 July 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix Group	3.44	0.18	+3.26
Tesco	4.35	1.11	+3.24
Legal & General Group	3.82	0.66	+3.16
Glencore	4.03	1.01	+3.02
BP	5.96	2.97	+2.99
Anglo American	4.20	1.22	+2.98
Barclays	3.90	0.92	+2.98
WPP	3.27	0.36	+2.91
Vistry Group	2.71	0.07	+2.64
DS Smith	2.71	0.18	+2.63

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	6.06	-6.06
GlaxoSmithKline	0.00	3.98	-3.98
HSBC	0.00	3.73	-3.73
Diageo	0.00	3.46	-3.46
British American Tobacco	0.00	3.20	-3.20

Performance to 31 July 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	**-6.16**	**-33.55**	**171.30**	**£1,596mn**	**£1,961mn**
Lipper UK Equity Income mean*	-2.98	-22.85	127.32		
FTSE All-Share TR Index (12pm adjusted)	-2.68	-19.42	147.26		

Discrete 12-month performance (%) to:

	31.07.20	31.07.19	31.07.18	31.07.17	31.07.16
JOHCM UK Equity Income Fund – A Acc GBP	**-25.28**	**-9.50**	**9.83**	**26.45**	**-5.06**
FTSE All-Share TR Index (12pm adjusted)	-16.81	1.33	9.17	15.33	4.06

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

As most economies progressively relaxed lockdowns, all eyes have been focused upon the trajectory of economic improvement, with sceptics dominating the airwaves. In that regard, the relatively modest 1.8% month-on-month recovery in UK GDP registered in May appeared disappointing. But in many respects this data point is more historic than most and still represents a period in which many industries were still closed or operating on a part-time basis. In that regard, the 14% month-on-month growth in retail sales in June represented a period when more normal activity had resumed and interestingly left the annual contraction in retail sales at only -1.6% so far this year. Within this mix, obviously online has gained at the expense of physical stores. The most recent UK PMI surveys also show a very marked and V-shaped recovery. The composite reading of 57.1 was actually higher than it was in the post-election months of January and February 2020 and in fact represented the highest reading since June 2015 and a significant recovery from the reading of 14.1 a couple of months ago. Of course, this measure represents whether activity levels are improving or deteriorating. In that regard, it is no surprise to see such a high reading, but it does still augur well for much stronger June and July GDP prints. Housing activity in particular has recovered quickly, with June mortgage approvals back up to 40,000 versus only 9,000 in May and compared to 60-70,000 a month pre-Covid-19. Furthermore both anecdotal commentary from housebuilders and agents as well as the July Nationwide price index suggest house prices have held up well so far. The employment market remains the greatest uncertainty given short-term government support will fade after the summer. For now, unemployment remains at around 4% but with the vacancies number falling to an all-time low of 333,000, it is clearly going to rise from here quite materially.

Economic recovery in Continental Europe is accelerating, too. The Q2 GDP contraction of around 12% was better than the consensus expectations and again many of the lead indicators, such as the PMI surveys, suggest a continued strengthening in July. Observations from companies operating in the region also suggest that Germany has weathered Covid-19 particularly well and that France is improving quickly. The Chinese economy continues to accelerate, with the PMI surveys for both manufacturing and services in positive territory and demand for commodities particularly strong for the likes of iron ore and copper. Consequently both commodities reached their highest price levels for around 18 months.

North America continues to be the region that is hardest to read due to the uneven spread of the virus across the US and the differing strategies adopted by state governments. Whilst June retail sales grew by 7.5% month-on-month and activity in the housing market in terms of mortgage approvals and home sale are very strong, the real time economic indicators suggest a moderation

in the recovery during July as the southern states and California bore the brunt of the spread of the virus. This moderation was commented upon by Jerome Powell and has been one of the reasons the dollar has had such a weak month, falling by around 5-7% against both the euro and sterling.

Lastly, we continue to believe that whilst in the short term the pandemic will have a deflationary impact, in the medium term it could have inflationary consequences as governments raise minimum wages to deal with inequality and as globalisation of supply chains reverses. In this regard, it is noteworthy that this month the US 10-year inflation breakeven rate rose by 20 bps to 1.53% and is back to the level it was in late February 2020, having bottomed at 0.5% in the middle of March.

Performance

After a bit more balance in terms of style leadership in June, July saw markets revert back to their previous trends and value again underperformed markedly. This was reflected in our relative performance: the Fund returned -6.16% versus -2.68% for the Fund's benchmark, the FTSE All-Share Total Return index (12pm adjusted). The Fund is significantly behind year to date (-33.55% versus -19.42%), with most of the underperformance arising after the pandemic first broke.

Looking at the peer group, the Fund ranked fourth quartile within the IA UK Equity Income sector for July. On a longer-term basis, the Fund is ranked fourth quartile over three years and five years and second quartile over ten years and first quartile since launch (Nov 2004).

The mining sector led the positive contributors in July underpinned by China's recovery from Covid-19 and rising metal prices. Both **Rio Tinto** and **Anglo American** subsequently beat our dividend forecasts. In other positive news, a few companies confirmed they will now pay their dividends after initially deferring them (**Severfield**, for example). These positives for the Fund dividend were offset by the weaker dollar, meaning our existing guidance (a fall of between 45% and 55% which we outlined here), remains valid. Other strong performers were **Phoenix** and **Drax**.

There were a number of positive statements during the month: **DFS** reported c. 70% like-for-like growth since lockdown ended; **Tyman**, **Norcros** and **Headlam** are all back to positive like-for-like growth; **Sthree** (which we cover in a separate paper on small caps here) had better-than-expected results, with signs that demand will return quickly given their end use market mix. We would normally expect these positives to lead to strong share price performance but despite the very low valuations of these stocks, performance was sluggish. Banks performed in a similar manner - we discuss their results below.

Elsewhere, **ITV**, **Countryside**, **Vistry** and **National Express** also performed poorly.

Portfolio activity

During the month we exited our position in Brewin Dolphin. It is a much improved business compared to where it was four or five years ago. To a large extent that manifests itself in the reasonable mid-teens P/E multiple that the stock now sits on. Whilst this is not expensive given the defensive and sticky nature of its revenue and assets, it offers less upside compared to the rest of the portfolio. Elsewhere, we trimmed positions in **Phoenix** and **Glencore** following outperformance, and we more materially reduced our holding in **Standard Life Aberdeen**. It has also recovered strongly from its lows in April and the valuation of the "rump" of the fund management business (after stripping out the values of its associate businesses in India and the UK) is no longer as absurdly low as it was. However, it remains a core holding and it will be interesting to see what changes in strategic direction result from the newly announced CEO.

With a number of stocks in the Fund having a poor relative month, we took the opportunity to increase position sizes in a number of these more modestly priced stocks. We significantly increased our weighting in **National Express**, which suffered from ongoing concerns about the shorter-term trajectory of virus cases in the US and Spain. As we have explained before, we see National Express as very well placed to gain market share in all of its core markets and as usage of public transport and school buses gradually returns to normal over the next two years, the shares will be very modestly valued. We added to **DS Smith** following its share price fall after some sluggish results. We still see the group as very well positioned strategically particularly as demand for recycled packaging continues to grow. With banks such as **Barclays** and **Standard**

Chartered reporting strong Q2 trading and high capital ratios, we would have expected the shares to perform better. However, the market chose to focus on falling net interest margins and rising provisions, even though the new accounting standard forces the banks to recognise provisions very early. In a sense, it is positive banks are making significant provisions upfront, unlike during the GFC. With both stocks on less than 0.4x book value and capital ratios more than 3x higher than during the GFC, we added further to our holdings.

Within construction, one of our holdings, **Countryside Properties**, raised fresh equity partly to strengthen its balance sheet and partly to accelerate its partnership homes strategy in core locations. We added to our position both via the placing and afterwards when the shares fell further. As discussed previously, stocks such as Countryside and **Vistry** are perfectly placed to benefit from the UK government's focus upon infrastructure and affordable home provision as industries to kick start the economic recovery.

Outlook

As we described above, it was another difficult and disappointing month for the Fund. The main driver of the poor relative performance has been the ongoing underperformance of 'value' stocks and the outperformance of 'growth' and 'momentum' factors. At points in the month we felt that we were reaching a crescendo in this trend. As we mention above, we had numerous positive company updates (versus consensus expectations and in an absolute sense) during the month, but there was scant feed-through to share prices. We also noted above that sterling rallied c. 7% against the dollar, during the month. We would normally expect this to materially assist the Fund's relative performance given we are very underweight overseas-earners. It was, however, these sectors that continued to lead the market, which means in sterling terms they have once again re-rated materially. Diageo, for example, re-rated c. 15% in July when you take into account both sterling's appreciation and its own price action.

We have laid out in recent papers how stretched the market is between the haves ('growth') and the have nots ('value'). We are confident that this will reverse and when it does, the reversal is likely to be swift given the crowded positioning on the 'growth' side of the divide. We are often asked what the catalyst for the reversal could be. There are a range of answers. It could be the Covid-19 narrative improving (particularly in the US); it could be the arrival of a vaccine; it could be the continuing rebound in economic data; it could be increasing corporate activity (of which there was some initial signs in July, such as Hastings); or it could be that inflation starts to feed into the system. There is an increasing amount of commentary around this risk amongst market participants and the acknowledgement that it is a key potential outcome of the policy response to Covid-19 and other trends such as de-globalisation. We will write more on this in the future. What *is* clear though, is that despite the discussion and the acknowledgement of the risk, very few people are positioned for this outcome. The table overleaf shows the correlation of sector performance to rising inflation expectations. The current 'winners' would find life very difficult if this outcome happened. The table also shows the Fund's big overweights are those sectors that would benefit. A return of inflation or the expectation that inflation will rise would see a major reversal in the Fund's performance.

The other reason we are confident of a future performance recovery is the 'quality' of the Fund (within the value envelope). As we laid out here, we believe we have one of the best Fund compositions we have ever had, as well as one of the cheapest. Today we have published a separate paper here which looks specifically at our small cap exposure, which remains c. 18-19% of the Fund. This paper echoes this Fund composition point from a fundamental perspective and also showcases how much upside there is in each name (typically 100-200%, in our view).

Fund is overweight

Sectors correlated to inflation expectation	
Global Sectors	Infl Exp. ↓
Construction Materials	0.461
Real Estate	0.451
Banks	0.381
Metals & Mining	0.367
Energy	0.311
Diversified Financials	0.251
Paper & Packaging	0.212
Consumer Durables & Apparel	0.196
Automobiles & Components	0.170
Utilities	-0.030
Telecommunication Services	-0.058
Retailing	-0.202
Healthcare Equipment & Services	-0.264
Food Products	-0.269
Beverages	-0.290
Software & Services	-0.311
Media	-0.337
Household & Personal Products	-0.341
Food & Staples Retailing	-0.487
Pharmaceuticals & Biotechnology	-0.571

Source: Credit Suisse, Global Equity Strategy, 2 July 2020.

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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