**Professional Investors Only**

# JOHCM UK Equity Income Fund

Monthly Bulletin: September 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 31 August 2023:

### Top five

| Sector | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| Life Insurance | 9.22 | 2.45 | 6.77 |
| Construction and Materials | 8.23 | 1.82 | 6.41 |
| Household Goods and Home Construction | 5.81 | 1.04 | 4.77 |
| Industrial Metals and Mining | 10.89 | 6.14 | 4.75 |
| Banks | 13.81 | 9.14 | 4.67 |

### Bottom five

| Sector | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| Pharmaceuticals & Biotechnology | 0.00 | 10.72 | -10.72 |
| Personal Care, Drug and Grocery Stores | 0.00 | 7.67 | -7.67 |
| Closed End Investments | 0.00 | 6.09 | -6.09 |
| Beverages | 0.00 | 3.56 | -3.56 |
| Tobacco | 0.00 | 3.29 | -3.29 |

# Active stock bets as at 31 August 2023:

## Top ten

| Stock | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| DS Smith | 3.21 | 0.18 | 3.03 |
| Phoenix | 3.16 | 0.17 | 2.99 |
| Aviva | 3.40 | 0.46 | 2.94 |
| NatWest | 3.51 | 0.57 | 2.94 |
| Barclays | 3.92 | 1.01 | 2.91 |
| Paragon | 2.94 | 0.05 | 2.89 |
| BP | 6.56 | 3.71 | 2.85 |
| Standard Chartered | 3.56 | 0.73 | 2.83 |
| Glencore | 5.06 | 2.40 | 2.66 |
| ITV | 2.76 | 0.12 | 2.64 |

## Bottom five

| Stock | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| HSBC | 2.05 | 5.18 | -3.13 |
| Diageo | 0.00 | 3.22 | -3.22 |
| Unilever | 0.00 | 4.47 | -4.47 |
| Shell | 2.25 | 7.24 | -4.99 |
| AstraZeneca | 0.00 | 6.96 | -6.96 |

# Performance to 31 August 2023 (%):

| | 1 month | Year-to-date | Since inception | Fund size (£m) | Strategy size (£m) |
|---|---|---|---|---|---|
| **Fund – A Acc GBP** | **-2.20** | **0.16** | **326.30** | **1,532** | **1,813** |
| Lipper UK Equity Income mean* | -1.75 | 1.04 | 206.04 | | |
| FTSE All-Share TR Index (12pm adjusted) | **-2.11** | 2.70 | 238.30 | | |

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

| | 31.08.23 | 31.08.22 | 31.08.21 | 31.08.20 | 31.08.19 |
|---|---|---|---|---|---|
| **JOHCM UK Equity Income Fund – A Acc GBP** | 4.61 | -2.72 | 51.34 | -20.21 | -10.94 |
| FTSE All-Share TR Index (12pm adjusted) | 5.65 | 1.06 | 26.19 | -12.55 | 0.18 |

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

Markets in the month of August tend to be more volatile, with many participants taking well-earned breaks, and this proved to be the case again this year. For the first three weeks of the month, bond yields across the developed world moved materially higher across all durations, as economic data generally proved to be quite resilient and central bankers emphasised that interest rates are likely to remain elevated for some time. In the US, 10-year yields had risen 35bps to 4.35% by mid-August, and in the UK, they were 30bps higher at 4.74%. Similar moves were also observed at the shorter end of the yield curves. However, by the end of the month, both 2 and 10-year bond yields in the US and the UK had fallen c. 30-40bps below those mid-month peaks, partly due to some softer economic data, particularly in the US. The Job Openings and Labor Turnover Survey (JOLTS) showed new job openings slowing to their lowest level since March 2021; consumer confidence fell to its lowest point for 9 months and Q2 GDP was modestly restated lower to 2.1% annualised. Whilst Governor Powell's language remains quite hawkish, inflationary pressures look to be well contained, and as such, further rate increases may not be needed.

In the UK, this month saw a material reduction in the rate of inflation, with CPI falling from 7.9% to 6.8%, with around 70% of that driven by the fall in energy prices, as the latest lower retail price cap came into the equation. Whilst food inflation remains elevated at 14.9%, it is already around 500bps lower than the peak in March and will continue to fall during the rest of this year, partly due to base effects. Although inflation may not fall much in the next couple of months, it is still on track to be below 5% during Q4 2023 as further energy price falls impact and lower goods prices in general feed through.

The month also saw an elevated wage inflation print, averaging 8.2% for Q2. This was boosted by several back-dated settlements, including in the health service. This has led to some concerns that inflation could prove stickier in the UK than elsewhere because of a particularly tight labour market. However, wage inflation is likely to prove to be a late cycle / backward-looking indicator as the UK labour market continues to show signs of returning to balance. The participation rate continues to rise as younger and older cohorts return to the labour market, and as such, unemployment rose by 20bps to 4.2% even though the number of people in employment was broadly flat. Vacancies are also continuing to reduce, although they are still 200,000 higher than the pre-Covid level. The vacancies/unemployment ratio has already fallen back to 0.72 in July vs the peak of 1.05 in August 2022 and compares to around 0.6 pre-Covid. As a result of these trends, we expect wage inflation to begin to soften from here, reducing the pressure on the Bank of England (BoE) to tighten further. With real wage growth turning positive in the UK this quarter, economic activity continues to show resilience, with consumer confidence recovering from last Autumn's budget shock and the Lloyds business confidence barometer hitting an 18-month high. Housing is the one area of marked weakness as that sector re-adjusts to higher interest rates, although the cost of 2-year fixed mortgages continued to fall during the month. We would not be surprised to see policy action to stimulate housing demand by both the Government and the Labour party during the upcoming party conference season.

Economic indicators in Europe have continued to be sluggish, particularly manufacturing activity. Inflation, though having fallen heavily as a wider trend, looks to have plateaued in several countries on the continent, with Spain, for example, reporting inflation 30bps higher this month. China continues to concern investors, particularly the property development sector and the related shadow banking system. However, various monetary and fiscal actions are likely to have an impact over time, and we note that the manufacturing PMI reading has now risen for 3 months in a row. Furthermore, the services PMI surveys remain in expansionary territory.

## Performance

After a strong July, markets fell sharply in the first 3 weeks of August before recovering some of the fall in the last week of the month. For the month, as a whole, the UK FTSE All Share was down -2.11%. The Fund was in line with this (down -2.20%). Year-to-date, the Fund is up 0.16%, whilst the FTSE All Share is up 2.70%.

Looking at the peer group, the Fund is ranked in the 3rd 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 is the best Fund in the sector since inception in 2004.[1]

Performance trends were mixed between sectors and within sectors. This is partly explained by low liquidity across the holiday period. The oil sector strengthened with the rise in the oil price. In mining, our two large caps were weak, e.g. **Anglo American** was down 10% relative. In contrast, our two small caps in this area, which had been laggards, strengthened. **Central Asia Metals** was up 10% relative and **Kenmare** was up 3% relative after a set of figures that delivered a better-than-expected dividend and a tender offer (a form of share buyback). Including newly announced buybacks in August, c.46% of the Fund is currently actively buying back shares.

Several small caps continued to show good form, such as **Costain**, which has been an ‘issue’ stock for us in the last 3 years, had a decent set of results and announced it would return to the dividend list. **International Personal Finance** continued to perform well, up 12% relative, and also announced strong results.

Elsewhere, **TP ICAP** (up 8% relative) had strong results, announced a buyback and confirmed that its data business had signed internal long-term agreements with its broking businesses. We have long called for the data business to be split from the central business to realise value (we value this unit more than TP ICAP’s total market cap). An internal agreement is one requirement needed for the Board to agree this is the right option.

**Marks & Spencer’s** rose a further 11% relative after an unscheduled trading update upgrading forecasts. At the end of the month, it was announced that it had been promoted to the FTSE 100.

On the negative side, a sluggish set of figures from **WPP** (where sales targets were downgraded c.2% due to weakness amongst Tech clients) saw the share price fall 7% relatively. **Drax** drifted (down 5% relative) despite a positive government update on biomass generally and carbon capture (using biomass) specifically. **Mobico** (previously National Express) fell 8% and **Inchcape** fell 5% (both in relative terms) - we cover these stocks in the next section. Finally, **Phoenix** was weak (down 4%

[1] Source: Lipper

relative). The stock now yields 11%. In the outlook section, we showcase more detail on this stock and the broader life insurance sector.

## Portfolio activity

Following the increase in the takeover offer price at the end of the previous month, we sold our residual position in **Lookers**, a stock we have owned twice during the life of the Fund. It contributed more than 200bps to relative performance across both holding periods. It has been the only flicker of takeover activity that the Fund has seen in the last 18 months. We would expect there to be significantly more such events, given the (low) valuation picture across the Fund in the next 6-12 months.

The sales proceeds were useful in the context of the market weakness for much of the month, which created numerous opportunities to add to holdings. Beyond Lookers, there is little at the edge of the envelope in terms of (high) valuation across the Fund. Other sales were limited to stocks being pared back after reaching our 300bp maximum active weight limit (e.g. **DS Smith**) and at the start of the month **First Group**. It sounds somewhat churlish saying this, but this stock 'only' has 33% upside to our target price. The dividend yield is also one of our lowest.

We added to **Marks & Spencer** at the start of the month. As noted above, it issued an unscheduled positive trading update in the middle of the month. The thesis we outlined when we acquired the stock earlier this year is in full playout mode. We are now 100bps overweight. We also continued to add to **Inchcape**, which had strong results at the end of July. The shares reacted sharply to the news, up 10%, but in August, they lost all of this performance, and more, in the market malaise.

We also added to **Ibstock** following robust results, **Page**, which had inline results and announced another special dividend, and **Keller**.

In contrast to **First Group,** which has been one of the Fund's best performers this year, **Mobico** (previously National Express) has performed poorly. The reason has been sluggish results, but primarily, it has a weaker-than-optimal balance sheet. As regular readers will know, in Q4 2022, we wrote to the Board to suggest they sell one of their three divisions, which would have created a strong balance sheet and highlighted significant undervaluation. We have refrained from adding much to the stock this year as it has weakened, but after a more robust meeting with management, the weighting was slightly increased to 50bps. We will continue to monitor events.

We also added to **Anglo American**, which has been weak.

## Outlook

Two themes are evident in the Fund; company results are strong, and balance sheets and dividends are robust. The last time valuations were as low as they are now was coming out of the Global Financial Crisis (GFC). Then, results continued to be very poor as 'value' rallied. The contrast in company performance now compared to then is vivid.

The dividend profile of the Fund remains strong; we are running slightly above our current guidance band of 1-5% growth in the Fund dividend for 2023. With much of the interim results season now behind us, we raise guidance to 3-7% growth in the Fund dividend. The Fund yields 5.8% for 2023 at the midpoint of the new range. Based on current forecasts, we would expect continued healthy growth in the Fund dividend in 2024.

We have discussed how cheap the Fund in aggregate is, and its individual components are in detail in these recent monthly reports. This month, in the box below, we have placed a spotlight on the Life Insurance sector.

**UK Life Insurance Spotlight**

By way of example of the valuation picture across the Fund, it is worth looking at the life insurance sector in detail. The Fund holds three positions in this sector, **Aviva**, **Phoenix** and **Legal & General**, which in aggregate are c.9% of the Fund. On average, the dividend yields of these three stocks are c.10%.

All three stocks have excess capital at a headline level – this has been borne out of their respective board's prudence post the GFC and higher interest rates, which is a positive for this sector. By our calculations, moving to the top end of target capital ranges equates to c. 15% of market capitalisation. On top of this, the recent Solvency II deregulation (a Brexit dividend) will create further excess capital, as well as highlighting governmental support for the sector. Unfortunately, there has also been an increase in mortality rates since Covid ended due to a lack of cancer treatment during Covid, long waiting lists etc. Since 2021 to the middle of this year, there has been a 17-month fall in the average life expectancy of a 60-year-old. This new reality will lead to the need for assumption changes at all of our life assurers, which we estimate will free up capital equal to c.10-15% of market capitalisations. **This sector is awash with excess capital.**

All three stocks also have strong growth dynamics. For example, pension fund buyouts are exploding post the rise in interest rates. With our three holdings dominating this market, they have a unique position in a market that will see strong growth for the next 4-5 years, a supply and demand imbalance and sturdy margins. Another component fuelling the growth dynamic is auto-enrolment for pensions – which means each year, like night follows day, billions of pounds are (automatically) saved into pensions, which underpins inflows/growth in the workplace pensions businesses of these stocks. Finally, there is the rise in general insurance pricing, which readers will have seen if they have renewed their car insurance recently. We encourage readers to listen to the first 15 minutes of the Aviva interim results presentation (LINK here), highlighting these points. You will note the degree of confidence in the CEO, the raised targets, the dividend growth, the underlying growth in the businesses and the excess capital. The difference between this picture vs the valuation is stark.

The income growth potential of a sector such as Insurance is one of the many reasons we feel so positive about the total return potential of the Fund. Whilst the increase in bond yields has meant that gilts or corporate bond funds have, for many, become an alternative to Equity Income Funds, the key differential is that dividend distributions for a Fund such as ours have grown historically in nominal and real terms and continue to have the potential to do so. For much of the period from the 1960s until the GFC in 2007/8, equities tended to yield substantially less than government bonds precisely because their income distributions grew over time, unlike the fixed coupon nature of bond investments. Indeed, for much of that 40-year period (during which inflation was present), the UK Equity market regularly yielded around half that of the 10-year bond yield; indeed, the relationship was so well established that we regularly included a chart of it in our quarterly pack.

However, the distortion to interest rates caused by the GFC and commensurate policy actions as well as more latterly, Covid, has confined any discussion of this relationship to the history books. With a positive rate of inflation not only re-established but likely to persist and a positive cost of money here to stay, there is every reason for investors to reconsider the income characteristics of equities vs bonds.

Our Fund currently yields almost 6% and over the last 19 years it was established, its distribution has grown by around 9% per annum. With payout ratios lower than in the past and balance sheets much stronger, there is every reason to expect growth to continue in future years, with 2023 on track to deliver ahead of our initial expectations, as outlined above. We think that a starting yield of almost 6% with possible mid to high single-digit growth has to look competitive against, for example, the UK 10-year bond yield of 4.37%. As we have outlined many times before, we believe that there is also considerable capital upside to our portfolio due to the **low ratings that all of the stocks trade on**, with the UK market falling out of favour over the last 15 years, during which growth and momentum as a style has outperformed. The valuation elastic is close to as stretched as it has ever been, between value and growth, defensives versus cyclicals, and large versus small, which we have extensively commented on in recent reports. A reversal of these trends looks very likely as investors recognise that interest rates are unlikely to be cut anytime soon.

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