Professional Investors Only

J O Hambro Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: December 2017

Active sector bets for the month ending 30 November 2017

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.66	2.95	+5.71
Construction & Materials	6.48	1.45	+5.03
Banks	15.82	11.30	+4.52
Mining	9.47	6.08	+3.39
Oil & Gas Producers	15.74	12.42	+3.32

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.81	-5.81
Pharmaceuticals & Biotechnology	2.82	7.11	-4.29
Equity Investment Instruments	1.00	4.51	-3.51
Beverages	0.00	3.01	-3.01
Personal Goods	0.00	2.49	-2.49

Active stock bets for the month ending 30 November 2017

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.96	0.86	+3.10
Lloyds Banking Group	4.96	2.00	+2.96
ITV	3.06	0.25	+2.81
BP	6.76	3.99	+2.77
Barclays	4.01	1.38	+2.63
Rio Tinto	4.38	1.75	+2.63
Standard Life Aberdeen	3.10	0.48	+2.62
National Express Group	2.40	0.06	+2.34
DS Smith	2.30	0.21	+2.09
Morgan Sindall Group	1.93	0.02	+1.91

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.59	-4.59
Diageo	0.00	2.68	-2.68
GlaxoSmithKline	0.00	2.64	-2.64
Unilever	0.00	2.08	-2.08
Prudential	0.00	2.06	-2.06

Performance to 30 November 2017

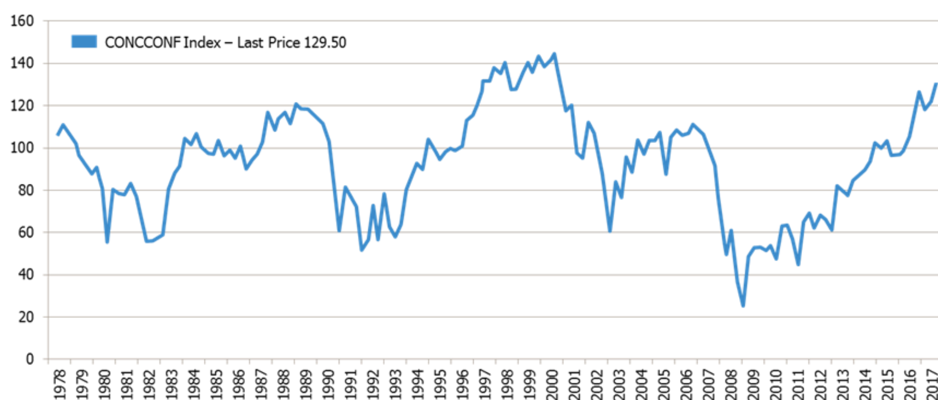
	1 month (%)	Year to date (%)	Since inception (%)	Fund size
JOHCM UK Equity Income Fund	**-0.24**	**14.41**	**279.60**	**£3,413m**
Lipper UK Equity Income Mean*	-0.96	8.23	167.39	
FTSE All-Share TR Index (adjusted)	-0.69	9.61	174.14	

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

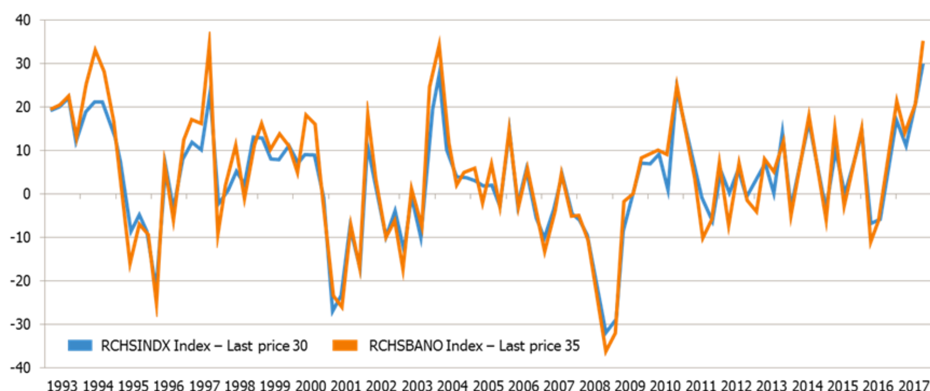
November saw a continuation of the strong sequence of economic data being seen globally, with the US leading the way. As the two charts below show, US consumer confidence and manufacturing sentiment are close to 20-30 year highs while Q3 GDP growth was upgraded to 3.3%. European macro data likewise remains strong. Manufacturing PMI survey readings are close to highs, consumer confidence is near record levels and there is continued evidence of increased bank lending. Collectively this suggests eurozone GDP growth is running closer to 3% annually than 2%. It is this strong backdrop allied with likely higher wages and resultant higher inflation that should lead to higher bond yields in 2018 as ultra-accommodative monetary policy / QE is withdrawn.

US consumer confidence measure at highest level since 2001



Conference Board data to 30 November 2017. Source: Bloomberg.

US manufacturing is booming



Richmond Federal Reserve Manufacturing Survey – m-o-m change. Source: Bloomberg.

In the UK it has been noticeable that economic data points have rebounded somewhat from a lull in the summer, with a recovery since August in the Citi Economic Surprise Index. This also correlates with what we are hearing from our holdings at a company level. We continue to monitor UK and US wage inflation data closely. UK wage data is very backward looking and changes in the pace of wage growth take time to show up. That said, UK wage growth for the September quarter was c. +2.2%. The Bank of England Agents' summary highlighted that "recruitment difficulties had intensified" and that "wage settlements were expected to be between 2.5-3.5% in 2018". We are also hearing a similar message from our domestic holdings when asked about their budgets for wage inflation in 2018. Based on this we would expect wage inflation to move towards c. 3% during the next 12 months while inflation will fall towards 2% as sterling's depreciation effects annualise out. The much-discussed negative real wage pressure currently dominating the news and sentiment around the domestic part of the equity market will turn into a narrative of real wage growth.

In the November budget, the Office for Budget Responsibility's (OBR) gloomy forecasts for UK productivity growth dominated the headlines. We would note, though, that the OBR's grim predictions come just as evidence of an upturn in productivity growth has emerged. The budget did bring encouraging announcements on infrastructure and housing, themes that sit well with the portfolio given our current sizeable exposure to the construction sub-sector through the likes of brickmakers Ibstock and Forterra and construction services firm Morgan Sindall.

We had movement on Brexit at the end of November, with a broad agreement on the cost of exit seemingly agreed. We have always thought a deal of some sort would be patched together given the cost of not having one would be materially negative for both sides. We will see if the other issues associated with Ireland and the European Court of Justice are ironed out before the EU summit in a few weeks' time. The breakthrough on the Brexit divorce costs saw a dramatic move in the FX and bond markets, which flowed through to the mix in the equity market. The size of these moves show how polarised the market is on the Brexit issue.

Finally, turning to oil, OPEC agreed to extend production cuts. This should secure the oil price above US$55/bbl. As we have said previously, oil is not just about OPEC. We have seen material upgrades to global oil demand growth this year (and also for 2018), driven by the synchronous global GDP growth noted above (with a major influence on oil demand being the economic recovery in Europe). We are also seeing a lower-than-expected growth rate from US shale producers, partly linked to higher cost inflation in that area but also because of less access to capital and a greater focus on returns versus growth on the part of operators. Shale is growing quickly, but not as quickly as some had forecast. The increase in the oil price year to date also feeds into higher inflationary pressure and into the narrative of upward pressure on bond yields.

Performance

The market was sluggish during November, with the FTSE All-Share Total Return Index (12pm adjusted) posting a decrease of -0.69%. The Fund continued to perform better than the index in returning -0.24%. Year-to-date the Fund is up 14.41% versus the benchmark return of 9.61%.

Looking at the peer group, the Fund is ranked first decile within the IA UK Equity Income sector over one year to 30 November 2017. On a longer-term basis, the Fund is ranked first decile over three years, 10 years and since launch (November 2004) and first quartile (second decile) over five years.

For much of the month overseas earners performed well. This included many of our large portfolio voids (e.g. Diageo) but also a number of the Fund’s holdings, such as **BBA Aviation** and **DS Smith**. In contrast, domestic-related shares weakened. The trend twisted back the other way in the last two days of the month following the aforementioned rumours of an agreement between the UK and the EU on the costs of Brexit.

Our oil stocks have both done well over the past three months. During November **BP** announced it would buy back shares to offset its scrip dividend, and, in one of the best capital market events of the year, **Royal Dutch Shell** upgraded its free cash flow forecast materially, removed its scrip dividend and indicated it would do a US$25bn share buyback. Our thesis of a dramatic improvement in free cash flow in the oil sector driven by management action on costs, capex and

high grading of their portfolios has become very evident. In mining, performance was more sluggish, but our new smaller cap name **Central Asia Metals** bucked this trend.

The results season continued in November, with the majority of our companies producing good performances. Notable were **Vodafone** (up 6% relative) upgrading its profit and cash forecasts, **Bloomsbury** (up 13% relative) producing goods interim results and **Severfield** (up 15% relative) beating forecasts.

Severfield is a good example of the degree of undervaluation we have in the Fund. On our forecasts, it will have c. £50m of net cash in two years; its Indian business is showing real momentum; while the market-leading UK business, source of the earnings beat, has close to a record order book and pipeline. Placing the UK business on a low P/E of 12x and adding the cash and Indian business gives a target price c. 60% higher than the current level.

Elsewhere, last month's addition to the portfolio, **Kingfisher**, performed well (up 9% relative) following its capital market day and an in line trading statement. **Barclays** bounced back following a poor statement in October. **CMC** also had a strong statement. Strong stock-specific performance continues to underpin the Fund's performance.

On the negative side, **TP ICAP** fell after the surprise announcement that its highly capable finance director was leaving the company. **Laird** and **Eurocell** were also weak.

Portfolio activity

During the month we continued to tilt the Fund away from overseas earners towards more domestically-orientated stocks. We have been doing this gently during most of this year, but stepped up the pace somewhat in November. The drivers of this were the widening valuation gap (the average P/E of the stocks reduced is c. 15-16x vs c. 10x for those we added to), our view of a more robust GDP outlook than consensus expectations, and finally the likelihood of some form of Brexit deal in the near term. We have purposely been evolutionary rather than revolutionary in our approach, since there are a number of risks that could keep the value gap wide in the short term (e.g. the risk of a Corbyn-led government). In aggregate, we moved c. 1.5% of the Fund across this divide during the month. Most of the change came from adjusting weightings of current holdings, although one new domestic stock was added in the form of **Norcros**.

Norcros is the market leader in shower appliances and related materials in the UK and also has a South African business. Despite good operational performance, the presence of the latter and a large pension deficit (c. £50m versus a market cap of c. £150m) have contributed to the stock being valued on a P/E of c. 5x and a free cash flow yield of c. 18-20%. It is therefore one of the cheapest stocks in the market. We participated in the fundraising the company undertook to acquire Merlyn (another high quality company in the shower supply chain) during November. This acquisition and the associated equity raised reduce the relative size of both the pension fund deficit and South African business and should, in our view, be the bridge towards a higher stock market rating in time. After the acquisition net debt to EBITDA peaks at c. 1.3x, which is low, and, assuming no further acquisitions, the company's high free cash flow yield means it should be close to being debt free in roughly two years' time. Norcros should also benefit from the housing-related announcements in the budget, discussed above.

Stocks we reduced included **Brewin Dolphin**, **National Express**, **BBA Aviation**, **AstraZeneca** and **DS Smith**. All of these continue to trade well and are well positioned. They therefore remain holdings in the Fund but at lower weightings, reflecting the reduced upside to our target prices after strong performances year to date. We continued to add to recent new names **Kingfisher** and **Hammerson.** We also added to our other retail names, **DFS** and **Halfords**. The Competition Commission cleared DFS's acquisition of Sofology during November. This transaction means DFS now has c. 30% market share of sofa sales in the UK. One of the smaller players in this market; Multiyork, also went into liquidation in November, which should see some sales switch to DFS. Halfords' results were robust and there remains a material buffer in forecasts, with management confident they can fully recover the FX headwind (associated with the delayed impact of the Brexit-related depreciation in sterling) on cost of goods sold compared to an analyst community which takes a more cautious view. Halfords trades on a P/E of 10x and its low leverage means it is likely to continue to return capital to shareholders.

We also added **Catco Reinsurance Opportunities** to the Fund in November. Catco, which the Fund has owned before (c. five years ago), holds reinsurance contracts covering low probability, large loss events. Insurance prices and in particular reinsurance prices have moved materially higher after the two large hurricanes that hit the Caribbean and the US this summer; Catco reports that its pricing is up 30-40%. We wanted the Fund to have exposure to this pricing trend (and likely much higher ROCE), but are somewhat restricted by the limited amount of stocks that are now quoted in the UK market which are exposed to this trend after a number of takeovers over the last five years. Meanwhile those that are left (Hiscox, Beazley and Lancashire) currently trade on very high multiples (2x price-to-book). Catco, which has a good track record, has listed the new shares at par, meaning we should see good absolute upside as 2018 progresses, assuming a more normal year of large loss activity.

Dividend update

As we near the end of the year, we are able to upgrade our forecast for the Fund's dividend growth for 2017 to c. 13% (we had previously guided 9-11%). This has been driven by good underlying dividend growth (particularly from our large holdings) and the annualisation of the post-Brexit vote sterling devaluation in the first half of the year. The strength in free cash flow and capital discipline in the mining sector was another notable driver as these factors translated into robust dividend growth. A Fund dividend growth rate of 13% would result in a dividend per unit of c. 16.15p (for the 'A' share class) and a now largely historic yield of 4.25%. The discrete Q4 dividend should be up c. 5%.

As we look into 2018, the dividend base of the Fund looks solid, with a good growth trajectory across a number of areas. Large active positions like **Aviva**, **DS Smith** and **National Express** are expected to deliver good dividend growth in 2018; the strength in the mining sector will annualise; and we expect the banks sector to continue to move towards a more normal dividend framework. When we look at our detailed, bottom up, stock by stock, dividend forecasts, there is less identifiable stock-specific risk this year compared to last year. The main risk relates to currency, particularly moves in the £/US$ exchange rate across the year. As we have indicated above, the better than expected UK GDP picture, the likelihood of a Brexit transition deal, coupled with the current level of pessimism priced into the pound and all domestic UK assets, mean we would expect sterling to strengthen, which would place pressure on the overall UK dividend base. The sensitivity of the Fund's dividend growth rate to a 5 cent move in both the pound/dollar and pound/euro rate is c. 2%.

Given all of these factors, and building in a buffer for the FX risk, our initial guidance for the Fund dividend growth in 2018 is for mid-single-digit percentage growth. This would mean the Fund would yield 4.5% on a 2018 prospective basis. We will update this guidance at the end of Q1 2017 when we have seen the trends evident in the full-year results reporting cycle.

Outlook

The path to policy normalisation has categorically begun in the US, 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. There are also a number of geopolitical risks that also make for a more cautious tone – namely Korea, Trump’s progress (or lack of) on policy, Trump / Russia, the tensions in the Middle East, Brexit, etc.

Within the equity market, we strongly believe that the overvaluation is most apparent in consumer staples and other perceived defensive sectors such as utilities and pharmaceuticals. It is pleasing that we have started to see chinks in the armour in the operational performances of these businesses in the last two months. Conversely, we believe that many of the areas that we are exposed to will respond well to a change of stock market leadership if monetary policy were to normalise, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also selective opportunities in the UK domestic arena, too.

A Brexit agreement to move discussions forward to transition / trade would, if it occurred in the next few months, be a positive for the Fund. As reflected in the gilt and FX markets and within the domestic side of the stock market, sentiment is polarised. Even a small move forward would cause

a big adjustment in these markets given the level of risk priced in and the absolute valuations, which have all trended to around a P/E of 10x and a dividend yield of 5%.

The long-term performance of the Fund is heavily correlated to the Fund's dividend growth and the resulting absolute level of the dividend. The upgrade to our guidance to 13% growth in the Fund dividend for 2017 and the confidence (even allowing for some sterling appreciation) in the 2018 dividend outlook is an important underpin to the unit price evolution. As noted above, the Fund's prospective yield for 2018 is c. 4.5%. This yield, strong dividend growth and low valuations embedded across the portfolio, coupled with the shift in monetary policy, leave us cautiously optimistic in our outlook for the Fund.

We would like to take the opportunity to thank all our investors for their continued support in 2017 and extend our season's greetings and best wishes for a prosperous 2018.

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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