JOHCM UK Equity Income Fund

Monthly Bulletin: December 2018

Active sector bets for the month ending 30 November 2018:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.25	3.00	+6.25
Banks	16.51	10.57	+5.94
Oil & Gas Producers	17.50	13.65	+3.85
Mining	10.00	6.22	+3.78
Construction & Materials	5.19	1.56	+3.63

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.23	-9.23
Equity Investment Instruments	0.38	4.93	-4.55
Tobacco	0.00	3.84	-3.84
Beverages	0.00	3.39	-3.39
Personal Goods	0.00	2.51	-2.51

Active stock bets for the month ending 30 November 2018:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	7.53	4.53	+3.00
Aviva	3.63	0.72	+2.91
ITV	3.08	0.25	+2.83
Barclays	4.00	1.27	+2.73
Lloyds Banking Group	4.44	1.79	+2.65
DS Smith	2.81	0.19	+2.62
Glencore	4.01	1.52	+2.49
Standard Life Aberdeen	2.73	0.31	+2.42
Vodafone Group	4.39	1.99	+2.40
National Express Group	2.20	0.08	+2.12

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	3.47	-3.47
GlaxoSmithKline	0.00	3.46	-3.46
Diageo	0.00	3.04	-3.04
British American Tobacco	0.00	2.82	-2.82
Unilever	0.00	2.11	-2.11

Performance to 30 November 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-3.09**	**-8.85**	**257.20**	**£3,389mn**
Lipper UK Equity Income mean*	-1.49	-6.79	157.62	
FTSE All-Share TR Index (12pm adjusted)	-1.68	-5.34	167.76	

Discrete 12-month performance (%) to:

	30.11.18	30.11.17	30.11.16	30.11.15	28.11.14
JOHCM UK Equity Income Fund – A Acc GBP	**-5.90**	**20.43**	**9.10**	**2.12**	**3.59**
FTSE All-Share TR Index (12pm adjusted)	-2.33	13.70	10.32	1.35	3.88

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

Expectations for global growth continued to drift lower over the month, with Europe and China at the forefront of those concerns as PMI data remained sluggish, particularly in the industrial sectors. This creates difficulties for the ECB as it has flagged for some time that it would like to formally exit QE in the next few months. At the same time, the stand-off between the populist Italian government and the European Commission over the appropriate level of the budget deficit continues to rumble on, although the gap between the two sides has narrowed appreciably. This was reflected in Italian 10-year government bond yields falling from 3.7% mid-month to closer to 3.2% by the end of November. The Chinese authorities have continued to increase stimulus and ease monetary policy, but thus far the impact has been fairly modest, with the uncertainties around the US trade relationship weighing on business confidence.

This softer global economic picture has led the Federal Reserve to alter its language around further monetary tightening, with Governor Powell moving from his October comment that "we are a long way from neutral" on interest rates, to last week's statement that they are "now just below neutral". This shift has also been partly driven by evidence of slowing activity in parts of the domestic US economy, such as homebuilding sales, as well as lower shorter-term inflationary pressures from commodity prices. Clearly this has led investors to lower the number of rate rises they expect in 2019, but it should be noted that 10-year US Treasury yields only fell by around 13 bps over the month to 3.02%. Whether this more dovish approach from the Fed causes the US dollar to weaken will be an important dynamic in 2019, particularly for emerging markets where it may take the pressure off local currencies.

The role of lower oil prices in reducing shorter-term input inflation should not be ignored. President Trump has tried to claim the credit for this event, but where he is correct is that the 30% fall over the last two months represents a significant expansionary boost for American consumers. Whilst oil prices looked a little vulnerable at the start of the quarter, the scale of the fall looks exaggerated relative to the events: greater Saudi production; slightly slower economic growth; higher short-term inventories in the US; and no meaningful decline yet in Iranian output do not look sufficient collectively to justify in full the 30% drop. This suggests that part of the fall is probably down to investor positioning, which was consensually 'long' oil earlier in the quarter. In this regard, it is noticeable that whilst the oil price has fallen 30% since the end of September, US natural gas prices have risen 50% over the same period. Whilst the seasonally colder weather in North America arrived earlier than normal, again the move looks outsized relative to the event, with evidence emerging of hedge fund liquidations compounding the moves. If OPEC can deliver a coherent message in December, a meaningful rebound in oil prices looks possible.

In the UK, the Brexit constitutional debate has taken centre stage. Market participants appear to be giving little chance of Mrs May winning the parliamentary vote on 11th December. The scale of the defeat may be of more significance, as it will affect any attempted path to change the agreement. A defeat in the Commons may not lead to the much heralded "market chaos" since the outcome is well anticipated and the consensus amongst investors is that some kind of amendment is possible. In that respect, it is worth highlighting that at €1.12/£, the sterling/euro exchange rate is only 2% below its high for the year.

Underlying momentum in the UK economy has continued to be fairly robust. Wage data pushed higher again in November to 3.2% (for the three months to September) and job vacancies, at 845,000, again hit a record high. However, business confidence clearly continues to fall as the uncertainty drags on and there are signs that consumers are being slightly more cautious in their spending, with sales in the supermarket sector, for example, falling back after the long, hot summer.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) fell further in November, returning -1.68%. The Fund underperformed in returning -3.09%. Year to date the Fund has returned -8.85% versus an index return of -5.34%.

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

Performance trends in November remained distinctly defensive. This was partly driven by the continued decline in global markets, creating a rush to perceived safe areas, and partly, in a UK context, by developments / noise around the outcome of the Brexit negotiations and the upcoming vote in the House of Commons. The majority of the defensive sectors (excluding tobacco, which remained under pressure) performed well, which hurt the Fund's relative performance.

The other feature of November (and October) was the lack of market focus on valuation. These conditions do not favour the Fund's style, but will iron out over time as the market returns to focus on valuation, as it always does. Some of the examples provided in this report as well as the aggregate price-to-book chart overleaf, highlight this.

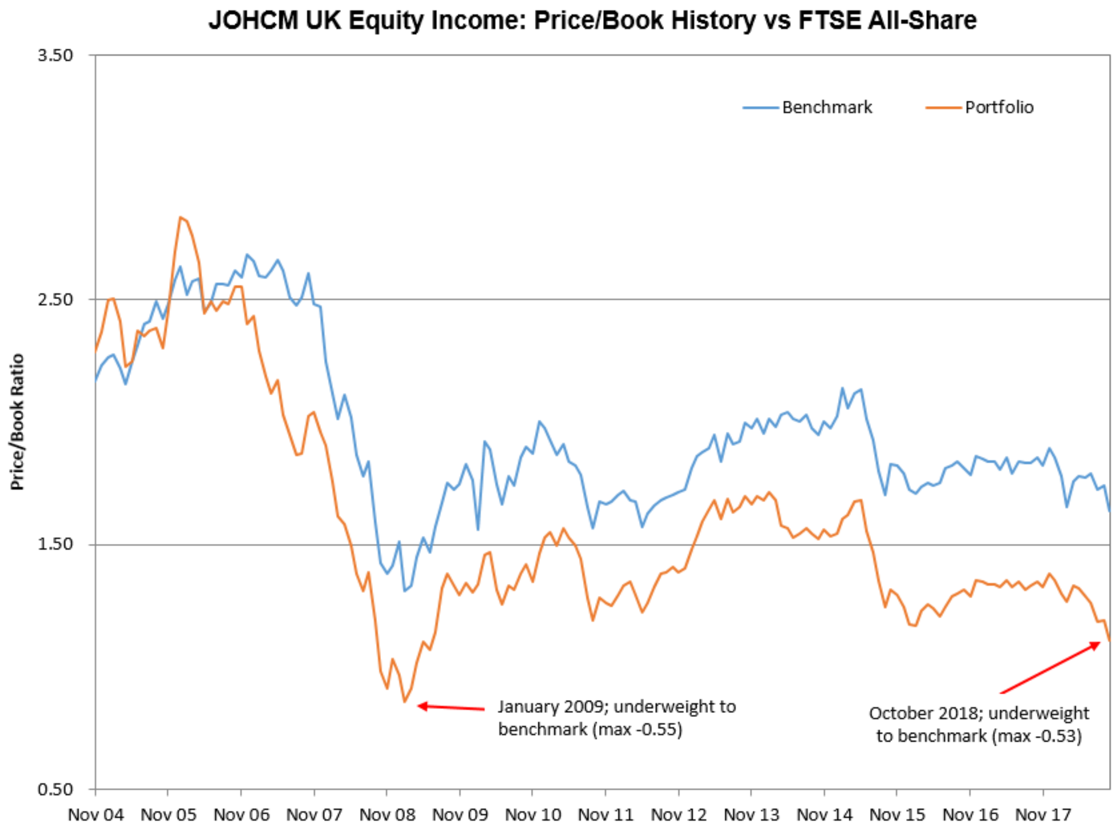
The oil and mining sector performed poorly during the month, the former driven by the fall in the oil price noted above. Most stocks in these two sectors dropped between 4-8% relative. As regular readers will know, we never based our investment thesis in this area on US$80/bbl (or the equivalent commodity prices), and neither will we set in stone what we think will be cycle low price points. However, even at current spot commodity prices, stocks like **Glencore** and **Anglo American** are on very high free cash flow yields (18% and 12% respectively).

Our overseas earners did well. **Standard Chartered** (up 13% relative) and **HSBC** (up 5% relative) both outperformed, as did **Vodafone** (up 15% relative) after a long period of sluggish performance. **TP ICAP** also continued to bounce back following the fall associated with its profit warning in the summer. One stock we would normally expect to do well in this type of market is the relatively defensive **DS Smith** (with its customer base being largely the FMCG companies), but this fell 12% relative, leaving it on a lowly P/E of c. 9x.

Two of our small caps fell: **CATCo** on various potential insurance losses (e.g. wild fires in Western US) and **Urban Exposure** on a delay in profit recognition. The combined cost of these two stock price falls was c. 25bp.

Portfolio activity

Following the sale of stocks like Sainsbury and AstraZeneca in recent months, the majority of the Fund is now, in our view, in deep value territory. The chart overleaf shows the price-to-book history of the Fund versus the FTSE All-Share since the Fund's launch in November 2004 to the end of October 2018. It highlights that the absolute price-to-book of the Fund is near its record low (Q1 2009) and the gap on this valuation measure to the overall market is at one of its widest points.



Source: JOHCM/Style Analytics

This, coupled with the recent negative relative performance of the Fund, means there are less stocks that are reaching a natural exit point, which also means there is less space for new names. So, unusually, no new names were added to the Fund during the month. But behind the scenes we have continued to work on building a bench of ideas that will come to the fore as the market mix changes and the valuation of the Fund versus the market narrows from this current wide point.

As noted above, **TP ICAP** continued to recover from its profit warning over the summer. We marked our position down to its starting weight. We also reduced some of the month's strong performers like **Standard Chartered**.

Kingfisher also performed reasonably well despite another sluggish update. We top-sliced our holding, moving the proceeds into **Tesco**, which we discussed in last month's update. Tesco, which continued to underperform during the month, is now on a P/E ratio of 10x and a free cash flow yield of 9%. Tesco is now c. 60bp of the Fund and we are likely to continue to add to it.

The weakness in the oil and mining sectors created a number of opportunities to add to current positions. **Petrofac** has seen positive contract awards and a series of disposals since we re-acquired it earlier this year. These developments mean it will transition from being a company where the market was concerned about its balance sheet a year ago to one that will have net cash at the end of 2019. We added to this stock and some of our miners (**Glencore** and **Anglo American**).

We also added to **DS Smith** and **Countryside Properties**. The latter is the market leader in partnership home delivery, a key policy focus area of the government as it encourages local authorities to reinvigorate council estates and provide better housing. Countryside Properties, which dominates this sector, has a pipeline of 10+ years and yet is on a P/E ratio of < 7x, with net cash. It is another example of the material distortion that currently exists in valuations across the market.

Fund dividend

2018 final position:

As we have articulated for much of the year, the Fund's dividend dynamics have been strong at an underlying level. Notable developments during the year have been: (a) the first dividend increase in nearly five years from BP, c. 3%; (b) the banking sector in clear dividend growth territory as legacy issues finally fall away; (c) strong free cash flow and dividend growth from the mining sector; and (d) strong growth from a number of the Fund's larger holdings (e.g. Morgan Sindall's interim dividend up 19%, Rio Tinto's interim dividend up 15%, Paragon's annual dividend up 24% - all are top 15 active positions). The weakening of sterling during the second half of the year also underpinned the Fund's dividend growth.

The result of these trends is one of the fastest annual rates of Fund dividend growth since the Fund launched 14 years ago. We upgrade our guidance for the Fund's dividend growth for 2018 to c. 18% (previously we had guided to 12-13%).

Taking 18% growth, the Fund dividend for 2018 should be 19.1p (A Accumulation shares), which means the now nearly historic yield on the Fund (for the 12 months to December 2018) is 5.3%.

The Fund dividend for Q4 (which will go ex-dividend on 28 December) should be up slightly more than 20% year-on-year.

2019 initial outlook:

Over the last month, we have conducted a detailed review of our dividend forecasts on a stock by stock basis to create a well-defined bottom up picture for 2019.

As we move into next year, there are a number of somewhat binary macroeconomic and political risks to consider, some of which we have noted elsewhere in this bulletin. The stock by stock work, which we always do on a prudent basis, suggests a reasonable growth trajectory into next year as a central case.

There are also less identifiable stock specific risks this year compared to previous years. As we did the work, the main risk we factored into our thinking was a potential dividend cut by Vodafone. Since then Vodafone, under its new Chief Executive, has updated its strategy, announced a material cost reduction programme and restated its confidence in its balance sheet and cash flow dynamics. The new Chief Executive has also restated his confidence in the dividend. If it were to have been cut, it would have likely happened at this set of results. The chance of a cut in the next 12-24 months is relatively low and the cost saving programme and accretive Liberty acquisition open up the free cash flow cover of the dividend materially as time passes after that.

Another driver of historic Fund dividend growth and lower risk looking forward is the continued strength of the balance sheets of holdings across the Fund. This strength reduces the risk of dividend cuts (where the latest example in the market is Kier, a stock we sold in May 2017 due to concerns regarding its balance sheet) and creates upside optionality as robust balance sheets are used to strengthen businesses.

The main risk to the rate of Fund dividend growth in 2019 is FX moves, in particular GBP/USD. As we allude to in this report, we think sterling and domestic assets in the UK stock market are materially undervalued. We do expect the pound to strengthen as clarity over Brexit emerges and the strength of the UK economy continues to confound the negative consensus. A 10¢ move in the FX rate would knock c. 4% off the growth rate of the dividend. In contrast, a more negative Brexit outcome could meaningfully slow UK economic momentum and commensurately lower UK domestics' dividend growth but this impact would be somewhat offset by the Fund's foreign currency-denominated dividends.

Bearing this scenario in mind, and including a buffer for such an outturn, our initial formal guidance for Fund dividend growth for 2019 is low to mid-single digit growth.

Outlook

We commented last month about how low valuations have become in the universe of stocks in which we are invested. Little has changed since then. We still have around two thirds of the Fund trading on more than a 10% prospective free cash flow yield and a dividend yield of more than 6%. Furthermore, at the aggregate level, the price-to-book multiple of the Fund sits just above 1x. This is extremely low relative to history.

It is noticeable that elsewhere in the world, such as the US and Asia, value has started to outperform growth. However, that has not been the case in the UK, where the Brexit overlay has led to very high levels of risk aversion. Consequently, any kind of resolution of the Brexit debate could lead to a dramatic change in stock market leadership. Identifying the precise path of such a resolution is difficult at this stage, but with the UK equity market at 30-year lows relative to the rest of the world, and with sterling looking modestly valued on a purchasing power parity basis, the potential upside is clear. If the UK were to experience a hard Brexit, there would clearly be some short-term disruption to economic activity, but with the UK's budget deficit now running close to zero, there will be scope for some fiscal stimulus to provide a degree of support, a process which actually began with this year's October budget. Regardless of which path the politicians take, we will continue to focus on delivering dividend and income growth to our investors, which we think is being materially undervalued at the moment.

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

This document is for professional investors only.

Past performance is not necessarily a guide to future performance. Dividend yield quoted is prospective and is not guaranteed.

Investors should note that there may be no recognised market for investments selected by the Investment Manager and it may, therefore, be difficult to deal in the investments or to obtain reliable information about their value or the extent of the risks to which they are exposed.
The Investment Manager may undertake investments on behalf of the Fund in countries other than the investors' own domicile. Investors should also note that changes in rates of exchange may cause the value of investments to go up or down.