



JOHCM UK Equity Income Fund

Monthly Bulletin: December 2019

Active sector bets for the month ending 30 November 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.59	3.84	+5.75
Life Insurance	9.04	3.43	+5.61
Construction & Materials	4.80	0.84	+3.96
Mining	9.50	6.33	+3.17
Media	6.93	3.82	+3.11

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.34	-8.34
Equity Investment Instruments	0.00	6.35	-3.35
Tobacco	0.00	3.71	-3.71
Beverages	0.00	3.57	-3.57
Support Services	2.71	5.46	-2.75

Active stock bets for the month ending 30 November 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
ITV	3.26	0.23	+3.03
Phoenix Group Holdings	3.18	0.17	+3.01
Barclays	4.24	1.29	+2.95
Standard Life Aberdeen	3.23	0.33	+2.90
Aviva	3.56	0.67	+2.87
BP	7.02	4.16	+2.86
DS Smith	2.95	0.21	+2.74
Lloyds Banking Group	4.58	1.90	+2.68
Glencore	3.82	1.17	+2.65
Hammerson	2.59	0.10	+2.49

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.23	-4.23
GlaxoSmithKline	0.00	3.71	-3.71
Diageo	0.00	3.20	-3.20
British American Tobacco	0.00	3.01	-3.01
HSBC	2.07	5.05	-2.98

Performance to 30 November 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	3.95	15.31	292.30	£3,081mn
Lipper UK Equity Income mean*	3.03	15.00	184.35	
FTSE All-Share TR Index (12pm adjusted)	2.82	16.24	199.00	

Discrete 12-month performance (%) to:

	30.11.19	30.11.18	30.11.17	30.11.16	30.11.15
JOHCM UK Equity Income Fund – A Acc GBP	9.83	-5.90	20.43	9.10	2.12
FTSE All-Share TR Index (12pm adjusted)	11.67	-2.33	13.70	10.32	1.35

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 UK general election has understandably dominated news commentary over the last few weeks. Despite the meaningful lead that the Conservative party has shown in polling so far, investors remain cautious about assuming the result is guaranteed, due to misreadings of both the 2016 referendum and 2017 general election. Furthermore, even if the Conservatives were to win control of Parliament, the implications on their Brexit strategy will depend upon the size and make up of that majority. Consequently, sterling has been relatively flat over the last 30 days and 10-year gilt yields remain around 70 bps.

In the meantime, the headline economic indicators in the UK have been relatively soft, driven by the lack of political clarity. The latest set of PMIs were lacklustre in both the manufacturing and service sectors, and the employment market has weakened progressively over the last few months, although real wages are still growing at a healthy rate. This weaker economic sentiment led two members of the Monetary Policy Committee to vote for an interest rate cut at the latest meeting. However, despite this high-level caution, engagements with a number of our more domestically orientated companies suggest that parts of the UK economy are more robust than the data suggests, despite the political backdrop. We would highlight three examples. First, a number of housebuilders, such as **Countryside**, have reported very strong sales in the last few weeks, outperforming their own expectations. Second, the CBI monthly survey of distributive trades (mainly the retail sector) released this week had its strongest reading for six months. Third, **ITV** indicated in an open meeting that advertising markets were "very lively" in November. Clearly, the election outcome will be critical in potentially sustaining consumer momentum, but as we have stated before, a clean result could see a swift economic rebound, particularly if accompanied by an acceleration in fiscal policy.

In the US, the economic picture is also mixed; business confidence and investment spending are currently weak, predominantly due to the ongoing US-China trade dispute. The Federal Reserve's response to this short-term weakness now appears to be complete following the series of rate cuts over the last six months. However, in contrast, US consumer spending appears to be holding up well, growing by around 3% in the last quarter, and there have been improvements in the new housing market activity indices, too. For now, it appears that Fed policy is on hold whilst uncertainties around President Trump's impeachment and China trade negotiations remain unresolved.

The impact of the unresolved US-China trade dispute remains most clearly observed in the weak performance of the German manufacturing industry. However, market participants are highly focused upon the modest improvements that many of the forward-looking surveys have begun to show in the last 2-3 months. Whilst still in contraction, the PMI surveys suggest it is, at the very

least, getting less bad, although the situation remains fragile. At the same time, German consumer confidence surveys have also begun to improve, too.

In China, there are increasing signs that policy stimulus is having an impact in certain sectors, particularly construction and property, with new housing floor space up over 20% in October. On the flip side, developments in Hong Kong are an obvious downside risk, both economically and politically, in the region, while the US trade dispute continues to cast a shadow over business confidence more broadly.

Performance

November was mixed in terms of market leadership, caused by a wait-and-see attitude on the election and little progress in the US-China trade dispute. This compares to September when global bond yields moved higher and October when sterling rallied strongly – both led to rotations from growth to value and from overseas-earners to domestics. Despite this more mixed market environment, the Fund's recent relative performance recovery continued. In relative terms, the Fund returned 3.95% versus a 2.82% return for its benchmark, the FTSE All-Share Total Return index (12pm adjusted). Year to date the Fund has returned 15.31% against the benchmark return of 16.24%. As we said last month, though, there remains much to be done on the fund performance front.

Looking at the peer group, the Fund is ranked third quartile/sixth decile 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).

The main drivers of the Fund's outperformance in November were positive developments among several of our small caps. **Forterra**, the only stock to report a poor update in the previous month, rallied 10% relative.* Its shares are now back to their previous level before the trading statement. **Norcros** was up 10% relative following strong results. **Sthree** was up 20% relative, helped by a strong capital markets event while **Countryside** also jumped 10% relative following strong results and speculation it might split its business in two. Elsewhere, **Charles Stanley** rose 13% relative in response to good results. In the larger-cap space, **ITV** and **Lloyds Banking Group** were strong.

Offsetting some of those positive trends, the oil sector was sluggish and **Aviva** underperformed following a disappointing capital markets day.

Portfolio activity

We made a number of changes to the Fund during November. We added **SSE** and sold **National Express**, **Halfords** and **McKay Securities**.

Dealing with the sells first, National Express has been one of our most successful investments since the Fund launched 15 years ago. Across our period of ownership (about five years) the stock more than doubled, contributing c. 165bp of relative performance. We sold on valuation grounds. McKay, a small-cap property stock, added marginally to performance across our ownership. This was despite, as with the whole sector, being hurt by the EU referendum result and ensuing uncertainty. We also sold Halfords, a disappointing holding, with materially more margin investment required across successive management teams. Whilst the new strategy from the most recent new leadership team has positive points, it will be difficult to execute in the current environment. The Fund lost 50bp here.

SSE has completely transformed itself in the last 12 months. It is now a networks business similar to National Grid. It owns high-value, strategic hydro-electric-generating capacity and has a fast growing valuable offshore wind portfolio. It is selling its troubled businesses (like energy retail) and heavy-carbon assets (oil and coal), so will be a pure play clean energy company in its new form. This is not reflected in its valuation: it trades on a p/e of 13.5x, has a dividend yield of 6.2% and a free cash flow yield of 8.4%. We have gradually reduced our oil exposure (and will continue to do

* All share price moves quoted are relative to the Fund's benchmark, the FTSE All-Share TR index (12pm adjusted).

so) against this addition.

Elsewhere, we have materially added to three recent additions: **WPP**, **Tesco** and **Legal & General**. These have all been covered in recent updates. All three are on cheap valuations: a p/e of 10x, a free cash flow yield of 9% and a p/e of 9x, respectively. All have 30%+ upside by our estimates.

We also added to our small-cap holdings in **Costain** (a recent addition), **U&I** (which trades at a 50% discount to book value) and **DFS**. Our total small cap weighting remains c. 20% of the Fund. The average upside across our core holdings in this area is 40-50%, on our estimates. Morgan Sindall, one of our larger small-cap holdings, continued to perform well, and we trimmed our position.

We also reduced our holdings in **Paragon**, **DS Smith** and **Easyjet**. All three had robust trading statements or results. These have underpinned better share price performances, and we marked our positions down slightly.

Fund dividend

We are upgrading our guidance for the Fund's dividend growth in 2019 to c. 7.5% (previously we had guided to mid-single-digit growth). We view this outcome as very strong given we delivered 18% growth in 2018, making for a high base-line comparator.

This Fund growth has been driven by strong dividend increases across the Fund. Highlights during November included **Countryside** raising its dividend by 51%, **Liontrust** by 28% and **Norcros** beating our forecast with 10% dividend growth.

Actual dividend growth could be slightly higher than this (up to 1.5% more, making overall Fund dividend growth c. 9%). This is due to the Bovis / Galliford Try deal – Bovis is bringing its final ex-dividend date forward from Q1 2020 to the end of December 2019 because of the timing of its acquisition of Galliford. This will correspondingly reduce the Fund's 2020 dividend growth. The exact impact will depend on the size of the position on the date it goes ex-dividend.

The Fund will go ex-dividend at the end of December, with the discrete Q4 2019 dividend (excluding the Bovis effect) being 3.95p per unit ('A' accumulation share class). This represents a rise of 7% year on year. On our current guidance of mid-single-digit growth, the Fund yields 5.3% for 2019.

In the paper we issued in September, titled 'Deciphering the dividend gap and our 2020 dividend vision' we laid out, in detail, our expectations for Fund dividend growth in 2020. The paper highlights why we are confident we will grow the dividend in 2020:

- 1) The average dividend cover across the Fund's holdings is c. 2x, which is better than the wider market;
- 2) The Fund's holdings are significantly less levered than the market (with only three stocks with a net debt to EBITDA ratio of over 2x);
- 3) A large number of companies within the portfolio (c. 42%) are engaging in share buy-backs. This creates a buffer that would protect the dividend flow were earnings outcomes to be worse than expected.

We took a large discount from our modelled dividend growth to account for the fact that sterling is likely to appreciate if we get political and Brexit clarity in the upcoming election. Our initial guidance, factoring this buffer in, is for low-single-digit growth in the Fund dividend in 2020. Based on this initial guidance, the Fund yields c. 5.4% for 2020. We will provide an update on this and the impact on this forecast of the Bovis effect in early January.

Outlook

As highlighted above, November represented something of a pause in terms of style leadership between value and growth. With sterling and UK government bond yields largely flat over the month, individual stock fundamentals were more influential on performance than we have seen for a while. However, this situation is unlikely to repeat in December, particularly once the election result is known. What is beyond doubt is that UK stocks remain modestly owned and, in our view, commensurately modestly valued relative to other equity markets around the world. Furthermore, sterling continues to look meaningfully undervalued on a purchasing power parity basis. At the same time, whilst the valuation gap between value and growth has modestly closed since the end of August, it remains very wide relative to history and has the capacity to contract further if some of the global economic and political clouds clear.

Consequently, we continue to believe that the capacity for meaningful outperformance by our portfolio is still very high at present, particularly if we get a decisive poll result and a clearer Brexit path. In this regard, whilst the gap between the Fund's unit price and dividend trajectory has started to close in the last three months, it remains very wide and is likely to close further if UK political uncertainty reduces and/or if the US and China reach a trade accord. Furthermore, with the Fund continuing to show healthy rates of dividend growth, we believe the c. 5.4% prospective yield remains attractive, both in an absolute and relative sense.

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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