



JOHCM UK Equity Income Fund

Monthly Bulletin: December 2020

Active sector bets for the month ending 30 November 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.25	3.41	+6.84
Mining	14.20	7.60	+6.60
Media	8.42	3.56	+4.86
Food & Drug Retailers	6.05	2.05	+4.00
Banks	11.16	7.68	+3.48

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.90	-8.90
Equity Investment Instruments	0.00	6.96	-6.96
Beverages	0.00	3.66	-3.66
Tobacco	0.00	3.62	-3.62
Personal Goods	0.00	2.83	-2.83

Active stock bets for the month ending 30 November 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Legal & General Group	3.73	0.74	+2.99
Glencore	4.11	1.12	+2.99
Anglo American	4.33	1.35	+2.98
Aviva	3.51	0.62	+2.89
Barclays	4.06	1.17	+2.89
Vistry Group	2.98	0.09	+2.89
ITV	3.05	0.17	+2.88
WPP	3.28	0.43	+2.85
BP	5.37	2.53	+2.84
DS Smith	3.02	0.21	+2.81

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.96	-4.96
HSBC	0.00	4.01	-4.01
GlaxoSmithKline	0.00	3.31	-3.31
Diageo	0.00	3.27	-3.27
British American Tobacco	0.00	2.97	-2.97

Performance to 30 November 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	25.66	-19.76	227.60	£1,843mn	£2,232mn
Lipper UK Equity Income mean*	15.76	-13.73	76.00		
FTSE All-Share TR Index (12pm adjusted)	14.39	-12.03	169.94		

Discrete 12-month performance (%) to:

	30.11.20	30.11.19	30.11.18	30.11.17	30.11.16
JOHCM UK Equity Income Fund – A Acc GBP	-16.49	9.83	-5.90	20.43	9.10
FTSE All-Share TR Index (12pm adjusted)	-9.72	11.67	-2.33	13.70	10.32

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 US election and vaccine progress were, in many respects, the main developments of the month. The protracted nature of the US election result meant that its impact on markets, particularly bond yields, was somewhat subdued. In contrast, the publication of vaccine data and the very real prospect of widescale vaccination programmes beginning in the coming months allowed investors to start to look through the current economic impact of further lockdowns and to focus upon the recovery in 2021 and beyond. This optimism was far more evident in equity markets than fixed interest, but is likely to broaden as vaccines get regulatory approval.

In the UK, September's GDP growth of only 1.1% left the Q3 rebound at 15.5%, still 8% lower than the pre-Covid-19 February level and well below many other developed Western nations. It is likely that this underperformance is partly down to different measurement techniques, with the UK's use of output estimates, especially in the public sector, being a much more cautious approach than that used elsewhere. When you compare the UK's estimates of GDP with other more measurable (and reliable) data, the scale of the mismatch is very clear. PAYE income tax receipts for April-October 2020 were flat versus the same six months last year; retail sales (online and offline combined) are only running 2-3% below last year's levels despite the restrictions put in place in Q2 and again in the autumn; average weekly earnings are still rising; and in recent months the number of new vacancies per month has been comparable to the number of redundancies. The housing market continues to show very strong characteristics, with October's mortgage approvals of 97,500 marking a 13-year high and house prices rising across the country in contrast to many gloomy predictions made a few months ago (the OBR had forecast a fall of 10% this year following the pandemic). Indeed, the OBR forecasts published with the spending review during November continue to look extremely conservative and overly cautious. Whilst unemployment is likely to continue to rise from the current 4.8% rate as government support schemes are tapered, there is the very likely potential for both a recovery in business investment and consumer spending, with the UK's current savings ratio at around 17% and clear pent-up demand in areas of restriction such as holidays and wider hospitality. Indeed, it has been striking that a number of our companies involved in areas such as advertising, recruitment and construction have reported very resilient trading during Lockdown 2.0, in marked contrast to Q2. CPI inflation has also begun to rise from the lows of August, at 0.7% in October, with the likelihood of an acceleration in 2021, particularly as we lap the weak comparative months worst affected by the pandemic in Q2.

Elsewhere in the world, China's strong recovery from its earlier virus impact continues, with the manufacturing PMI hitting a three-year high and the services PMI hitting an eight-year high. China's economic strength, as well as hopes of a global recovery in 2021, contributed to a sharp

increase in a number of commodity prices over the month, with copper, for example, rising another 13% in November, leaving it at its highest level since 2013. Many other commodities saw similar or larger increases including oil, which was up over 20% partly in anticipation of a return in demand from the transportation sectors. Economic activity in the US has continued to soften somewhat under the weight of further virus cases and rolling restrictions. Both consumer confidence and retail sales have slowed over the last couple of months, although they could rebound sharply on vaccine optimism and greater political certainty in the coming months.

Performance

Market dynamics changed dramatically in November. News flow on the various vaccines and to a lesser extent the Biden victory in the US presidential election were the catalysts for a material rotation in markets from 'growth' stocks to 'value' stocks. On certain days (e.g. after the first vaccine news from Pfizer) the rotation was as marked as it has ever been. This was, of course, caused by the extremities in positioning, with the valuation gap between the two factors at the widest it has ever been.

The Fund performed very well, rising 25.66% compared to an index return of 14.39%, therefore outperforming by 9.86%. Whilst this is a positive development, we remain behind the market year to date with a return of -19.76% versus the FTSE All-Share Total Return index (12pm adjusted) which returned -12.03%. Hence, we see this as only a partial step in the right direction. To use a football analogy, if we were 4-0 down, we are now at 4-2. The outlook section shows how small this move in valuation has been versus the valuation disparities that have been growing for years and why we are confident we will fully close our performance gap, as we did in other major market drawdowns (the bursting of the TMT bubble whilst at Newton Investment Management and the Global Financial Crisis (GFC) at JOHCM).

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

The majority of the Fund performed well in the context of the trends noted above. Large sectors such as oil (**BP** up c. 20% relative), banks (all our stocks were up c. 15-20% relative), mining (**Glencore** up c. 20% relative) and insurance (**Legal & General** up 25% relative) did well, whilst our voids such as pharmaceuticals (down 11% relative) helped relative performance.

The other story of the month, hidden behind this big picture change but equally important, was a step change in the operational performance of our stocks. We have noted this in our last few monthly commentaries but it accelerated materially in November. **Eurocell, Keller, Tyman, Sthree, Vistry, Headlam, Lookers, ITV** and most of the banks either warned 'to the upside' or had positive trading updates that led to upgrades. All of these stocks rose materially. We have described this 'front footedness' before and it bodes well for 2021. Many of these stocks are small caps, and it is pleasing to see this very lowly valued part of the Fund start to show form. This is exactly what happened following the GFC when small- and mid-cap names were the main drivers of the Fund's recovery.

Our limited exposure to heavily Covid-19-affected sectors (which we estimate at just c. 3% of the Fund) performed very well. **Easyjet** was up c. 50% relative and **National Express** was up c. 30% relative.

We had a small number of detractors from relative performance. **Diversified Gas & Oil** and **Hipgnosis** underperformed. These two stocks are more defensive and have performed well across the year as a whole, so it is not surprising they were a little sluggish given the wider market dynamics. On the last day of the month Hipgnosis had a very positive NAV update. Elsewhere **TP ICAP** continued to be a poor performer.

Portfolio activity

We have made comparatively few changes to the Fund over the last few months. As we have frequently observed, there was significant value in the Fund and we needed to be patient to let it feed through to performance. This started in October (on a relative basis) and accelerated in November (on both an absolute and relative basis). Despite this partial recovery the majority of our

stocks still look very cheap (see the Outlook section), hence it is right that we continue to not make wholesale changes. We did, however, see an increased tempo of activity.

We sold **Mondi**, which had recovered to its pre Covid-19 absolute levels and consequently performed well on a relative basis. It is now on a much higher valuation than the rest of the Fund at c. 15x current EPS and c. 13x recovered EPS. Over the period of ownership, it added 10bp to relative performance.

We continued to reduce **Lloyds Banking Group**. We have indicated before that there are a few stocks in the Fund (less than 5% of total capital) that have significant upside but do not have the same multi-pronged fundamental dynamics as the majority of the Fund. One of those stocks is Lloyds Bank, which step changed higher due to the vaccine news. Where we have found better ideas, we have gradually reduced Lloyds as it recovers. Part of the proceeds was added to a recent new addition, **Natwest Group**.

We added brick-maker **Forterra** back into the Fund. We had previously sold Forterra at prices as high as 370p on valuation grounds. The repurchase price was c. 210-230p. Since we sold it, the management team have raised new equity. This reduces the potential upside (as earnings are spread over a greater number of shares) but as its markets recover, and as its new manufacturing plant becomes operational in 2022/23, we calculate there is at least 50% upside, assuming an exit multiple of just 12x EPS. The price rise of Vistry, noted above, meant we had to reduce our holding to keep our overweight position at around 300bp. This funded the Forterra purchase. We also modestly trimmed our position in **Countryside**, which, despite Covid-19, is now up 10% year-to-date.

A few other stocks that performed very well were also marked back towards 300bp – **ITV**, **Legal & General** and **Barclays** being notable examples. We indicated above we have a limited amount of the portfolio (c. 3%) in heavily Covid-19-impacted areas. We argued it would have been wrong to have no weighting in this area as there are some high quality multi-year structural winners in this basket. Our main two positions, as highlighted above (**Easyjet** and **National Express**), were strong and we kept our position sizes in check.

We added to **Diversified Gas & Oil**, which underperformed and **Kenmare**, where, as we commented last month, a recent complex capital project which moves its free cashflow yield to c. 30%, has not been reflected in the share price. We also added to **TP ICAP** which continued to weaken following the issues around the financing of the Liquidnet transaction. Whilst **Drax** has been strong we continue to modestly add to our position, as Boris Johnson's accelerated ten-point green plan includes carbon capture, where Drax is well positioned.

We expect to add insurance sector IPO **Conduit** to the Fund during the first few days of December. The reinsurance market is seeing a material increase in prices due to a series of loss events before Covid-19, which were compounded by the pandemic. This 'hard market' will lead to a high return environment over the next 2-5 years. Conduit is coming to the market at book value in comparison to its sector peers which trade on 1.5x book value (the premium due to the hardening market). In this sector it may be better to be a start-up as there are no legacy issues. The leadership of this new company have a good track record and are well known in the London market. We will write more on this stock in next month's update.

Outlook

We had previously stated that November was likely to be a key month and a potential catalyst for change given the US election, the Brexit timetable and potential vaccine announcements. Although we have not had a 'clean sweep' on these issues, the progress on vaccines has clearly allowed investors to place Covid-19 into a finite compartment and allows them to look through the 2020 earnings disruption to the potential recovery in 2021 and beyond. Policy makers are likely to keep stimulus and loose monetary policy in place for some time which will help the recovery process further. Given these conditions we would expect the change of leadership within stock markets to continue because the valuation dispersion between the perceived growth and momentum names compared to everything else is still abnormally wide. To illustrate this point, it is worth looking at a few names that have risen sharply in November, to assess how much upside is left from here.

Vistry is one of our two core housebuilding positions. The shares rose by around 50% in November. Despite this recovery, they are still 35% lower than where they started 2020 and still

only trade on around book value and 5.5-6x consensus earnings for 2022, even though Vistry has one of the UK's leading partnership homes businesses, which is set for a decade of structural growth.

Glencore was up 38% in November but its most important metal is copper, which contributes around 40% of its operating profit. As highlighted earlier, copper is trading at multi-year highs as both the economic recovery and growing appreciation of its role in renewable energy have begun to affect demand. When the copper price was last close to the current price, in the summer of 2018, the Glencore share price was 68% higher than it is today and, using spot commodity prices, it currently trades on a mid to high-teens free cash flow yield.

Legal & General was up 40% in November but it has structural growth opportunities ahead of it in all of its businesses and it is well placed to exploit ESG trends. The shares still yield around 7% prospectively, despite the fact that credit markets have become much more relaxed about future levels of defaults from corporate bonds. Indeed, credit default spreads have returned to levels last seen in February, when the Legal & General share price was around 320p, 25% higher than it is today.

There are many other examples we could cite on a similar basis, which emphasise the point that the sharp recovery in value as a style has probably only just begun. Furthermore, UK assets have been battling the headwind of Brexit for over four years. Any kind of resolution on that front would provide a further stimulus to close the very wide valuation gap between many UK stocks and their international peers.

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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