JOHCM UK Equity Income Fund

Monthly Bulletin: December 2021

Active sector bets for the month ending 30 November 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.48	3.00	+7.48
Industrial Metals and Mining	14.70	7.64	+7.06
Media	7.68	3.20	+4.48
Household Goods & Home Construction	5.57	1.56	+4.01
Construction and Materials	5.21	1.62	+3.59

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.10	-9.10
Closed End Investments	0.00	7.14	-7.14
Personal Care, Drug and Grocery Stores	3.27	7.39	-4.12
Beverages	0.00	3.97	-3.97
Tobacco	0.00	3.02	-3.02

Active stock bets for the month ending 30 November 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.64	0.61	+3.03
Phoenix Group	3.17	0.17	+3.00
Legal & General	3.66	0.70	+2.96
Vistry Group	3.04	0.10	+2.94
Anglo American	4.30	1.36	+2.94
ITV	3.10	0.17	+2.93
Barclays	4.21	1.28	+2.93
Glencore	4.86	1.96	+2.90
BP	5.57	2.69	+2.88
Standard Chartered	3.08	0.44	+2.64

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.35	-5.35
Unilever	0.00	4.18	-4.18
Diageo	0.00	3.63	-3.63
HSBC	0.00	3.52	-3.52
Royal Dutch Shell	1.71	5.14	-3.43

Performance to 30 November 2021 (%):

	1 month	Year to date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**-4.29**	**18.63**	**308.20**	**£2,012mn**	**£2,359mn**
Lipper UK Equity Income mean*	-2.14	12.51	189.95		
FTSE All-Share TR Index (12pm adjusted)	-2.30	12.51	212.36		

Discrete 12-month performance (%) to:

	30.11.21	30.11.20	30.11.19	30.11.18	30.11.17
JOHCM UK Equity Income Fund – A Acc GBP	24.60	-16.49	9.83	-5.90	20.43
FTSE All-Share TR Index (12pm adjusted)	15.71	-9.72	11.67	-2.33	13.70

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 beginning of the month saw the Federal Reserve announce a tapering of their $120bn a month asset purchases, with the programme scheduled to end around the middle of 2022. The market took this well-choreographed adjustment very calmly but subsequent economic data from the US has continued to be very strong. In October, consumer price inflation hit 6.2%, US retail sales grew +1.7% on the previous month, 16.3% on last year and 21% on pre-pandemic levels. Labour markets are extremely tight and most companies are struggling to recruit new staff. All of the real time economic indicators suggest an economy that has re-accelerated towards an 8-9% annualised GDP growth rate in the fourth quarter. It is in this context that we should view Jerome Powell's comments to the Senate's Banking Committee on 30 November. His admission that the use of the word "transitory" regarding inflation should be retired and that the Fed should consider accelerating the pace of the tapering of asset purchases, despite the extra uncertainties of the Omicron variant, are striking. It is an admission that aggregate demand is simply too strong at present, which is no surprise given how loose monetary policy has been and how supportive fiscal stimulus has been. The next stage of the debate will likely be the timing of the first Fed rate rise.

There are many similarities here in the UK. Whilst the Monetary Policy Committee voted (7 to 2) not increase interest rates at their November meeting, the economic data clearly shows that it is only a matter of time before they will have to make a move. Employment grew by 250,000 in Q3, bringing unemployment down to 4.3% with the rate at 2.9% for 35-49 year olds. Job vacancies were just under 1.2 million in October, which compares to the 1.4 million who are unemployed, suggesting an economy effectively at full employment. It has never been easier to find a new job and as such it is no surprise that wage growth continues to rise, with regular pay growth at 4.9% in Q3. Employment growth and wage increases are the key drivers of economic growth and as such, we continue to expect further upward revisions to the official GDP data, which has been a regular occurrence in recent years. As an illustration, total hours worked grew by 2.5% in Q3 compared to the current estimate for GDP growth of only 1.3% suggesting that output per hour was down by around 1.4%, which is highly unlikely. Furthermore, the end of furlough in the UK has passed very smoothly with 812,000 gross new hires in October alone, which suggests that effectively all of the previously furloughed workers have found alternative roles. Given the strong demand backdrop as well as accelerating energy prices, inflation will continue to rise in the UK; it reached 4.2% in October but will move above 5% in 2022, particularly when the UK energy price cap for domestic gas and electricity is revisited in April. Whilst this will create some cost of living pressures, it should be more than offset by both wage growth and critically the £200bn of excess consumer savings that have built up since the start of the pandemic. We cover this issue in more detail in the outlook section below.

Elsewhere in the world, there are further tentative signs that economic activity is bottoming out in China as monetary policy is loosened; the PMI surveys slightly beat expectations for the second month running and whilst they only suggest a moderate rate of economic growth, it is stronger than many commentators have been suggesting. In Europe, similar inflationary pressures are widely observed with German CPI hitting 5.2% this month and a number of peripheral European countries increasing their interest rates in response.

The emergence of the Omicron variant has clearly added a degree of uncertainty and will impact consumer confidence and travel-related activity in the short term. Only time will tell whether this variant is a cause for greater caution due to its higher transmissibility and its potential to reduce the efficacy of the current vaccines, or whether it proves to be a key step in the virus' development where it becomes more transmissible but less deadly and, as such, could highlight a lower risk phase in this pandemic. Regardless of which outcome proves to be the case, the strength of economic activity in many Western countries should not be ignored by policy makers.

Performance

Stock markets had a difficult month due to an acceleration in Covid-19 cases in Europe at the beginning of the month and then the emergence of the Omicron variant in the last week. The FTSE All-Share Total Return index (12pm adjusted) finished down -2.30%. As is usual for a period of heightened uncertainty and a rush to perceived safety, the Fund underperformed its benchmark with a return of -4.29%. Year-to-date the Fund is up 18.63% while the benchmark is up 12.51% over the same period. Looking at the peer group, the Fund is ranked first quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked third quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

Amidst this risk-off sentiment, defensives outperformed. Our holdings in this area – **Drax**, **National Grid**, **Tesco** and **Vodafone** all performed well (up 3-9% relative to the Fund's benchmark, the FTSE All-Share Total Return index). We also had a number of strong, stock-specific performances. **U & I** was up 73% in relative terms following the announcement of a takeover by Land Securities; **Currys** was up 12% in relative terms following a good trading update and the announcement of a £75m share buyback; and **ITV** was up 4% in relative terms following strong results. These stock performances highlight some themes that are currently running through the Fund: (a) close to 50% of the Fund's holdings are buying back their own shares (a reflection of strong balance sheets, management confidence and a view that their shares are cheap); (b) the majority of the Fund is showing strong operational performance; and (c) when we receive a takeover bid, the premia tends to be significant (a function of the significant undervaluation within the Fund).

These positives were offset by the risk-off mentality with banks' share prices falling as 10-year bond yields fell in response to Covid-19 developments. This contrasts with a series of positive meetings we had with management teams of the banks during the month. There seems to be a collective confidence that a return on capital of 10% can be sustainably achieved. This contrasts with valuations at 0.4-0.6x book value. Other areas of weakness included travel and leisure - in recent quarters we have modestly added to the stocks we think will be winners coming out of the Covid-19 period. This basket, which is c. 2.5% of the Fund, was very weak (e.g. **Easyjet,** which is 0.75% of the Fund, fell 17% relative). Finally, small caps were weak for no specific reason that we can see. **Sthree**, **Galliford** and **DFS** were down 7-10% in relative terms.

Portfolio activity

November was, as described above, a sluggish month for performance. We therefore made relatively few changes to the portfolio as we need to let the Fund 'breathe' to allow the undervaluation be recognised (see outlook section).

As noted above, U&I (c. 80bp of the Fund) was bid for by Land Securities. This stock will be sold into that bid in December unless a counter offer is made by a third party. Our pro-forma cash position is therefore higher than the headline number.

A number of our large active positions continued to perform well, which meant we had to trim our positions, particularly early in the month before the wider market fell, to keep them at c. 300bp. ITV, noted above, and **Legal & General**, both fit into this category. We also reduced our positions in **Tesco**, **Hipgnosis, Endeavour** and **WPP** following strong performances. In our view, all five of these stocks retain material upside.

In terms of additions, we added to **Petrofac** via a placing and open offer. We discussed this last month in detail – suffice to say, in our view, the shares are materially undervalued given the resolution of the SFO investigation (regarding legacy issues from a previous management team) and the recent equity raise (which strengthens the balance sheet). Adding to the tailwinds are a record pipeline of bid opportunities and its exposure to the transition in the energy space.

Elsewhere we added to **Vodafone** ahead of its results, which were strong. We have had four meetings with executives / non-executives in the last two months, where we have articulated how the investment case could be made clearer and how value in the sum-of-the-parts could be released. This includes how the tower assets could be monetised, which would reduce debt (which still concerns some market participants) and how understanding in the emerging market assets could be strengthened. Encouragingly these were themes of the results.

We also added to **Conduit,** which has been very weak due to some large insurance losses that have affected the sector and in particular other similar UK-listed stocks. Its trading update during the month showed it had performed very well relatively. The industry-wide losses mean pricing will go up again next year, which is a positive. Its directors made material stock purchases during the month.

We have a good pipeline of potential new stock ideas as we move towards 2022, but, as implied above, there is currently a high hurdle to get into the Fund given the degree of undervaluation among our existing holdings.

Outlook

As highlighted above, economic activity has continued to be extremely strong in Western economies and is beginning to force policy makers to withdraw stimulus, although some are more reluctant than others! With this in mind, it is worth considering the economic maths in the UK as we look to 2022. First the bad news: with rising inflationary pressures, particularly in energy prices, there will be an increase in the cost of living for households as essential / non-discretionary spending bills are likely to rise 5-6% in 2022. Whilst wage and employment growth will offset some of this, it is likely to mean that households “free cash flow” or income available for discretionary spending will fall by around 3% in 2022 vs 2021. However, as we have highlighted before, this is likely to be more than offset by the presence of the additional £200bn of UK consumer savings that have accumulated since the start of 2020, effectively an increase in the savings ratio from 5% to 13%.

In the past this £200bn has been spent on areas such as travel and entertainment; for example air travel spending is running £27bn below pre-pandemic levels and hotel and restaurant spend £67bn lower. The October consumer credit card data suggests that the picture is finally beginning to change and whilst virus variants might muddy the water, the potential for a release of consumer spending is very clear and in sharp contrast to the US, where consumers have been more actively spending their extra savings as shown by the very strong retail sales data referred to at the beginning of this report. By way of illustration, if the UK savings ratio were to return to 5.5% during 2022, this would drive a near 10% increase in consumer spending which would compare to the 10% fall we saw in 2020 and a likely 5% increase during 2021. Combined with an economy at full employment and a proactive government investment programme, this could drive real GDP in 2022 well above 6% and nominal GDP (which is what really matters for corporate earnings) towards 10%. Such strong growth would see government finances naturally improve very rapidly with the budget deficit falling back towards 3% in 2022. Clearly interest rates will need to rise during the year in this environment.

With such a potentially bright outlook for the UK economy, we remain utterly bemused by valuations in the UK stock market. Despite very clear messages from private equity buyers that the UK is comfortably the most attractively valued developed market in the world, the rest of the investment community just doesn’t seem to be listening. With interest rates and discount rates set to rise during the next year, this has to help the UK, given its value factor weighting, but there is so much more to it than that. As we have highlighted many times before, in an absolute sense, valuations across our portfolio continue to look extremely undemanding. Balance sheets are in extremely good shape with around 50% of the portfolio by value currently buying back stock with surplus capital. We expect to see our Fund dividend return to its pre-pandemic level during 2022 and grow thereafter, which would equate to a dividend yield of 5%. Rarely, if ever, have the relative attractions of the UK and our Fund been brighter than this, yet very few investors seem to be interested. We encourage all of you to have another look.

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

Sources for all data: JOHCM/Bloomberg (unless otherwise stated).