Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: January 2024

Fund Overview

- The Fund aims to generate long-term capital and income growth through active management of a portfolio of UK listed equities.
- Established income investors James Lowen and Clive Beagles abide by a strict dividend yield discipline, which leads to an emphasis on higher-yielding stocks and promotes a naturally contrarian style.
- The Fund will typically have significant exposure to small and mid-cap stocks, often giving the portfolio a different holdings profile to many other income funds.
- Benchmark: FTSE All-Share Total Return Index.

Active sector positions as at 31 December 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction and Materials	8.89	0.42	8.47
Life Insurance	9.64	2.44	7.20
Banks	14.08	9.21	4.87
Industrial Metals and Mining	10.44	6.64	3.80
Household Goods and Home Construction	4.75	1.25	3.50

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.51	-10.51
Closed End Investments	0.00	6.32	-6.32
Personal Care, Drug and Grocery Stores	1.51	7.46	-5.95
Aerospace and Defence	0.00	3.11	-3.11
Beverages	0.00	3.06	-3.06

Active stock bets as at 31 December 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix	3.23	0.17	3.06
Barclays	4.05	1.00	3.05
Aviva	3.38	0.51	2.87
NatWest	3.38	0.52	2.86
Paragon	2.90	0.06	2.84
DS Smith	3.00	0.17	2.83
Standard Chartered	3.25	0.63	2.62
Glencore	4.92	2.51	2.41
Legal & General	3.03	0.64	2.39
ITV	2.46	0.10	2.36

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Rio Tinto	0.00	2.75	-2.75
HSBC	2.27	5.35	-3.08
Unilever	0.00	4.12	-4.12
Shell	1.92	7.34	-5.42
AstraZeneca	0.00	6.77	-6.77

Performance to 31 December 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**6.72**	**5.99**	**351.10**	**1,459**	**1,838**
Lipper UK Equity Income mean*	4.80	6.74	223.32		
FTSE All-Share TR Index (12pm adjusted)	4.37	7.69	254.72		

Discrete 12-month performance (%) to:

	31.12.23	31.12.22	31.12.21	31.12.20	31.12.19
JOHCM UK Equity Income Fund – A Acc GBP	5.99	-0.86	24.76	-15.72	20.02
FTSE All-Share TR Index (12pm adjusted)	7.69	0.74	17.77	-9.52	19.29

Past performance is no guarantee of future returns. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus. 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

Signs of slowing inflation were witnessed in many parts of the world during the month, often driven by lower input costs such as energy and transportation. German PPI was -7.9% in November, whilst China's CPI was -0.5%, its biggest decline for 3 years. CPI in the US was moderately lower at +3.1% despite further signs of resilience in the wider economy, with new job creation remaining positive, improving activity levels in the housing sector and consumer confidence rising sharply, to its highest level in 4 months. This combination of moderate economic growth and materially lower inflation compared to a year ago has raised both the prospects of a successful 'soft landing' and the likelihood of easier monetary policy during the first half of 2024. In that regard, Jerome Powell's comments at the FOMC press conference were particularly striking. He did not push back against the market-implied trajectory for interest rates in 2024, which assumes at least 75bps of cuts and went so far as to reveal that the Committee had a preliminary discussion about rate cuts at the December meeting. He also made some instructive observations about why inflation has fallen back so quickly despite the US economy not being in recession.

"This inflation was not the classic demand overload, pot boiling over kind of inflation that we think about. It was a combination of very strong demand and unusual supply side restriction, both on the goods side but also on the labour side, because we had a participation shock", Jerome Powell FOMC Press conference on 13 December 2023.

Whilst keen to stress that the Fed was not 'declaring victory', the tone of the press conference very much sounded like they were, particularly with the greater confidence that the post-COVID supply chain issues and labour market participation are much improved, thus dampening inflationary pressures. The bond market took all of this to mean that policy will be formally eased in H1 2024, with the 2-year bond yield falling 30bps on the day. By the end of the month, 2 and 10-year bond yields were around 50bps lower than at the end of November.

In the UK, the rate of CPI fell again in November, much quicker than anticipated. Lower used car prices, video game prices, moderating food inflation, and lower input costs saw the rate fall to +3.9%. Indeed, goods CPI of +2% compares to a peak of +15% in October 2022. Notably, service sector inflation also materially slowed. With fuel prices continuing to fall and food price inflation set to continue easing, December CPI will likely decline again before a moderate rise in January 2024, partly due to base effects and the increase in the January energy price cap. However, looking at current forward energy prices, we believe there is likely to be more than a 10% fall in the April OFGEM price cap, bringing UK CPI closer to +2% by mid-2024. This is much earlier than we and the market have been anticipating, and unsurprisingly UK 2-year bond yields moved 50bps lower to c.4% and 5-year bond yields to c.3.5%. UK 2-year yields have now fallen a material 180bps from their peak in July 2023, which is particularly important given it is (along with the 5-year swap rate) the reference point for many fixed-priced mortgages.

Despite this encouraging picture, the Bank of England retained its very hawkish stance, with three of the Monetary Policy Committee members still voting for a further rate increase at the December meeting. Much of their caution revolves around the potential stickiness of wage inflation, with Deputy Governor Ben Broadbent making this point during the month. However, the labour market does continue to normalise quite quickly, and indeed, the latest UK Labour Report showed this very clearly if you were prepared to look closely enough. Whilst the 3-month rolling average growth of regular weekly earnings has only fallen 60bps from the peak to 7.3%, the latest single month number was 140bps lower than the previous month at 6.3%. Furthermore, base effects mean that the 3-month rolling average will fall over the next few months, probably by at least 50bps per month, which may well convince the more hawkish members of the Monetary Policy Committee (MPC) that no more rate rises are necessary. Markets have already concluded that policy will be eased during 2024, although the starting date for a change in stance remains somewhat uncertain. In that regard, a further rise in UK Consumer Confidence this month and stronger PMI indicators across the board suggest that a nascent economic recovery has already begun, which could, ironically, temper the likelihood of a rate cut during H1 2024. However, with inflation set to be close to 2% by June, monetary easing of some degree does look likely for 2024, in our view.

Performance

December saw a further strong recovery in the Fund's relative performance. The FTSE All Share rose 4.37% over the period, with the Fund up 6.72%. For the year as a whole, the Fund was up 5.99%, whilst the FTSE All Share was up 7.69%.

We were disappointed to end the year down in relative terms. Analysing the performance across the year, we had two difficult periods, March to May, as the Silicon Valley Bank (SVB) and Credit Suisse issues roiled the market and October, when interest rate expectations spiked (and peaked) and the Israel/Gaza situation developed. During these risk-off periods, as we have noted before, valuation as a measure becomes redundant, and the Fund, given its emphasis on that, tends to underperform. Across those 4 months, we underperformed by c.10% in relative terms. Before SVB, between the two events and after October, the Fund performed well. As we lay out in this report, we think the fall in interest rate expectations since the end of October, which has helped drive the November/December recovery in Fund performance, should be an enduring feature into 2024.

Looking at the peer group, the Fund was ranked in the 3rd quartile within the UK Equity Income sector for the year. On a longer-term basis, the Fund is ranked 1st quartile over three years, 3rd quartile over five years, 2nd quartile over 10 years and is the best Fund in the sector since inception in 2004.[1]

A theme of the month was strong results in the Fund's top 10 holdings. **Paragon** was up 41% relative across the month; it outperformed forecasts, guided higher for 2024, beat our dividend forecasts and announced a new share buyback. Paragon acquired c.10% of outstanding stock last year. Our target price remains between 900p and 1000p, 30 to 40% higher than the current share price post December's sharp move. DS Smith delivered in-line results but provided greater clarity on returns that will be made from its ongoing elevated capex programme. This encouraged analysts to upgrade their outer year forecasts. The stock continued to trade around the lowest multiple it has over the last two decades. **Legal & General** issued 3-4 press releases (rather than RNS's), which detailed strong 2023 performance at different divisions. If this had been one RNS trading update, it would have received more (positive) attention. **Redde** and **Drax** also announced solid statements.

[1] Source: Lipper

We had two weaker statements in the mining sector. **Anglo American** (down 18% in relative terms) guided production lower. In the next section, we briefly detail our view on the stock. **Kenmare's** update was also sluggish for similar reasons and this stock was down 7% relative. The oil sector was also weak in general terms, with **Diversified Energy,** in particular, underperforming (down 17% relative) as third parties (a US House Committee) further focused on its environmental record. We believe these issues are misplaced, as the company has made great strides over recent years. Its stewardship of the assets from an 'E' perspective is materially better than previous owners. However, its business model does mean aggregate carbon/carbon equivalent emissions are material. The new TCFD reporting requirements on UK and European-based funds mean marginal buyers will be limited. *We have respectfully suggested to the board that there may be a better owner of the company that can more correctly (than the UK market) value its free cashflows*.

The other two themes of the month were (a) a recovery in UK domestics driven by the fall in interest rate expectations discussed above, with the housebuilders continuing to perform well and **DFS** (up 10% relative), **Wickes** (up 3% relative) and **Marks & Spencer** (up 4% relative) also strong and (b) small-caps starting to perform (**Tyman**, **Norcros**, **Eurocell** and **Headlam** being good examples).

Other stocks of note were **EasyJet** (up 5% relative) after a belated positive reaction to a strong CMD earlier in the quarter, that we have discussed previously. EasyJet is also one of the biggest beneficiaries of the permanent extension (announced in the Autumn statement) of capex allowances. On our calculations, on a gross basis, this will save the company £1.5bn over the next four years (equivalent to 30% of the current market cap). **Ashmore** (up 21% in relative terms) is a direct beneficiary of lower rates and a weaker dollar. Domestic banks also continued to recover from the October low point.

Portfolio activity

As described above, the market continued to recover with a (welcome) focus on valuation and a greater tolerance for cyclicals and financials.

Most of the reductions made reflected this market mix and some strong performances that moved certain stocks above our maximum 300bps active position. The main stock that fitted into that category was Paragon, which we highlighted above, and accordingly, it was top sliced to keep around 300bps and as it continued to rise moved below this level. This entailed selling c.20% of our position given the extent of its move. We note it goes ex-dividend early in the new year. **Phoenix** also fell into this category. We also had several other stocks that performed well, where we have lower target weights, and these positions were top-sliced: EasyJet (200bps), **Page Group** and **SThree** (both c.175bps). All 3 of these stocks still have material upside (50% to 150%). We also trimmed both our housebuilders – both up more than 30% during the year – this partly reflects the share price move, partly reflects they have, post-dividend adjustments, lower dividend yields and partly reflects there are now anomalies (in share price performance) between them and second derivatives of the same theme.

On the additions side, we added to some of these anomalies, including brick manufacturer Ibstock (down 10% across the year) and a few small-caps in related areas (**Severfield**, Costain, **Kier**, **Currys**).

We also continued to add to several recent additions, such as **Hammerson** and **TI Fluid Systems**. There were continuing rumours during the month that Hammerson would sell its stake in Value Retail (Bicester Village/equivalents across Europe). This would move the business close to zero debt and, even if sold at a slight discount (our expectation is -20%) would prove out the valuation implied in the current share price (c.50% discount to book). It would create flexibility to buyout JV partners in its residual asset base, e.g. the Bullring and return value to shareholders. Both would contribute significantly to accretion. The movement in bond yields throughout the month was also advantageous. The current position is now 80bps active. TI Fluid Systems has been adjusted to approximately 50bps.

As noted above, Anglo American was weak post-downgraded production guidance. We viewed the fall as overdone and added to the position. The extent of the fall is likely to increase pressure on management to adjust strategy. This could include asset sales (e.g. De Beers) or bringing in a partner on Woodside. Both of which would be material positive developments.

Across the year, we added 5 new stocks to the Fund: Marks & Spencer, Hammerson, TI Fluid Systems, **Energean** and **Inchcape**. This is lower than normal and is reflective of the fact there has not been much forcing itself out of the Fund, either on fundamental grounds or valuation grounds. We noted several times last year that it feels appropriate to have the ‘foot on the ball’ and let the large valuation differences across our holdings release themselves.

2023 Governance Scorecard

This section briefly outlines activity from an annual general meeting (AGM) and emergency general meeting (EGM) voting record perspective, and an engagement perspective for 2023.

In terms of AGM/EGM voting, there were 73 meetings that the Fund voted in during the year, out of which we voted against or abstained in 6, representing just over 8%. This was higher than in 2022 and is the highest number since the Fund was formed 19 years ago.

The stocks where one or more votes were against/abstention were **TP ICAP**, Currys, **Mobico**, **Hipgnosis**, Diversified Energy and **Vistry**.

There is a high crossover between a vote against and engagement activity. Most of the votes against involved remuneration where the themes were LTIP targets that were meaningfully below consensus expectations i.e. the company could warn on profits and the LTIP could still payout, where the overall quantum was viewed as being too high, and where the number of shares issued under LTIP’s was not adjusted to reflect low share prices (which meant the percentage of company issued was materially higher than viewed as appropriate). In several cases, we also voted against the non-executive director in charge of the remuneration committee.

The one exception was Hipgnosis, where we voted against the sale of certain assets, against the continuation of the company and against three non-executive directors, including the chairman. After this, we now have a much stronger board, who are pursuing a value realisation strategy.

In terms of engagement, we have increased our activity, which we term 'constructive activism'. Part of the reason for the step-up comes from the very low valuation of the Fund we discuss elsewhere. While several catalysts (e.g. falling interest rates, fund flows, M&A) could unlock this, we need to work with boards to try and release value whilst we wait for the external environment to improve.

Examples of activity during the year included:

- We repeated our public view that the small-cap construction sector should consolidate (as has happened in Europe). The Fund is a top 5 shareholder in two of the quoted names - **Galliford Try** and **Costain** and a top 10 shareholder in a third (Kier**)**. Consolidation would lead to material EPS enhancement (given the central cost to EBIT ratio), unlock balance sheet value (Costain, for example, trades not far above its net cash position), potentially move the combination from small-cap to mid-cap and enhance liquidity. In our view, the combination of these factors could unlock 50-100% of additional upside.
- We called for the board of Currys to sell their Greek business and ID Mobile. The former was sold towards the end of the year for £175m. Combined, they are valued more than the market cap of the stock.
- We continued to call on the board of TP ICAP to hive off their data business, which we value at more than the current market cap of the whole business. During the second half 2023, we noted the company had established long-term internal agreements between the data business and the broking business for the raw data and was also creating separate entities to hold the data business. Both would be needed before any separation is considered.
- We expressed our view to **ITV** after the announcement of their interest in All3Media that we had reservations around the rumoured price, the resultant leverage, and how the stock market would value the business within the broader 'ITV jacket'. We also suggested they could partially monetise their ITV Studios business (which similarly to TP ICAP and Currys, we value at more than their market cap), to highlight its value and fund any acquisition of All3Media.

We will continue engaging with boards as we move through 2024 to try and release the latent value across the Fund.

Dividend Update

We provided a detailed update in last month's bulletin (see here) on our expectations for how the Fund dividend picture for 2023 would finish and our initial formal guidance for the 2024 outlook.

Our latest 2023 guidance was for Fund dividend growth of 3-7%. The outturn was 6% growth for the full year. As we indicated, the Q4 dividend (which went ex on 29 December) fell by c.10%. Quarterly dividends are a function of the mix of stocks in the Fund and when they go ex-dividend. The focus should be on the annual trend.

Our guidance for 2024 last month regarding a flattish outturn remains valid. We discussed the drivers and assumptions behind this in detail last month. Within this, the Q1 dividend will likely be up, with modest falls later in the year.

After the results season (the end of Q1 24), we will provide an update on this guidance.

The Fund yields 5.5%.

Outlook

For the last 18 months, exacerbated by the Truss/Kwarteng budget and a post-Brexit hangover, the UK has been seen by international and many domestic investors as an economy with some unique ‘inflation problem’. The somewhat late and reactionary 50bps hike by the BOE last summer did little to quell this fear. But as the year drew to a close, UK inflation fell rapidly and no longer looks like an outlier in an international context. The UK was exposed to the rise in energy prices more than many other countries, but the impact on the headline inflation rate was exacerbated by how the Government dealt with the Ukraine-driven spike by allowing prices to rise and sending rebate cheques in the post, as opposed to capping prices as was done elsewhere in Europe.

Furthermore, this time last year, UK real GDP consensus forecasts anticipated a reduction of around 0.6% for 2023, and in fact, the outturn will likely be positive growth of a similar magnitude, which again looks respectable compared to other large European countries. Why this matters is less down to the impact this positive delta has on UK corporate earnings but much more to do with the rating that is placed upon UK-listed stocks, by overseas investors.

Regardless of where they generate their earnings, UK-listed stocks continue to trade on meaningful discounts to their international peers, not just in North America but in Europe too. As we enter 2024, as UK inflation falls below 3% and towards the 2% target, policymakers’ rhetoric will pivot towards monetary easing, which will not only boost economic activity, but will encourage all investors to investigate the modest ratings on offer across the UK market, particularly in cyclical and domestically orientated sectors.

Long term bears will no doubt talk about the UK’s low productivity, although Jeremy Hunt’s extended capital allowances for Capex will likely help in that area. They will talk about looming political risk even though the outcome of the domestic election is far more predictable than those elsewhere in the world in 2024, including the US. They will probably talk about the risks of a housing crash even though prices have risen in recent months, according to reliable Land Registry data and as implied above 5 year fixed-rate mortgage rates will move towards c.4%. They may also talk about a UK economy that is over-leveraged even though it has dramatically de-levered since 2008, where UK households have actually been a net beneficiary of rising rates, in aggregate, due to rising interest income (which is higher than the aggregate additional mortgage costs).

As we have stated before, we are not here to be apologists for the state of UK politics, but someone must speak up for the UK Stock Market, and for that, we do not apologise. The UK market may not have high exposure to technology or biotech, but it is full of well-established, well run companies with strong balance sheets and very modest valuations. Whilst it is sad that many investors fail to exploit this opportunity, it is left to the world of private equity to take advantage, this does mean that the market is likely to rise as more companies are taken off the market. Close to 1% of the UK market by market cap was acquired in 2023. As we have pointed out before, our companies are also taking advantage of the remarkable value on offer by buying ever increasing amounts of their own shares, which is perfectly logical and sets us up for higher earnings and dividend growth in future years. In 2023 on average across the Fund c.5% of share capital was retired via share buybacks. A remarkable number.

To have a situation where valuations are very low, and the prospects for both the domestic economy and more broadly the world economy are brightening, as rates have peaked is a very attractive combination. Whether bond markets have jumped the gun too much in terms of the degree of monetary easing they are assuming in 2024, only time will tell, but already, the moves in 2 and 5-year rates have delivered a degree of monetary easing to the real economy via lower mortgage and corporate borrowing costs. The biggest risk for 2024 may well be a policy mistake centred around easing policy too soon, particularly in the US. Whilst in the short term, markets would welcome an early rate cut, if too much easing in H1 2024 sees a degree of inflationary pressures re-emerge toward the back end of the year, it could prove challenging to get the inflationary genie back into the bottle.

2024 is our 20th year of operations. Whilst it is pleasing across this time frame that we are the best Fund in the UK income universe, we recognise it has been more of a battle over the last few years.[1] Once again with that as a context, we thank our investors for their patience and fortitude during a volatile year, and we look forward to a prosperous and vibrant 2024.

[1] Source: Lipper

Investments may include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.
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