



JOHCM UK Equity Income Fund

Monthly Bulletin: February 2018

Active sector bets for the month ending 31 January 2018

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.59	3.08	+5.51
Construction & Materials	6.19	1.47	+4.72
Banks	16.05	11.47	+4.58
Mining	10.51	6.75	+3.76
Oil & Gas Producers	16.17	12.75	+3.42

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.66	-5.66
Pharmaceuticals & Biotechnology	2.73	7.00	-4.27
Equity Investment Instruments	0.83	4.53	-3.70
Beverages	0.00	2.88	-2.88
Personal Goods	0.00	2.26	-2.26

Active stock bets for the month ending 31 January 2018

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.86	0.85	+3.01
BP	6.98	4.01	+2.97
Lloyds Banking Group	5.02	2.06	+2.96
ITV	3.21	0.26	+2.95
DS Smith	2.66	0.21	+2.45
Rio Tinto	4.31	1.93	+2.38
Standard Life Aberdeen	2.82	0.48	+2.34
National Express Group	2.30	0.06	+2.24
Barclays	3.47	1.40	+2.07
Glencore	3.82	1.95	+1.87

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.53	-4.53
GlaxoSmithKline	0.00	2.65	-2.65
Diageo	0.00	2.56	-2.56
Prudential	0.00	2.02	-2.02
Unilever	0.00	1.88	-1.88

Performance to 31 January 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	-0.23	-0.23	291.00	£3,539m
Lipper UK Equity Income mean*	-1.05	-1.05	173.27	
FTSE All-Share TR Index (12pm adjusted)	-0.89	-0.89	180.34	

Discrete 12-month performance (%) to:

	31.01.18	31.01.17	31.01.16	31.01.15	31.01.14
JOHCM UK Equity Income Fund – A Acc GBP	16.61	25.44	-6.80	5.02	19.78
FTSE All-Share TR Index (12pm adjusted)	11.12	22.46	-6.33	8.50	9.01

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

Further evidence emerged during the month that UK economic performance is beating consensus expectations, despite the endless media hysteria about government infighting over Brexit. Q4 2017 GDP grew by 0.5% quarter-on-quarter, which was the strongest rate of growth over the year. Consumer spending proved to be more resilient than expected over Christmas, with retail sales growing by 1.3% in December. Most strikingly, the January labour market report from the ONS painted a very promising picture: the employment rate of 75.3% of 16-64 year olds was the highest recorded ever (records began in 1971) and the level of vacancies, at 810,000, was also the highest number ever seen. Given record employment and reduced inward migration of workers from mainland Europe, it is no surprise that wage growth is beginning to accelerate, reaching 2.4% growth in the latest release. We confidently expect this number to reach 3% during 2018, with a likely sharp shift higher in the first half against weak comparatives.

Against this strengthening backdrop and with the assistance of a booming global economy, we were not surprised that sterling pushed through US\$1.40/£1 and that the 10-year UK gilt yield moved 20 bps higher to around 1.45%. However, we continue to believe that markets are still underestimating the pace of monetary tightening that will occur in the UK over the coming months, particularly if more progress is made towards a transition agreement with the EU. As Bank of England Governor Mark Carney pointed out on the 30th January at the House of Lords Economic Affairs Committee meeting, the rationale for ultra-loose policy is fading fast:

“We felt that inflation could go above three percent, but most importantly we were taking a longer period of time to bring it back to two percent than usual because we wanted to support the economy during this period. Now that we’re getting towards full capacity in the economy, it becomes a much more conventional decision in terms of timing and stance of policy.”

Government bond yields have been rising across the globe, despite half-hearted attempts by both the European Central Bank and the Bank of Japan to temper expectations of tapering. In Europe, in particular, dissenting voices are growing louder about the current duration of the QE programme. We would anticipate a more hawkish stance at some stage from Mr Draghi in the coming months. Even Swiss 10-year government bond yields have moved into positive territory, having bottomed at minus 60bps during the summer of 2016.

The sustained weakness of the dollar has drawn much comment over the last few weeks, given strong US economic momentum and the likelihood of further interest rate rises by the Federal Reserve in the coming months. As we know, currency performance is always a relative game, and the reason for the dollar weakness is principally because the economic performance in other parts

of the world (Europe/UK/emerging markets) is improving at a faster rate, relative to expectations, than in the US. The weak dollar has partly contributed to the continued strength in commodities, such as copper and oil. But regular readers will know that we also believe the limited amount of new capex in these sectors over the last two to three years is beginning to improve the supply/demand balance and is likely to extend this strength for the foreseeable future.

Performance

The market started the year slightly down, with the FTSE All-Share Total Return Index (12pm adjusted) posting a decline of -0.89%. The Fund outperformed the index in returning -0.23%.

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

The rise in bond yields during January helped the Fund's relative performance, with banks (particularly **Barclays** and **Lloyds Banking Group**) and other cyclicals generally outperforming whilst defensives struggled. The strength in sterling, particularly against the dollar, also helped. The mining sector performed well during the month, continuing the strength seen at the end of 2017. Whilst we are very underweight in defensives / overseas-earners, our positions in **Laird** and **National Express** did offset these trends slightly.

Our retail names performed brightly (particularly **Sainsbury's** and **Kingfisher**), as did a number of other stocks with elements of UK domestic exposure (**ITV**, **Thomas Cook** and **Northgate**). **Randall & Quilter** performed well and **CMC Markets** bounced back following the adverse regulatory announcements last December.

A number of our small caps, most of which fared well in 2017, saw some profit taking: **Morgan Sindall** (down 9% relative), **Costain** (down 4% relative) and **Rank** (down 7% relative). The first two potentially fell due to some tangential read-across from the Carillion situation. In our view, the only similarity is they are in the same sector – both of our holdings have significant levels of average net cash (c. £100m in each case), have good cash to profit conversion, have healthy governance and prudent accounting practices. The medium-term implications of the Carillion episode may be that sector contractual risk/reward changes for the better and margins move higher. This would benefit our holdings. There has been significant criticism of institutional investors in relation to governance oversight relating to Carillion. For our part, we took the decision in August 2017 to write to the advisors of two of our portfolio holdings, where a former Carillion director sat on both boards, voicing the fact that we would not support their re-election as a director. The individual resigned from both boards in Q4 last year.

January was a heavy month for trading updates. These brought a number of profit warnings, including Capita, Debenhams, Dignity, Carpetright, Card Factory, Connect Group and Mothercare (none of which were owned by the Fund), amongst others. The Fund was hurt by one negative update from **Countrywide**, where a continued poor market share performance led to a further profit warning and the change of the CEO.

Portfolio activity

We added two new stocks to the Fund during January, **Standard Chartered** and **Liontrust Asset Management**.

Standard Chartered had a long financial crisis, elongated due to its large exposure to commodities and oil during the 2015/16 downturn in those sectors. This was compounded by having too little capital and needing to change the majority of the management team and board as it repositioned itself. With new management, a reset capital base and the bank refocused on its core operations, we are starting to see evidence that growth momentum is returning and its return on capital is starting to rise. Given Standard Chartered's geographical footprint, it should deliver the best cross-cycle income growth amongst the UK-quoted bank stocks. It should also see strong operational leverage. Standard Chartered is also the biggest beneficiary of rising US interest rates among the UK-listed banks.

We expect Standard Chartered to return to the dividend list with its full-year results later this month, with the dividend then growing strongly as the payout ratio normalises. The stock trades on 0.8-0.9x book value, which is very low versus its peer group, history and prospects. Staying in the sector, we slightly modified our position in Barclays, which as noted above, was strong during January, to make way for Standard Chartered.

Liontrust, which we acquired for 520p (on 12x EPS), joins **Polar Capital** in a basket of boutique asset managers in the Fund. Both have strong balance sheets and their main funds have been performing well, which has translated into strong asset under management (AUM) growth. In addition, Liontrust acquired one of the best sustainable investment franchises from Alliance last year and has since grown it from £2.4bn to £3bn. We anticipate significant growth in this franchise over the next 3-5 years given the structural interest in that area. Liontrust has also started to attract a number of highly respected fund managers (e.g. the former Kames Capital fixed income team), who are likely to build other sizeable franchises. Neither of these two growth engines is included in the forecast agenda. To ensure we avoided adding to our overall financial market exposure via this addition, we reduced our weighting in wealth manager **Brewin Dolphin**. As we have previously commented, this stock is within 10% of our fair value target after a robust 2017.

We also sold two stocks from the Fund in January, **Savills** and **DX Group**. The latter has been a small position, following a number of profit warnings in 2016/17 (where the net cost to the Fund was 35bp). Our holding in DX Group reaffirmed the need to keep a high hurdle on both structural risk and high leverage when assessing new stocks for the Fund. Savills, which the Fund has owned three times since we launched in 2004, added 25bp to Fund performance across this period of ownership. We sold the stock on valuation grounds.

Elsewhere in the portfolio, we marginally reduced our positions in **Thomas Cook** and **Keller**. Both continue to perform well in share price terms, with the former benefiting from the US tax reforms as well as announcing a potentially very accretive acquisition. Tighter capacity in the airline sector after the Monarch and Air Berlin failures has helped Thomas Cook.

We increased our holdings in our retailers (**Kingfisher**, **Halfords** and **Sainsbury's**), as they underperformed at the start of the month after a number of profit warnings elsewhere in the sector. All of these names recovered as the month progressed. Sainsbury's and Halfords both had good updates whilst Kingfisher is due to update in March / April. All are beneficiaries of the recent move in the £/\$ exchange rate. **DFS** is our final retail name, with an update due in early February. It is exposed to more near-term trading risk. Therefore, despite a number of medium-term positives – the travails of Steinhoff, owners of Harvey's Furniture, Multiyork Furniture's bankruptcy and the acquisition of Sofology by DFS – we have only made modest additions to our position.

Outlook

The path to policy normalisation has categorically begun in the US, the UK and Europe. The continuation of the rise in global bond yields during January was very encouraging evidence that this transition to a more normal interest rate environment is underway. The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, it has undoubtedly pushed valuations of many assets and individual instruments to elevated levels that will be hard to justify if the cost of capital rises. We indicated at the end of last year that we would not be surprised if markets, after a strong run over a number of years, found life tougher at a headline level, as this adjustment in bond yields feeds through. We still think this will be the case.

Within the equity market, we strongly believe that the overvaluation is most apparent in consumer staples and other perceived defensive sectors, such as utilities and pharmaceuticals. These continued to underperform during January. Conversely, we believe that many of the areas to which the Fund is exposed will respond well to a change of stock market leadership if monetary policy normalises, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also selective opportunities in the UK domestic arena, too.

The Fund's long-term performance is highly correlated to its dividend growth and the resulting absolute level of the dividend. The delivery of 13.4% growth in 2017, which continues a track record of strong growth since the Fund's launch, and our confidence in 2018's dividend outlook is

an important driver of the unit price. As we noted in December's bulletin, when we guided to mid-single-digit growth in the Fund dividend for 2018, the Fund's prospective yield for 2018 is c. 4.35%. We will update our guidance on the Fund dividend formally at the end of Q1, but we remain very comfortable with the current guidance. This is despite the pressure the rise in sterling has had on UK plc dividend flow, which we had budgeted for in the guidance we provided.

This yield, strong dividend growth and low valuations embedded across the portfolio, coupled with the shift in monetary policy, leave us cautiously optimistic in our outlook for the Fund's relative performance.

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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