Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: February 2019

Active sector bets for the month ending 31 January 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.88	3.15	5.73
Banks	16.05	10.79	5.26
Mining	10.80	6.72	4.08
Oil & Gas Producers	17.45	13.48	3.97
Construction & Materials	5.35	1.59	3.76

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.01	-7.01
Equity Investment Instruments	0.30	5.14	-4.84
Tobacco	0.00	3.84	-3.84
Beverages	0.00	3.46	-3.46
Personal Goods	0.00	2.44	-2.44

Active stock bets for the month ending 31 January 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.71	0.75	+2.96
BP	7.54	4.59	+2.95
DS Smith	3.09	0.20	+2.89
Barclays	4.13	1.27	+2.86
Glencore	4.38	1.60	+2.78
ITV	2.97	0.23	+2.74
Lloyds Banking Group	4.64	1.90	+2.74
Standard Life Aberdeen	2.73	0.31	+2.42
Phoenix Group	2.51	0.15	+2.36
National Express Group	2.03	0.08	+1.95

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
GlaxoSmithKline	0.00	3.31	-3.31
AstraZeneca	0.00	3.18	-3.18
Diageo	0.00	3.07	-3.07
British American Tobacco	0.00	2.76	-2.76
Unilever	0.00	2.04	-2.04

Performance to 31 January 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**6.03**	**6.03**	**260.70**	**£3,404mn**
Lipper UK Equity Income mean*	4.93	4.93	158.22	
FTSE All-Share TR Index (12pm adjusted)	4.59	4.59	169.05	

Discrete 12-month performance (%) to:

	31.01.19	31.01.18	31.01.17	29.01.16	30.01.15
JOHCM UK Equity Income Fund – A Acc GBP	**-7.75**	**16.61**	**25.44**	**-6.80**	**5.02**
FTSE All-Share TR Index (12pm adjusted)	-4.03	11.12	22.46	-6.33	8.50

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

It was only at the start of October 2018 that Federal Reserve Chairman Powell stated that "we're a long way from neutral" on interest rates, indicating further meaningful monetary tightening. Yet, the tone had changed materially by 30 January 2019, with the central bank now articulating a much more patient approach. Clearly, during the intervening period, global markets have grown increasingly nervous about slowing economic growth and trade tensions, as well as the short-term impact of the US government shutdown. In that regard, the "wait and see" approach may be more appropriate from the Fed. However, it is critical that Chairman Powell is not perceived to have responded to President Trump's highly critical comments about their hiking path in recent months. Powell went out of his way to deny this at the press conference: "We're never going to take political considerations into account or discuss them as part of our work." Nonetheless, the risk of a central bank policy mistake do seem to be rising.

The most significant market impact of the dovish stance adopted by the Fed was to see the dollar weakening at the end of the month. This move could well relieve pressure on emerging market currencies, not least the Chinese yuan, and may allow for more extensive policy easing in that economic region. Thus far, Chinese stimulus efforts have met with limited success, although the ongoing trade dispute with the US makes it difficult to analyse underlying momentum, particularly in business confidence indicators. The Chinese slowdown has clearly affected parts of industrial Europe, with the German economy ministry now predicting only 1% GDP growth in 2019, the weakest pace of growth for six years. Consequently, it is disappointing to observe that the ECB may have missed its opportunity to tighten monetary policy during this economic cycle, which will leave their toolkit exposed if economic growth falters further.

In the UK, the Bank of England faces a tricky dilemma on monetary policy. Whilst the endless political wrangling over Brexit has dampened GDP growth, the labour market remains extremely tight and wage growth continues to accelerate, reaching 3.4% this month. Were it not for the Brexit uncertainty, there is no doubt in our view that the Bank of England would be raising interest rates given the limited spare capacity in the economy. As such, if there is any kind of progress on the negotiations with the EU, we are likely to see some catching up by the central bank. We therefore continue to see sterling as materially undervalued, with the potential to move sharply higher on any political progress. It is worth noting that sterling rallied around 3% against the major currencies in January despite the political backdrop.

Performance

After a difficult end to 2018, the FTSE All-Share Total Return Index (12pm adjusted) rallied during January, returning 4.59%. The Fund outperformed in returning 6.03%.

Looking at the peer group, the Fund ranked first quartile / second decile within the IA UK Equity Income sector for 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 over five years.

The second half of 2018 was characterised by a 'risk off' mentality, with a focus on incremental and largely negative news flow (slowing growth/Brexit/Trump/China). There was no focus on valuation. Pleasingly, the start of the year has seen the pendulum swing back towards valuations. Additional tailwinds came from some good trading updates across the Fund and some positive movement on Brexit and subsequently sterling.

The combination of these points have led to a big rally in most (but not all) domestic parts of the market. **Forterra**, **Ibstock**, **Bovis Homes Group**, **Galliford Try**, **DFS** and **Tesco** were all up between 10-25% relative. There were some anomalies, however, including **ITV** (flat relative) and **Halfords** (down 10% following a poor statement). The moves, whilst significant, need to be seen in the context of how undervalued the stocks were before – for example, Forterra, the second largest brick producer in the UK, is still only on a normalised P/E of 7x after the rally. Where domestic stocks have lagged this upward move, we added to our positions.

In the commodity sectors, the miners were strong, with **Anglo American** and **Rio Tinto** marking in higher iron ore prices following the tragic dam failure in Vale's Brazilian iron ore operations. Our oil names were marginally lower overall.

Some of our 2018 laggards bounced back strongly. **DS Smith**, (up 12% relative), our worst contributor in Q4 2018, was the stand out in this regard.

Financials were more mixed, with lower interest rate expectations offsetting some of the other positive trends. Some of our small caps (**Raven Russia** and **Charles Stanley** were both down c.15% relative) were also weak in this area.

Vodafone was also very weak as the likely inflexion in revenue was pushed out by a quarter.

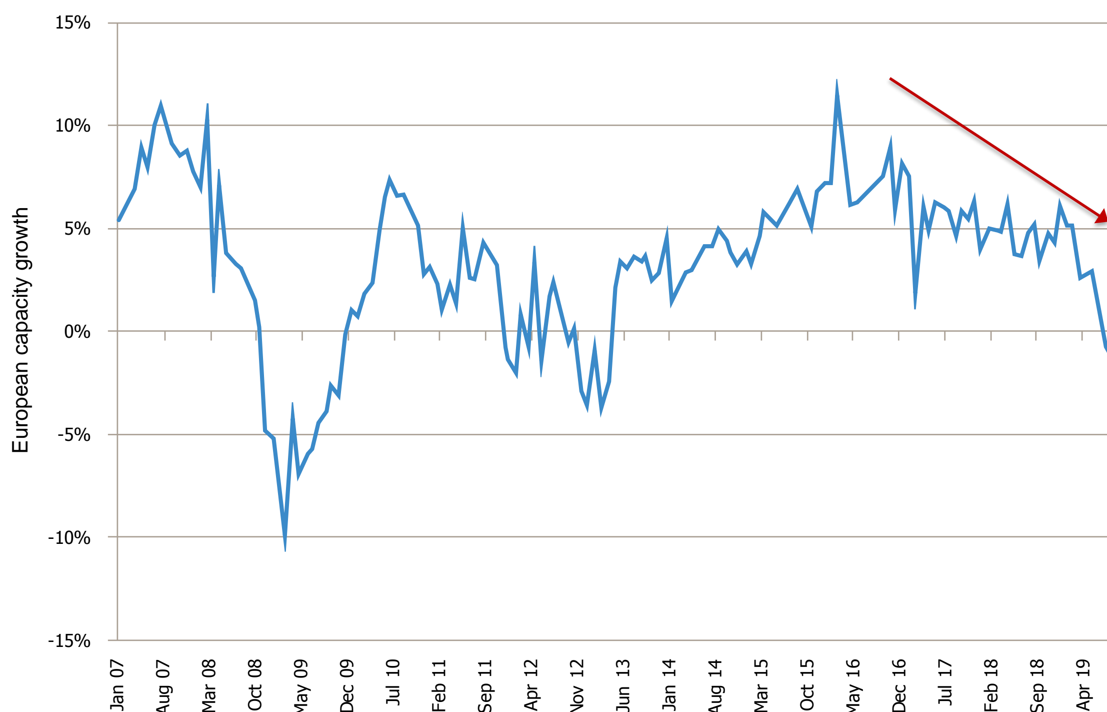
Portfolio activity

We added one new stock to the Fund in January, **EasyJet**. We have reviewed the low-cost carrier at least five times in the last five years but always rejected it. In the past, our concerns revolved around margins being too high, excess capacity in its markets, the company running too hard operationally (thereby creating high disruption and customer service issues) and, finally, its high valuation.

All of these issues have either been resolved or turned positive. Margins are a long way below peak and, on our forecasts, should move higher. Capacity growth is slowing dramatically (see chart overleaf), and the board has rebalanced operating expenditure to make the business more resilient. Yet, because of Brexit, the stock is trading below replacement cost, on a P/E of c. 10x and a yield of 5%.

Outside of the nearer-term drivers, it is clear in our view EasyJet, courtesy of its brand, cost structure and dominance in certain key airports, will be a long-term winner in a market that is seeing the large national carriers lose market share and should benefit from consolidation, as we have seen in the US.

European short-haul air travel capacity growth



Source: HSBC

In the commodity sectors, we reduced our position in **Royal Dutch Shell** at the start of the month and continued to add to recent addition **Savannah Petroleum.** It had a small placing to fund the cost of completing a recently announced acquisition. We also trimmed **Anglo American** (now 100bp overweight), which has been the best performer in the mining sector. The miner is on a new relative high since our initial purchase and because of this performance is now on the lowest free cash flow yield in the sector (c. 7% compared to **Glencore**, our biggest active position at c.15%).

One of our poorest performers over the last three years has been **Low & Bonar**, which has suffered from poor management, both operationally and of its balance sheet. The latter meant it conducted a rights issue in January, which we supported. Armed with a strengthened balance sheet, the new management team should be able to extract the value that we have always believed lay in the company's market positions. On normalised earnings, the stock trades on a P/E of 4.5x and a yield of 9%.

We continued to reduce our weighting in **Kingfisher** (now 100bp overweight) to more accurately reflect its near term challenges (the French 'gilets jaunes' riots have added to other issues) versus the low valuation and the likely pressure to release value (e.g. Screwfix) in the event management's strategy is unsuccessful. We also reduced **HSBC** and moved underweight for the first time in over five years. This recognised relative valuation and potential earnings pressures from rate movements and competition in Hong Kong.

We constantly review stocks that have underperformed to test our thesis and the valuation agenda. This month we reviewed **Hammerson**, one of the Fund's biggest underperformers during 2018. Whilst the UK elements of its portfolio are under value pressure – which we have reflected in our forecasts for net asset value – the other parts of the portfolio, namely value retail (e.g. Bicester Village), Ireland and France, are attractive. The balance sheet is secure, even assuming the prudent writedown of the UK elements, and the stock is trading on a large discount to our NAV forecasts. (These forecasts see NAV fall to c. 600p vs 750p as last reported and a share price that troughed at c.330p in January.) Elsewhere in financials, **Aviva** continued to recover, and we marked our weight back to 300bp overweight. We also continued to trim **TP ICAP.**

Outlook

As we enter 2019, there are plenty of risks for both the market and us to focus upon. Brexit, the wider UK political landscape, the trajectory of monetary policy globally, the conflict between Trump and China, tensions in the Middle East, the Italian budget stand-off with the EU and French civil unrest make for a long list of worries, and we could go on.

However, as we said last month, these risks and the resultant sell-off in global stock markets at the end of last year have created a clear anomaly in the valuation of the UK market and also the Fund. We laid out this value case in our paper, 'Mind the Gap' (see https://www.johcm.com/uk/news-views/details/1372/johcm-uk-equity-income-fund-mind-the-gap-), published at the start of the year.

Beside valuations, there are also some macro positives to consider, such as the rise in nominal wage growth (now at 10-year highs in both the UK and the US), rising real wages as inflation falls, stimulus in China and the potential end to some of the abovementioned risks. These are tangible positives, yet the market is ignoring them.

Whilst we wait for sentiment to change – with some evidence that it had started to do so in the first month of the year – we will continue to focus on growing the Fund's dividend (where the 2019 yield based on our current guidance of low to mid-single-digit growth is 5.5%) and companies with solid balance sheets. The low valuations coupled with the evidence laid out above is why we remain cautiously optimistic for the Fund in 2019.

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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