Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: February 2020

Active sector bets for the month ending 31 January 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.95	3.50	+6.45
Financial Services	8.72	4.55	+4.17
Mining	9.77	6.16	+3.61
Media	7.36	3.83	+3.53
Construction & Materials	4.73	1.41	+3.32

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.43	-8.43
Equity Investment Instruments	0.00	5.47	-5.47
Tobacco	0.00	4.09	-4.09
Beverages	0.00	3.43	-3.43
Travel & Leisure	1.28	4.47	-3.19

Active stock bets for the month ending 31 January 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.31	1.27	+3.04
ITV	3.23	0.22	+3.01
Phoenix Group	3.18	0.17	+3.01
Aviva	3.57	0.68	+2.89
BP	6.89	4.01	+2.88
Standard Life Aberdeen	3.17	0.31	+2.86
DS Smith	2.92	0.19	+2.73
Vistry Group	2.84	0.13	+2.71
WPP	2.79	0.08	+2.71
Glencore	3.75	1.06	+2.69

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.25	-4.25
GlaxoSmithKline	0.00	3.79	-3.79
British American Tobacco	0.00	3.30	-3.30
Diageo	0.00	3.01	-3.01
HSBC	1.92	4.91	-2.99

Performance to 31 January 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	**-4.43**	**-4.43**	**290.20**	**£2,605 mn**	**£3,151 mn**
Lipper UK Equity Income mean*	-2.64	-2.64	186.51		
FTSE All-Share TR Index (12pm adjusted)	-2.84	-2.84	198.14		

Discrete 12-month performance (%) to:

	31.01.20	31.01.19	31.01.18	31.01.17	31.01.16
JOHCM UK Equity Income Fund – A Acc GBP	**8.18**	**-7.75**	**16.61**	**25.44**	**-6.80**
FTSE All-Share TR Index (12pm adjusted)	10.81	-4.03	11.12	22.46	-6.33

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.

Fund size change

Eagle-eyed readers will have noted a reduction in the Fund size to £2.6bn. This follows the long-planned move by our largest client (which was c. 20% of the Fund) to transition out of the Fund into two segregated accounts, a shift that happened in early January. These two separate mandates are managed by us using exactly the same process that we use to manage the Fund and the stocks held are identical. To that end, whilst there has been a drop in Fund size, there has been no change in the overall size of the strategy, which remains c. £3.2bn.

The Fund was already reasonably diversified from a client base perspective. After this move it is now highly diversified, with the largest investor accounting for c. 10% of its assets.

The greater political clarity following the UK election result has translated into modest inflows, and we remain focused on controlling the size of the Fund and overall strategy to preserve liquidity and safeguard the interest of our clients.

Economic developments

Concern about the global economic impact of the coronavirus outbreak in China led to falls in a number of key economic indicators during the second half of January. Both the oil and copper price fell more than 10% and the US 10-year Treasury yield ended the month 30bps lower at 1.60%. It is likely that the travel restrictions will have a bigger economic impact than the outbreak itself, but, more than anything, it has heightened economic uncertainty at a time when policy makers have limited scope for manoeuvre.

Ironically, the virus outbreak followed soon after the eventual signing of the US-China "phase one" trade deal in mid-January. The uncertainty around trade relations had led to a series of softer business confidence readings in the US during the fourth quarter, but the more recent surveys have suggested an improvement in tone, although this may be tested by the spread of the virus. In contrast, US consumer activity continues to be robust, with strong retail sales over Christmas and two-year highs for US existing home sales, as well as further rises in consumer confidence surveys. As such, it seems likely that the Fed will remain on hold for a few months as these competing forces play out.

In the UK, there has been an even more marked contrast between the historic (pre-election) economic data, which has been unsurprisingly soft, and the more recent, forward-looking (post-election) surveys, which have rebounded very strongly as the threat of a radical left-wing government disappeared. A number of members of the Bank of England Monetary Policy Committee seem to have overly focused on the “rear view mirror” and openly discussed the possibility of an interest rate cut, with the soft December retail sales print (-0.6% year-on-year) giving fresh stimulus to this view. However, the consistent message from business surveys (Deloitte CFO, REC/KPMG hiring and CBI Industrial), as well as a marked rebound in the Markit composite PMI survey (49.3 to 52.4), provided clear evidence of a major improvement in business confidence. Furthermore, anecdotal and company feedback from the housing market in particular paints a picture of a much more vibrant market. This was confirmed by a material pick up in new enquiries from the RICS survey. Lastly, the UK labour market has continued to be resilient. Wages (ex bonuses) are growing at 3.4% annually and vacancies actually rose back above the 800,000 level in November. Consequently, it was no surprise to see the Bank of England hold rates in the end, particularly with the prospect of a fiscally expansionary budget to come in the next few weeks. We continue to expect a meaningful acceleration in the UK economy over the next few months, led by stronger consumer activity.

In Europe, Christine Lagarde’s first ECB press conference was dominated by the launch of a review of the Bank’s policy framework, questioning whether its inflation target needs to be reviewed. Whilst this review is welcome, the frustration is that the conclusions may not be published until the autumn. Policy paralysis could therefore set in. In the meantime, the requirement for fiscal policy to take up the baton from monetary easing remains in place.

The short-term impact of President Trump’s aggressive military action in Iran feels like a distant memory already. But it should be noted that it did lead to a US$4-5 spike in the oil price and an equity market sell-off, neither of which persisted for long and which have subsequently been superseded by other events. However, the risk of further military action and retaliation in the region cannot be ruled out.

Performance

The market, represented by our benchmark, the FTSE All-Share Total Return index (12pm adjusted), started the year poorly following its strong end to 2019. The Fund was weaker than the market over the month in returning -4.43% versus -2.84%.

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

For much of the month the UK equity market was driven by the two points highlighted in the economic developments section above, namely the coronavirus outbreak and the downbeat commentary on the UK economy by Bank of England officials. The market mix was therefore very ‘risk off’ in nature, with defensives performing strongly and cyclicals, banks and commodity sectors sluggish. This provided a headwind to the Fund’s performance.

Beyond this, our construction stocks were positive contributors. **Morgan Sindall** was up strongly and **Costain** rallied as government sources suggested HS2 would go ahead. Were this to be confirmed, it would be very positive for a number of our stocks, particularly Costain. Elsewhere, **Countryside Properties** also contributed positively following a robust update.

Vodafone and **SSE** performed well in line with the more defensive tone of the market noted above. **Liontrust Asset Management** continued to enjoy notable flows into its ESG funds amongst products, which has led to further earnings upgrades. **Phoenix** was also a good performer.

On the negative side, international cyclicals were weak. Examples in the portfolio included our paper stocks (including new addition **Mondi** – see below), as well as **Page Group** and **WPP**. In the UK, in contrast to the construction sector, many names suffered from profit taking following the strength at the end of last year – **ITV**, **Hammerson** and the food retail sector were down.

Most of the trading updates from stocks within the portfolio were strong in January (with the odd exception, such as **Forterra**). This, coupled with the low valuations, should bode well for the rest of the year.

Portfolio activity

We sold **Rank** from the Fund as its yield fell below the market average and therefore no longer met our process criteria. Its share price has nearly doubled since August as a result of a strong recovery plan by the new management and the positive implications of its acquisition of Stride Gaming. The Fund made c. 35bps of relative performance from this investment.

A number of other small caps performed very strongly, **Liontrust** (up 20% relative*) and **Morgan Sindall** (up 15% relative) being good examples. We trimmed these positions to reflect this performance and the reduced upside to our target prices. Both of these stocks remain cheap, in our view, and well positioned. Small cap exposure remains at c. 20% of the Fund, with the aforementioned sales offset by positive performance (which increases the weight), additions to a number of existing names, such as **Hipgnosis** and **Northgate**, and the addition of a new position, which we will discuss in a future report.

We entered the year with a large position in **Vistry Group** (formally **Bovis Homes Group**) after it acquired the majority of **Galliford Try's** (also owned in the Fund) business units. The shares have performed very well (up a further 7% relative). We have continued to reduce our position towards a more normal weighting.

We have made a number of new additions in recent months: **SSE**, **WPP**, **Legal & General** and **Page Group**. We continued to add to all four during January. They are now collectively c. 7% of the Fund. We also added one new stock: **Mondi**. This FTSE 100 paper & packaging stock is under-covered by UK analysts and under-owned by UK active funds. It has a strong position in packaging assets and capacity that will benefit from the accelerating switch away from plastics, a secular trend that is benefiting fellow portfolio holding **DS Smith**. The position in Mondi was funded via a reduction in our position in **Royal Dutch Shell**, which also funded the SSE purchase. This switch has reduced our exposure to oil and increased our exposure to clean energy and more environmentally-friendly packaging. It has also kept the valuation and yield dynamic of the Fund intact. Mondi yields just over 4% and is on a P/E of 11x. We also added to the mining sector, which was weak.

Elsewhere, we added to **Hammerson,** which performed poorly. We still expect the company to sell some of its 'good' assets, such as parts of the value retail portfolio (e.g. Bicester Village). This would throw the stock's low valuation into dramatic light. Finally, we added to both of our UK food retail names, **Tesco** and **WM Morrison**, which were lacklustre.

Outlook

January saw a pause in both the recovery of 'value' as an investment style and in the rehabilitation of the UK equity market. However, this should prove to be a temporary phenomenon on both fronts.

First, as we have consistently pointed out in recent months, value stocks continue to look as cheap relative to the wider market as they have done for at least 20 years, if not longer. Whilst technological disruption is a meaningful factor, selective stock picking should bring significantly positive returns from this starting point.

Second, the UK equity market continues to look highly attractive, both in absolute and relative terms. Sterling looks very modestly valued relative to its purchasing power parity, and the UK market is at its cheapest level relative to the global index for at least 20 years. Furthermore, with the material improvement that we have seen in business and consumer confidence in the UK since the decisive election result in December, a pick-up in domestic economic activity looks highly likely during the first half of 2020. Whilst uncertainties around the trade negotiations with the EU will inevitably create some uncertainties during the year, consumer activity, in particular, is still likely to strengthen because of the subdued nature of spending over the last couple of years, despite the healthy wage environment.

* All share price moves quoted are relative to the Fund's benchmark, the FTSE All-Share TR index (12pm adjusted).

Consequently, we continue to strongly believe that there is material absolute and relative upside from a carefully constructed UK equity portfolio with a bias towards domestic stocks as well as financials, commodities and smaller-cap companies.

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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