J O Hambro Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: February 2022

Active sector bets for the month ending 31 January 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Industrial Metals and Mining	14.60	6.45	+8.15
Life Insurance	10.52	3.00	+7.52
Media	7.14	3.20	+3.94
Household Goods & Home Construction	5.32	1.39	+3.93
Construction and Materials	5.09	1.59	+3.50

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.29	-9.29
Closed End Investments	0.00	6.59	-6.59
Personal Care, Drug and Grocery Stores	2.57	7.07	-4.50
Beverages	0.00	3.84	-3.84
Tobacco	0.00	3.63	-3.63

Active stock bets for the month ending 31 January 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix Group	3.19	0.19	+3.00
Legal & General	3.68	0.70	+2.98
Aviva	3.66	0.68	+2.98
ITV	3.13	0.17	+2.96
BP	5.97	3.05	+2.92
Barclays	4.25	1.35	+2.90
Vistry Group	2.95	0.09	+2.86
Standard Chartered	3.39	0.55	+2.84
Glencore	4.80	2.07	+2.73
Anglo American	4.30	1.61	+2.69

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.45	-5.45
HSBC	0.00	4.41	-4.41
Royal Dutch Shell	1.91	5.96	-4.05
Unilever	0.00	3.95	-3.95
Diageo	0.00	3.50	-3.50

Performance to 31 January 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**2.35**	**2.35**	**339.40**	**£2,221m**	**£2,596m**
Lipper UK Equity Income mean*	-0.48	-0.48	203.42		
FTSE All-Share TR Index (12pm adjusted)	-0.24	-0.24	226.20		

Discrete 12-month performance (%) to:

	31.01.22	31.01.21	31.01.20	31.01.19	31.01.18
JOHCM UK Equity Income Fund – A Acc GBP	28.55	-12.40	8.18	-7.75	16.61
FTSE All-Share TR Index (12pm adjusted)	18.01	-7.28	10.81	-4.03	11.12

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

"Inflation is running very far above trend. The economy no longer needs or wants the very accommodative policies we have in place"

Jerome Powell, US Senate Banking Committee, 11 January 2022.

This month has been characterised by central bankers being far more aggressive with their rhetoric around inflation and tightening monetary policy. Governor Powell's comments above have contributed to a 30 basis point rise in US 10-year bond yields this month and the market now discounting four or five rate rises in 2022. Starkly, US annual inflation reached 7% this month, a near 40-year high; critically, this is not just being driven by supply chain issues as core services inflation was +4% in the last 12 months and wage pressures continue to build.

In the UK, annual CPI hit 5.4%, its highest level since 1992 and is likely to breach 7% in the first half of the year as energy tariffs are re-set. These looming energy bill increases, as well as the impact of Omicron, have seen consumer confidence take a hit, with the GFK index falling to -19, an 11-month low. The UK Composite PMI survey has also fallen back to a 1-year low, mainly due to the pandemic's impact upon hospitality. However, it still suggests an expanding economy over the last couple of months, which is impressive given the level of infections and restrictions. Furthermore, 2021 ended with a period of very strong economic growth, with the November GDP expansion of 0.9% a particular stand out. Whilst it may have been inflated by forward buying of Christmas gifts due to concerns about festive product shortages, it also reflects the continuing tight labour markets in the UK, with vacancies once again posting a new record high at 1.25 million, and the ONS estimating December annual wage inflation above 5%. UK 10-year bond yields rose by 35 basis points this month, despite the simmering political uncertainty.

Even in Europe, annual inflation has reached 5% and markets are beginning to assume modest tightening of monetary policy at some stage this year, with German 10-year bund yields closing the month in positive territory! In contrast, Chinese authorities continue to actively loosen monetary policy in response to sluggish growth.

Oil prices have risen by $10-12 a barrel, partly in response to the growing tension on the Russian-Ukrainian border, with the already tight European gas market tightening even further. The rise in energy prices has been compounded by the global demand recovery not being matched by a sufficient supply response as the consequences of 2-3 years of under-investment by the industry have become apparent, a situation that is unlikely to reverse in the short term.

Performance

Stock markets stalled in January as the degree to which monetary policy needs to be tightened became clearer and was priced into the market. Geopolitical factors also weighed on sentiment. The FTSE All-Share Total Return index (12pm adjusted) finished down -0.24%. The Fund outperformed its benchmark with a return of 2.35%. 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 second quartile over three years and first quartile over five years, ten years and since launch (Nov 2004)[*].

The rise in bond yields created a material rotation in the equity market. We have been saying for a while, that 'growth', tech, the US generally and certain parts of the ESG complex are overvalued and very crowded. As we showed in last month's commentary, the valuation gap between these parts of the global market and 'value' (and specifically the UK), ended 2021, at close to its widest ever. The trends year-to-date are a welcome move back in the other direction. This was the main driver of the Fund's positive performance with sectors that benefit from this rotation leading markets. Banks, which are clear beneficiaries of higher interest rates, were strong with **Standard Chartered** up c. 20% relative. This stock has moved from less than 0.4x book value to still less than 0.5x book value – hardly expensive. Our target price would reside between 0.8x-1x book value. The mining sector was also strong with **Rio Tinto** and **Anglo American** both up more than 10% relative. The deeply unpopular oil sector rose strongly partly due to the Russia / Ukraine situation but also as it has become clearer that there has been severe underinvestment (versus requirements), and hence supply shortages arising, in the sector. **BP** was up 15% relative and some of our smaller holdings e.g. **Savannah Energy** were up even more.

Elsewhere **Vodafone** was strong as a series of rumours surfaced regarding consolidation in some of its main markets (e.g. Italy / the UK). Were any of these to consummate it would be materially positive given where the valuation resides. Towards the end of the month an activist investor was reported to have acquired a stake which will keep the focus on these potential options.

Small-caps were collectively quite significant laggards. **Keller**, **Central Asia Metal** and **DFS** were down more than 8-10%. The exception was **Lookers** which rose 33% after the owner of Webuyanycar.com / Cinch acquired c.20% of the company at a price 40% above the then screen price. The extract below from our current presentation shows the valuation of Lookers prior to this move in the share price, and the rationale for owning it. A full takeover of Lookers would need to be at a material premia to where the first 20% was acquired at.

Small Cap Example – Lookers (1% of Fund)

- Lookers - £300m mkt cap (at 75p share price), market leader in the UK new car, used and after-service markets
- Strong current momentum – c. 5 upgrades during 2021, took EPS forecasts from 4p a share to a record level of 16p. Balance sheet also moved to net cash
- New strategy laid out - heart of the EV roll-out, further cost out as they leverage digitalisation and embrace a new style agency relationship with certain OEM's which will release working capital and improve the quality of earnings
- 79p of property / 15p of cash (per share) at the end of 2022
- Earnings in 2021 were supernormal, but we expect them to make 12p+ in 2022 and 15p in 2023 = a PER of 6x and 5x
- On a prudent 3x payout ratio this means the stock yields 5.5% and 6.8%
- PE take-over or industry consolidation (note – Marshalls Motors acquired by owner of Webuyanycar.com / Cinch in late 2021) likely given low valuation
- The stock should be c. 125-175p at some point over the next 12 months

A market leader, backed by property and cash, on a ludicrous valuation

The other weak part of the Fund were our two housebuilders, **Vistry** and **Bellway**. Both were down c. 15% on the back of Michael Gove's new policy to extract further monies from the sector to pay for

[*] Source: Lipper

cladding remediation. We support the sector taking up its proportionate share of these costs, and both our holdings have already made material provisions. The likely cost of this has been priced into the share prices multiple times. Both trade below forward book value.

Portfolio activity

We indicated last month that we needed to let the Fund 'breathe' to allow the material embedded undervaluation to be recognised. As we indicated above in the performance section, this started to happen during January, but the scale of the undervaluation means that although some assets have risen materially, they still remain, in our view, cheap. We need to be patient.

The majority of the Fund remains a clear BUY. Capital for new ideas came from two sources. Firstly, our maximum active position size is c. 300bp. As stocks performed well and this level was reached, we reduced our weighting back to 300bp. Examples of this during the month include **Barclays**, **Anglo America** and **BP**. Secondly, there are four stocks in the Fund, that whilst still offering upside, are within 10-25% of our target prices. We gently faded these (**Tesco, WPP, National Grid** and **Paragon**) to create capital for the new ideas or additions elsewhere in the Fund. Our target prices continue to be based on very prudent valuation metrics – typically a P/E ratio of 13-14.5x. For example, our target price for Tesco of 330p is 14.5x our earnings forecasts. This is the edge of the valuation envelope for the Fund. On our calculations, the majority of our stocks have 50-75%+ upside to similarly constructed target prices. The value gap between where the Fund is versus the 'expensive' part of the UK market remains very wide with the index dominated by this cohort of stocks. By way of example, Diageo, LSE and Unilever (none of which are owned) together are 9% of the UK All-Share index and are, on average, on a 10 point P/E premia to our target prices for stocks in the Fund. Observations like this indicate why we still believe we are at the foothills of the regime change in markets.

We continued to modestly top up last month's new addition, **Lancashire**. We also introduced three new ideas into the Fund, two of which we detail here, **Ashmore** and **Ibstock** (both of which the Fund has owned before). Ashmore, the emerging market debt fund manager, trades on a 10-year relative low and has halved in relative terms since the start of last year and has halved in absolute terms from its pre-Covid price level in early 2020. We have had Ashmore on our watchlist for four years but have not invested. This was primarily due to its valuation being too high; this has now been eroded by the stock price fall. The stock (stripping out excess capital which consists of c. £500m of cash / seed capital) is now on a P/E of 10x. The spread between EM and DM debt is at a record high and their Fund performance is under pressure due to their 'value' bias. We have seen this before with Ashmore. This is likely a buying point on 'trough' EM valuations, 'trough' relative performance of the Ashmore funds, 'trough' earnings and a 'trough' valuation for the stock. Our other addition, Ibstock, is the market leader in the UK brick market. The stock, on a relative basis, is where it was in the initial weeks after Covid-19 first hit, and has only been lower (again in relative terms) in the months following the Brexit vote in 2016. This stock is also on c. 10x normalised earnings. The Fund has c. 100bp across the four new positions which will be built out as opportunities arise.

Elsewhere a number of our small-caps were weak for no specific reason we could see – **Keller, Sthree** and **Polar Capital** (where a Board member acquired c. £600k of stock) lagged. We added to these and also **Curry's** in the midcap space.

DS Smith hosted a very powerful mini capital markets event on its sustainability position and how its leadership in cardboard packaging is benefiting from the switch from plastic to cardboard. DS Smith is another stock on a P/E of 'only' 10-11x. We moved our position up to c. 250bp overweight.

Outlook

The path of monetary policy has clearly changed, with central banks recognising that inflationary pressures will prove to be longer lasting than they originally anticipated, partly due to very tight labour markets and a very rapid demand recovery, with the consequence being that policy, in aggregate, is far too loose. We would view this adjustment process as a positive one, as a more sustainable interest rate / discount rate is established. However, this development is unlikely to be a comfortable ride for investors in highly rated "growth" stocks and sectors, particularly those that are loss making or barely profitable and those which rely upon access to capital markets to expand their activities. We firmly believe that this de-rating process has only just begun and has many months or years to fully play out.

In contrast, rising interest rate expectations are clearly positive for some sectors, particularly banks and insurance and once again we think the re-rating of these parts of the market is in its infancy.

Commodity stocks are likely to prove a useful hedge against persistent inflationary pressures and we also continue to find very good value amongst domestically-orientated UK stocks, especially amongst the smaller caps. The "cost of living crisis" is getting a lot of airtime from the media and the rise in energy bills in April will cause problems for some sections of society. However, as we have mentioned before, at the aggregate level, this should be offset by both the acceleration in wage growth and the partial spending of the additional £200bn of savings that consumers have accumulated since the pandemic began. Consequently we still believe that 2022 will witness strong domestic and global growth and that rate rises of around 100 basis points by developed economies should be absorbed comfortably.

The UK market, with its high weighting towards the value factor, has performed well in January relative to other developed markets, especially the US, and we would expect this to continue; as we stated last month, the potential for a strong year of relative outperformance, in our view, is very high.

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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