Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: March 2023

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 bets as at 28 February 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.20	2.79	6.41
Construction and Materials	7.38	1.55	5.83
Household Goods & Home Construction	6.21	1.06	5.15
Banks	13.35	9.52	3.83
Industrial Metals and Mining	10.67	6.89	3.78

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.20	-10.20
Personal Care, Drug and Grocery Stores	0.00	7.31	-7.31
Closed End Investments	0.00	6.04	-6.04
Tobacco	0.00	3.75	-3.75
Beverages	0.00	3.63	-3.63

Active stock bets as at 28 February 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix	3.20	0.19	3.01
Vistry Group	3.09	0.11	2.98
Aviva	3.48	0.51	2.97
Standard Chartered	3.68	0.77	2.91
NatWest	3.47	0.59	2.88
DS Smith	3.03	0.18	2.85
ITV	2.98	0.14	2.84
Barclays	3.96	1.12	2.84
BP	6.73	4.10	2.63
Bellway	2.61	0.11	2.50

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.33	-3.33
HSBC	1.31	5.21	-3.90
Unilever	0.00	4.36	-4.36
Shell	2.52	7.38	-4.86
AstraZeneca	0.00	6.72	-6.72

Performance to 28 February 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**2.31**	**9.05**	**364.10**	**1,731**	**2,053**
Lipper UK Equity Income mean*	2.01	6.24	218.44		
FTSE All-Share TR Index (12pm adjusted)	2.36	6.01	249.18		

Discrete 12-month performance (%) to:

	28.02.23	28.02.22	28.02.21	29.02.20	28.02.19
JOHCM UK Equity Income Fund – A Acc GBP	8.94	16.17	5.68	-4.77	-3.73
FTSE All-Share TR Index (12pm adjusted)	8.45	14.13	4.41	-1.20	0.93

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

Compared to the last few months, February was characterised by inflation prints coming in line or even slightly higher than expectations rather than below, which has led to some skittishness across equity markets and increases in bond yields across all durations. The closely watched US CPI for January came in at an annualised 6.4% vs 6.5% in December, with shelter costs continuing to prove somewhat stubborn, whilst in some European countries, including France and Spain, annual inflation rates have begun to modestly rise again, partly driven by food prices. In the UK, the steady downward trajectory has continued with the 10.1% annual rate 40bps lower than in December. However, with tight labour markets, inflationary pressures in the services sectors may prove to be somewhat sticky, potentially offsetting some of the benefits from falling input cost pressures and the looming annualization against the Ukraine War driven energy spike. Consequently, most Western bond markets saw a material increase in yields across the curve, with the US 10-year bond rising almost 50bps to 3.95%, with similar moves seen throughout Europe. Notably, markets have reduced their expectation for interest rate cuts before the end of 2023, with only one rather than two reductions priced into forward expectations.

As well as the inflation outlook, markets have begun to price out rate cuts due to the continued resilience of the global economy. Forward-looking indicators, in particular, have improved significantly, with the European Composite PMI improving from 50.3 to 52.3 and the UK equivalent seeing a similar scale of improvement to 50.3 from 48.6. The UK services PMI increase to 53.3 was a particular standout, given this represents over 70% of the economy. Additional UK economic indicators continue to suggest an economic picture that is stronger than the official GDP data (which is often subsequently revised higher). HMRC tax receipts are running 12% higher in the nine months to January 2023, which has also meant that the UK's budget deficit is likely to be £20-30bn lower than that assumed by the Office for Budget Responsibility (OBR) in the Autumn Budget Statement, despite the energy support scheme and higher debt costs. UK unemployment has remained at 3.7% and is only 2.5% for the 35-64-year-old cohort. Surveys from the employment industry suggest that hiring activity has begun to accelerate once again in the last few weeks after the Kwarteng-induced lull in Q4 2022. A similar nascent improvement is happening in the UK housing market; housebuilders have reported a steady pick up in sales per site since the new year and Rightmove's latest data release shows sales agreed now running only 11% lower than in 2019 compared to 30% lower before Christmas.

Savills latest report on the UK housing market confirmed that more households own their own home outright (38%) than have a mortgage (33%) and that the average loan-to-value (LTV) on those mortgaged properties has fallen from 49% in 2012 to 38% in 2022. Combined with the degree of fixed priced mortgages that will take years to roll off fully, it means that the increases seen in mortgage rates will have less impact on consumer disposable incomes than is widely assumed. Furthermore, the £250bn of excess savings has still yet to be drawn upon by UK consumers and, as such, provides highly valuable downside protection to consumer behaviour and confidence. In that regard, it is noteworthy that GfK's UK consumer confidence index rose to its highest level since March 2022, and several UK consumer-facing companies continue to report strong and improving trading over the last three months.

Performance

After a strong start to the year in January, markets continued to make progress in February. The UK FTSE All Share was up 2.36% and the Fund performed broadly in line with the market, up 2.31%. Year-to-date, the Fund is up 9.05%, whilst the FTSE All Share is up 6.01% - an outperformance of 2.87%. Looking at the peer group, the fund is ranked 1st decile within the UK Equity Income sector year to date. On a longer-term basis, the fund is ranked 1st quartile over three years, 2nd quartile over five years, 1st quartile over 10 years and remains the best Fund in the sector since inception in 2004.[1]

With the exception of the market reaction to the banking sector results (see below), the start of the results season has been strong **BP** was up 11% relative during February as its results, with a clear roadmap of investment in energy transition, earnings targets and a higher than expected dividend, met with a strong share price reaction. Our media stocks were also strong with **WPP** (up 8% relative) modestly beating forecasts for 2022 and guiding confidently on revenue and margin for 2023. **Vodafone** (up 5% relative) benefited from further stake building by other telecom groups (eg Liberty Global took a 5% stake).

The banking sector had performed well in the run up to results (in January and early February). On the domestic side of the sector, the main message from the results was net interest margin gains (resulting from higher interest rates) were starting to slow, with guidance disappointing (particularly for **Barclays** and **NatWest**). The drivers of why the banks positioned results like this were threefold. First, it is correct that most of the gains from interest rate rises are now in consensus thinking and looking forward, banks are more likely to pass on a larger element of any further increases in interest rates to savers (or savers will migrate deposits to higher earning accounts). Second, the banks provided guidance based on prudent assumptions, for example, no additional base rate rises; we think this prudence is likely to lead to upgrades as the year progresses. Thirdly, bank executive boards are putting more emphasis on current returns being sustainable rather than trying to move them higher where political pressure could arise, or competitors could be allowed in. A more sustainable returns profile should eventually afford higher valuations across the group.

Towards the end of the month, the sector started to regain its poise. It remains an exceptionally cheap sector, with upsides to our target prices ranging from 50% to 130%. Four of our five holdings also announced dividends ahead of our forecasts. Standard Chartered continued to be the subject of bid speculation. The stock, at close to 800p per share, is at its highest for five years, yet it still trades on just 0.65x forward tangible book value. In our view, the minimum level for a takeover would be c.1300p.

A notable feature of February was the improving performance of certain small caps. **SThree** (up 8% relative) following strong results, **International Personal Finance** (up 15% relative) ahead of results due in early March, **Kier** (up 10% relative) and **Randall & Quilter** (up 15% relative) following the sale of a none core asset were notable features. SThree is likely to be promoted to the FTSE 250, which would reduced our small cap weighting to c.18%. Small caps remain materially undervalued.

[1] Source: Lipper

On the negative side, the mining sector was weak, as our large holdings were down c.15% relative (**Glencore** and **Anglo American**), and our small cap holding **Central Asia Metal** was down 9% relative. **Diversified Energy** fell c.10%, following a placing to fund an acquisition. Our two bus stocks (**National Express** and **First Group**) were also weak, and the life insurance sector was sluggish.

Portfolio activity

During February, we continued to add to the two new holdings we established in January and discussed in our last report (see here) – **HSBC** and **Energean**. These stocks are now c.1.3% and c.0.6% of the Fund, respectively.

No stocks were exited, but we top sliced several stocks that performed well to keep position sizes in check. **BP** was close to 7% of the Fund, after reaching its highest share price since Covid-19 started – we have placed an informal maximum absolute size of 6.75% on BP, which currently equates to c.2.7% overweight.

We also continued to gently trim **Vodafone** as its shares improved following more industry stake-building news as noted above. **Kier,** which has been in the doldrums for much of 2022, started to recover, and we marked our position to our target weight of c.100-110bp of the Fund. We also continued to gently trim our weight in **Legal & General** for the reasons discussed last month. Most of the capital released from Legal & General during the previous two months has been moved to HSBC. We also reduced our holding in **ABRDN** to reflect the 50% rise in the share price over the previous six months, coupled with ongoing pressure on its earnings in the legacy investments business. The final notable reduction was in Paragon, which at 50% upside to our target price, has the lowest upside to its target price of any of our banking positions; we moved the proceeds towards HSBC.

On the subject of additions, the drivers were mainly share price weakness, eg Glencore and DS Smith, which we commented on above. We also added to **Diversified Energy**, which announced a placing to fund the acquisition of contiguous assets in North America. The shares are exceptionally cheap on free cashflow metrics, which converts into one of the highest dividend yields in the Fund. We also added to **DFS,** which has yet to rally with other UK domestic exposure year-to-date. Trading is likely to have picked up, given the broader economic backdrop discussed above and ongoing market share gains. Finally, we added to **Ibstock**, which, like DFS, languishes around Brexit and Covid-19 lows, has a stronger balance sheet than at either of those time points and remains the market leader in supply constrained brick markets.

Outlook

During the fourth quarter of 2022, the vast majority of investors expected the world to be in recessionary conditions by now. However, this has not yet happened and may not occur at all during 2023. Gas prices have fallen heavily from their peaks last year, unemployment has not materially increased, China has done a 180 degree U-turn on its COVID policy, and consumers have continued to spend money, with the comfort blanket of considerable excess savings accrued during 2020-21. The flip side of this rosier economic picture is that central banks may need to tighten policy a little more than they had previously expected. Whether such additional rate rises will push inflation closer to their slavish 2% target by this time next year is a matter of some debate, given that secular trends such as onshoring and de-carbonisation will prove inflationary, regardless of monetary policy, whilst at the same time, the fall in participation rates in many labour markets are proving difficult to reverse, thus sustaining wage inflation.

In response, markets are beginning to recognise that the Fed is unlikely to cut rates by Q4 2023, and this realisation has seen bond yields rise and should, in due course, provide a further hurdle for growth stocks which have benefitted from low discount rates since the end of 2008. We strongly believe that investors have not shifted their portfolios far enough away from a narrow number of mega-cap US technology stocks and perceived defensive stocks in areas such as consumer staples and pharmaceuticals. These to us look dangerously expensive in this new regime of 4% plus cost of money. In contrast, many sectors that are actively benefitting from higher rates in the financial sectors as well as stocks in highly profitable and cash generative sectors, including oil, mining and media stocks are on very cheap valuation metrics. As we note above, smaller companies also look highly attractive to us at current levels. With Apple's market capitalisation still equivalent to that of the whole of the FTSE100, it is clear that global investors have not yet moved to take advantage of this opportunity. It may therefore need corporates to close this yawning valuation gap and the publicly stated interest of a Middle Eastern bank in Standard Chartered is exactly the kind of move that might draw the attention of the global investment community to the opportunity on offer in the UK and Europe.

With a healthy running yield on the Fund (c.5.3%) and strong balance sheets driving material share buybacks, we believe investors should continue to assess whether they have sufficient exposure to UK strategies, such as JOHCM UK Equity Income. The UK market has performed well over the last few months, despite the continued and relentless outflows from UK equity funds. One can only imagine how well it might do as and when those flows turn positive…

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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Please refer to the fund prospectus and to the KIID before making any final investment decisions. These documents are available in English at www.johcm.com, and available from JOHCML at the address set out above.

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Investments 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.

The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

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