Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: March 2024

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 positions as at 29 February 2024:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction and Materials	9.23	0.43	8.80
Life Insurance	9.76	2.33	7.43
Banks	15.28	9.23	6.05
Industrial Metals and Mining	9.04	5.71	3.33
Retailers	4.61	1.55	3.06

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.70	-10.70
Closed End Investments	0.00	6.35	-6.35
Personal Care, Drug and Grocery Stores	1.46	7.41	-5.95
Aerospace and Defence	0.00	3.66	-3.66
Beverages	0.00	3.28	-3.28

Active stock bets as at 29 February 2024:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
NatWest	3.76	0.57	3.19
Aviva	3.57	0.54	3.03
DS Smith	3.19	0.18	3.01
Barclays	4.08	1.12	2.96
Standard Chartered	3.57	0.63	2.94
Phoenix	3.09	0.16	2.93
Legal & General	3.09	0.62	2.47
BP	5.79	3.40	2.39
ITV	2.44	0.09	2.35
Paragon	2.31	0.06	2.25

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	2.92	-2.92
GSK	0.00	2.96	-2.96
Unilever	0.00	4.28	-4.28
Shell	1.82	7.16	-5.34
AstraZeneca	0.00	6.62	-6.62

Performance to 29 February 2024 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**0.02**	**-2.17**	**341.30**	**1,459**	**1,728**
Lipper UK Equity Income mean*	-0.41	-1.86	218.10		
FTSE All-Share TR Index (12pm adjusted)	0.01	-0.98	251.23		

Discrete 12-month performance (%) to:

	29.02.24	28.02.23	28.02.22	28.02.21	29.02.20
JOHCM UK Equity Income Fund – A Acc GBP	-4.91	8.94	16.17	5.68	-4.77
FTSE All-Share TR Index (12pm adjusted)	0.59	8.45	14.13	4.41	-1.20

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

In the UK, the ONS released data that suggested the economy experienced a technical recession in the second half of 2023. The 0.3% fall in real GDP in the last quarter of the year was entirely driven by a 6% fall in the value of services exported such as legal and accounting services. This part of the economy is notoriously difficult to measure, and as such, the number should be treated with some scepticism, particularly given the ONS's track record of delivering subsequent positive revisions to economic data.

The publication of the data was swiftly followed by the February consumer confidence survey, which saw a modest two point fall from the previous 2 year high, with participants' answers no doubt reflecting the media coverage of the recession. As such, this decline may well prove to be short-lived. Many of the other lead indicators have continued to firm over the last few weeks, with the February composite PMI reading of 53.3 hitting a 9-month high suggesting economic expansion. Elsewhere, activity in the housing market has continued to improve following the reduction in fixed-rate mortgage offers, with the latest monthly mortgage approval number above 55,000 compared to around 40,000 at the start of 2023, although still well below its long-run average. Interestingly, Land Registry official data, which reflect actual house prices paid, showed that average prices only fell by 1.4% during 2023, although the real fall was clearly much higher.

The UK's January CPI inflation print of 4.0% represented the second month in a row of a mini plateau in the inflation rate following the steep falls during the second half of 2023. However, looking ahead to the next few months, there will again be very powerful base effects in place, which, combined with decelerating food price inflation and lower energy bills, will see CPI inflation fall below 2% by April. Indeed, the next print for February, due in mid-March, is likely to see an outcome close to 3%, which will intensify the debate about when the Bank of England will begin to ease policy, which is covered in more detail in the Outlook section below. With inflation falling more rapidly than wages, real wage growth will continue to accelerate. This is already being reflected in the Asda Income tracker, which reflects that average household disposable income is the highest it has been in two years.

In the US, data continues its recent history of being mixed, albeit with the stronger prints getting more media coverage. Labour markets have continued to be resilient, with the more the 353,000 January non-farm payroll total being the highest for 12 months. Conversely, January retail sales fell 0.5% and delivered the weakest outcome for 10 months. This may well reflect the fact that in the US, consumers have now broadly spent accumulated savings that accrued during the COVID lockdowns, with the savings ratio falling to 4.2% in 2023, slightly below its long run average. In contrast, the UK's savings ratio was over 9% in 2023, almost double its long-run average and where cumulative post-COVID savings are over £300bn or around 13% of GDP. These very different attitudes from consumers on either side of the Atlantic have been partly responsible for the divergent GDP performance during 2023, but which look likely to converge during 2024. Deficit spending in the US has also played a significant role, and how this develops over the next couple of years in both countries will, in large part, depend upon election outcomes.

Performance

Following a strong finish to 2023 the first two months have seen the Fund underperform as bond yields have risen. The FTSE All Share rose 0.01% in February, with the Fund up 0.02%.

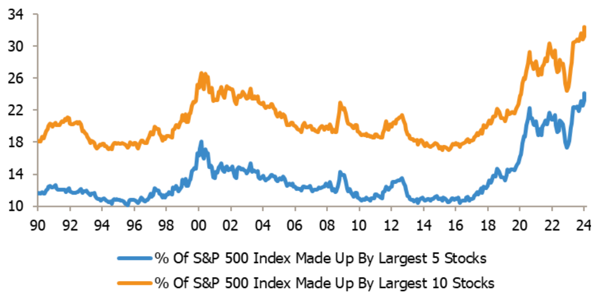
Looking at the peer group, the Fund was ranked in the 3rd quartile within the UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked 2nd quartile over three years, 3rd quartile over five years, 2nd quartile over 10 years and is the best Fund in the sector since inception in 2004.[1]

The ongoing global march of technology and growth-oriented stocks created a difficult mix effect for the Fund. In a UK context, stocks, such as RELX (now 3% of the FTSE All Share index), continued to power forward, driven by a higher rating (now 26x EPS). The two charts below show how stretched the market is currently between the ‘haves’ and the ‘have nots’.

12M Performance Of S&P 500 vs. Equal Weighted S&P 500

The 12M outperformance of the market cap weighted vs equal weighted S&P 500 is the biggest since the height of the TMT bubble... the US equity market has never been this concentrated with the largest 10 stocks accounting for almost a third of the S&P 500

% of S&P 500 made up by largest 5 stocks



Source: Bloomberg, FactSet as of January 2024

Apple and Microsoft are now each worth more than the entire FTSE 100, with Nvidia not far off this level.

In terms of positions within the Fund, the mining sector remained weak. This was particularly the case with **Glencore**, where we are in a holding pattern ahead of the acquisition of the Teck Resources energy assets. **Drax** was weak (until well received results on the last day of the month) as electricity prices fell, whilst our life assurance stocks were mixed with **Aviva** up, but both **Phoenix** and **Legal & General** struggling (down 5% relative). Small caps were mixed, with some bright spots (e.g. **DFS**, **Conduit** – the latter after strong results) but most weaker (e.g. **Severfield**, **Eurocell**). Our two bus companies were also weak – **First Group** following a very strong run and **Mobico** following a poor statement relating to its German rail business. The latter event will place more pressure on the board – to extract value via the sale of the US School bus business.

Two key factors contributed to the Fund’s upside in February: M&A and the banking sector. The Fund had two bid approaches during February, **Currys** (up 36% relative) and **DS Smith** (up 12% relative). February saw 5-6 notable corporate events within the FTSE 350 index, including the potential merger of Barratt and Redrow, alongside several developments in the property sector. We cover our view on both of the Fund’s bids in the next section. Notably, the banking sector delivered its strongest set of results in over 20 years, which is analysed in detail in a separate section ‘*Banking*

[1] Source: Lipper

Sector: Post-Results Analysis - A Turning Point?', also below. The fund's housebuilder names also continued to perform well.

Portfolio activity

The sales or reductions during February fell into three main groups: housebuilders, adjustments related to corporate activity and maintaining weights of large stocks around 300bps.

As noted above, two stocks were subject to corporate activity: Curry's and DS Smith. We have firm views on the valuation that should underpin any successful outcome for each of these ongoing situations. For Curry's, our current view based on known information is an acceptable offer would be in the range of 80-100p. This compares to an undisturbed share price of 47p, which would be close to a 100% premium. At 90p, the market cap would be c.£1bn. Regular readers may recall our 2023 recommendation for the board to sell two divisions. One, the Greek business, was sold for £175mn at the end of last year. We value the other, ID Mobile, at £350mn. Notably, before the bid, the market cap essentially only reflected the value of these two businesses. However, Curry's core business, with leadership positions in both online and offline markets across the Nordics and the UK, generates approximately £9.5bn in sales. This clearly shows the absurdity of UK stock market valuations, which we have discussed extensively in these reports over the last two years. Our normalised earnings per share for Curry's is 12p, suggesting an exit PE of 8x at the top end of the range. Our range reflects some pragmatism, as we can rotate the value received into other very cheap stocks. As we await the outcome, we have placed a portfolio construction cap of 200bps on our position size, which meant we trimmed the position slightly.

The DS Smith situation differs slightly, as it involves a potential share-for-share offer from industry peer Mondi. We do not want to get carried away with demanding or expecting a normal takeover premium - our view is the offer should be focused on a DS Smith share price of c.350/360p vs an undisturbed price of c.285p - as our main focus lies in the potential synergies and resulting valuation of the combined group. Considering these factors together, we believe a fair price could reach 450p, representing a 60% increase above the pre-bid price. DS Smith was one of our largest holdings, so we reduced our position towards our maximum level of 300bps as it rose.

Several other large holdings also delivered strong performance. As we exceeded our 300bps limit in some cases (**Barclays** and **NatWest**), we reduced our positions to maintain the maximum allocation. Some readers may note we remained slightly above on certain holdings at the end of the month e.g. NatWest. This is because these stocks are due to go ex-dividend in March, which will automatically reduce the weighting within the Fund.

We continued to gently reduce both our housebuilder holdings. As we indicated in previous months, these stocks have done well for the last six months, with **Bellway** up 90% from its Truss low point, including dividends. They now more accurately reflect the likely recovery in the market that is just starting. They were both buoyed up by the Barratts' announcement of its offer for Redrow. These stocks currently represent 350bps of the Fund, down from a previous allocation of 500bps.

We also sold a long standing small cap position, DCI Holdings, and rotated the proceeds into stocks with similar or more certain upside potential.

Looking at February's additions, we continued to build our position in **Hammerson**. Most competitors (e.g. **Land Securities** and British Land) are commenting that rents are starting to rise and values are expected to increase in the UK retail property segment, especially regional centres such as (Hammerson owned) Birmingham Bullring. Some of these companies have expressed an interest in buying such assets. We would remind readers that since 2020, pre-pandemic, asset values have declined by 60-70%. Hammerson is a pure play on this, trading at 50% of book value. We also increased **Marks & Spencer's** (post its pullback), Conduit (post strong results), Drax and First Group.

Banking Sector: Post-Results Analysis - A Turning Point?

The Fund is currently overweight banks, with significant holdings in Barclays, NatWest and **Standard Chartered** (all at c.300bps overweight). We also have a large holding in **Paragon** (c.250bps overweight) and hold smaller positions in **Lloyds Bank** and **HSBC**. For Lloyds, we are in line with the market (c.130bps), whilst we are significantly underweight in HSBC (220bps vs a market weight of 500bps). The rationale for the Lloyds and HSBC holdings is that it ensures we are overweight in the banking sector whilst allowing us to maintain targeted exposure to Barclays, NatWest and Standard Chartered. The table below only covers the main three holdings.

Besides HSBC, the results of all of the named banks led to large positive moves in their share prices (7-10%). Here are some general observations about the sector and the results:

- All major banks in the sector, including Barclays, with this set of results, have now set clear profitability targets for 2024 through to 2026. These range from a 12% to 14% return on tangible equity;
- The construct of the targets appears sensible: costs are under control, with new cost reduction programmes at Barclays and Standard Chartered. The targets are built on provisioning requirements returning to through the cycle levels (which, due to structurally lower risk appetite across the sector and gradual economic recovery, we would expect to be better) and, in the main, prudent revenue assumptions, where the largest driver is the repricing of the structural hedge over the next 3-4 years, which is a 'known known';
- The sector is materially better capitalised than at any time in the last 30 years, setting the stage for continued material capital returns. All banks have suppressed their dividend yields (albeit they remain high), to continue to focus on share buybacks, given the (low) valuation agenda. Barclays aims to buy back c.30% of its own shares within the next three years, assuming the share price remains where it is;
- The upcoming NatWest retail share offer, involving the government's remaining stake (c.33%), could, in our view, reduce regulatory risk as it is unlikely that after a 'tell Sid' campaign and likely more than one million new retail shareholders on the register, that there will be any major adverse regulatory change in the short to medium term. This should reduce the cost of capital (and increase valuations) on which the sector trades. Notably, Bank of England Governor Andrew Bailey

recently expressed concern about the sector's low valuations in a speech delivered in February;
- The current quality of bank management is clearly better than it has been at any point in the last 20 years, particularly at the Finance Director (FD) level.

The table below shows selected valuation metrics for our three main banking holdings:

UK Stock	Share Price	Mkt Cap £	2024 Dividend yield	2024 PE	2024-2026 Buy back £	Buyback as % of mkt cap	2026 TNAV	2026 targeted ROCE	Price to 2026 TNAV
BARCLAYS	163p	£25bn	5.3%	5.4x	£7bn	28%	465p	12%	0.35x
NatWest	232p	£20bn	6.8%	6.1x	£3bn	15%	348p	>13%	0.66x
standard chartered	651p	£17bn	4.4%	5.3x	£3.5bn	21%	1,457p	12%	0.45x

Source: JOHCM as of January 2024

The table shows high dividend yields (with an average c.5.5%), low price-to-earnings (PE) ratios (5-6x), with two companies having a PE yield crossover, significant share buyback programs (averaging over 20% over the next three years), and very low price-to-tangible book value ratios.

As a rule of thumb in normal times, from a valuation perspective, we would target a price-to-tangible-book (PTNAV) ratio that correlates with the return on tangible book (RTNAV) multiple. This framework would equate a 10% RTNAV to a 1x book multiple, and a 12% RTNAV to a 1.2x book multiple, and so on. Applying this rule of thumb to Barclays would imply a three-fold increase in its share price. Whilst we acknowledge that current market conditions in the UK stock market are far from normal and this is consequently not our target price, the low valuations and this historical insight into what valuations would have looked like, highlight the significant potential upside in the banking sector, particularly for the three mentioned names.

We hope and it feels like it, that this set of results across the sector marks a turning point for bank valuations.

Outlook

Many global fund managers' monthly commentaries in February will be full of observations about many equity indices hitting all-time highs and consequent concerns about valuation. No such observations apply to the UK equity market, with the FTSE 250 Index, for example, still trading more than 20% below its summer 2021 high.

This reflects that the UK market remains firmly out of favour with international investors despite widespread acknowledgement that it is a modestly priced market. The much sought-after catalysts are not only appearing on the horizon but are in danger of stampeding towards us at some pace. In particular, the last 4 weeks have not only seen a significant pick-up in corporate activity in the UK, but the nature of the transactions has also been very different from the last few years. Firstly, many of the approaches have been corporates bidding for other corporates using their equity paper as currency. Companies feel somewhat emboldened by the fact that interest rates have peaked but that the cost of finance has risen for private equity participants, making them less likely to be interlopers and that valuations, in many places, are very modest. The second significant change is the sectors where this potential corporate activity is taking place, namely housebuilding, general retailers, real estate and paper and packaging. In our opinion, many of these cyclical sectors are where the best valuation opportunities lie.

Another potential catalyst is the domestic economy looks set to accelerate during 2024. First, we are likely to see inflation below 2% during the second quarter of the year, with energy prices, in particular, continuing to soften following a very mild winter in the Northern Hemisphere. The risk is that inflation undershoots consensus over the next few months which will very much bring into focus the prospect of monetary easing in the UK. To be clear, business and consumer confidence need rates to fall at some stage during 2024 to sustain their improvement over the last few months, but this may well get delivered a little earlier than expected. Furthermore, such an easing of policy, as well as a likely modestly expansionary budget next week, will add more momentum to the rapidly improving outlook for UK households.

Looking at the aggregate position, gas and electricity bills are likely to be £13-14bn lower this year than in 2023 whilst fuel/petrol will be £4bn lower. With food prices now beginning to fall in some key categories, such as milk and cheese, this is unlikely to be a headwind to household budgets this year. Mortgage payments and rent increases will be higher by around £12bn as fixed-term mortgages are re-financed, but households' net interest income, which was £22bn higher in 2023 vs the prior year, is still likely to be higher over the whole year even if headline rates fall modestly. With wage growth slowing but remaining positive in real terms, the average UK household will likely see disposable incomes, after non-discretionary items (utility bills, mortgages etc), around 8% higher in 2024 compared to 2023. These households may choose to save part of this gain, but there is every likelihood that a proportion of it will be spent, resulting in a stronger-than-anticipated domestic economy. Given this outlook, if the Monetary Policy Committee wishes to reduce rates from c.5%, it may be easier to do this earlier in the year before evidence emerges of a strong pickup in activity.

Lastly, whilst we are not holding our breath for radical UK Government policy on ownership of UK equities, there is a chance that some moves could incrementally improve the appetite for investing in our very modestly valued domestic market, which is still the third largest equity market in the world. We remain highly constructive about the prospects for UK equities and our strategy.

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Sources: JOHCM/MSCI Barra /Bloomberg (unless otherwise stated)