Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: January 2019

Active sector bets for the month ending 31 December 2018:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.39	3.07	+6.32
Banks	16.38	10.76	+5.62
Mining	10.40	6.55	+3.85
Oil & Gas Producers	17.59	13.99	+3.60
Construction & Materials	5.06	1.53	+3.53

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.54	-7.54
Equity Investment Instruments	0.33	5.11	-4.78
Tobacco	0.00	3.80	-3.80
Beverages	0.00	3.60	-3.60
Personal Goods	0.00	2.53	-2.53

Active stock bets for the month ending 31 December 2018:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.55	0.70	+2.85
Barclays	3.99	1.22	+2.77
BP	7.37	4.62	+2.75
DS Smith	2.91	0.18	+2.73
ITV	2.92	0.22	+2.70
Glencore	4.16	1.58	+2.58
Standard Life Aberdeen	2.85	0.31	+2.54
Lloyds Banking Group	4.27	1.76	+2.51
Phoenix Group	2.31	0.14	+2.17
Vodafone Group	4.04	1.95	+2.09

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	3.55	-3.55
GlaxoSmithKline	0.00	3.46	-3.46
Diageo	0.00	3.22	-3.22
British American Tobacco	0.00	2.72	-2.72
Unilever	0.00	2.14	-2.14

Performance to 31 December 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-4.76**	**-13.19**	**240.20**	**£3,222mn**
Lipper UK Equity Income mean*	-4.43	-10.91	146.24	
FTSE All-Share TR Index (12pm adjusted)	-3.93	-9.06	157.23	

Discrete 12-month performance (%) to:

	31.12.18	29.12.17	30.12.16	31.12.15	31.12.14
JOHCM UK Equity Income Fund – A Acc GBP	**-13.19**	**18.11**	**16.79**	**0.96**	**1.11**
FTSE All-Share TR Index (12pm adjusted)	-9.06	13.10	16.05	1.25	0.93

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

Expectations for global growth continued to drift lower over the month, with Europe and China at the forefront of concerns as PMI data remained sluggish, particularly in the industrial sectors. The US has also shown some signs of slowing following the tax cut-fuelled growth we saw earlier in 2018.

This softer global economic picture has led the Federal Reserve to adjust its forward expectations for future rate rises. The December meeting, where the Fed increased interest rates for the ninth time in the current monetary tightening cycle, was accompanied by guidance that most Fed members now expect two rather than three rate rises in 2019. This remains ahead of current market consensus, with the market increasingly concerned that the Fed is overdoing tightening given the extent of the global economic slowdown. Ironically, it may be that President Trump's bluster and high profile opposition to recent rate rises is causing Fed Chair Powell to accentuate his independence and stick to the tightening path more than he should given the slowing economic momentum.

This more dovish tone from the Fed, coupled with increasingly prevalent risks like the high and rising fiscal deficit in the US, should herald a period of dollar weakness. This would be helpful for emerging stock markets but would also prove salient in a UK stock market context. UK-listed overseas-earners have had their earnings boosted significantly from the move in the GBP/USD FX rate from $1.43/£ earlier in 2018 to $1.27/£ today.

In the UK, the Brexit constitutional debate has taken centre stage as Theresa May pulled the 'meaningful' vote and then won a no confidence vote within the Conservative party. Our central case is that the EU makes a final change to the Northern Ireland 'backstop' in mid-January and that her deal then passes Parliament. It is interesting that the pro-Brexit European Research Group of MPs seem to be moderating their view on May's deal, as they realise not to do so could lead to 'no Brexit' given the preponderance of views in the House of Commons. Some sort of clarity – whether it is this or some other outcome – is likely to lead to a strengthening of sterling and a change in the leadership of the UK stock market.

We have noted before that the underlying momentum in the UK economy has been more robust than consensus expected for much of 2018. There was, however, evidence of some weakening in November and December as the Brexit uncertainty started to have an impact, particularly in the case of consumer spending and business investment. If there is Brexit clarity in Q1, GDP trends should pick up given the strength in nominal wage growth (at its strongest in 10 years) and real wage growth, as inflation falls back and as some pent up demand and investment is released.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) fell further during December, returning -3.93%. The Fund underperformed in returning -4.76%. For 2018 the Fund returned -13.19% versus an index return of -9.06%.

Looking at the peer group, the Fund ranked fourth quartile / eighth decile within the IA UK Equity Income sector for 2018. 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 main driver of the Fund's sluggish relative performance during December was the continuation of the 'risk-off' mentality seen for much of the past six months, driven by many political and geographic issues and accentuated in a UK context by the continuation of the Brexit process. Sterling fell sharply at the start of the month after Prime Minister May's decision to delay Parliament's 'meaningful' vote on her Brexit deal, but the pound did rally towards the end of December.

Our overseas-earners performed well during the month. These included our mining names, particularly **Anglo American**, both of our overseas-facing banks, **HSBC** and **Standard Chartered**, and **Vodafone**.

There were two specific areas of portfolio weakness in December. Firstly, **Galliford Try** and **Morgan Sindall** suffered collateral damage after Kier's (not owned) rescue rights issue. (We cover this situation below.) Secondly, our retail-focused names **Halfords**, **DFS** and **Hammerson** sold off after high profile profit warnings from elsewhere in the retail sector (e.g. ASOS and Primark - neither owned).

Beyond the risk-off conditions spurred by geopolitical concerns, another feature of the stock market during much of 2018 was the lack of focus on valuation. These conditions do not favour the Fund's style, but they should iron out over time as the importance placed on valuations by the market reasserts itself. We have issued a separate paper today alongside this month's bulletin, '*Mind the gap – five valuation arguments for the JOHCM UK Equity Income Fund'* (also in the appendix), which gives a detailed valuation review of the portfolio. It highlights how the Fund's negative absolute and relative performance in 2018 leaves it significantly undervalued on a range of measures.

Portfolio activity

As we mentioned last month and as we detail in our separate paper 'Mind the gap', the majority of the Fund is now, in our view, in deep value territory. Coupled with the recent negative relative performance of the Fund, this means there are fewer stocks in the portfolio reaching a natural exit point, thus there is also less space for new names. Similar to November, therefore, we did not add any new names to the Fund during the month. Nonetheless, behind the scenes we have continued to work on building a bench of ideas that will come to the fore as the market mix changes and the valuation of the Fund versus the market narrows from its current wide point.

While there were no new positions, we did make a number of portfolio changes. We noted above that our construction names were weak due to the knee jerk reaction to the Kier emergency rights issue, which was launched intra-day at the start of the month. We sold Kier in May 2017 at three times the current share price. At that point, we had concerns relating to the company's balance sheet, its extensive use of exceptional items and poor cash flow. The rights issue was a direct result of these issues manifesting themselves and management not addressing them earlier.

We added to both of our names in this sub-sector, **Morgan Sindall** and **Galliford Try** (valuation case discussed in the separate 'Mind the gap' paper). The former has average daily net cash; the latter does have average net debt but the metrics have already been improved by a rights issue in H1 2018 and are significantly better than Kier's metrics were before its rights issue. Elsewhere in construction, we added to **Countryside Properties** and trimmed our position in **McCarthy & Stone**.

In the commodity areas, we added to **Petrofac** (down 10% relative). It had a positive trading update in the middle of the month. As noted above, the mining sector strengthened, and we trimmed our positions in **Rio Tinto** and **Anglo American** to keep our sector weight in check.

We noted last month that we had moved part of our holding in **Kingfisher** into **Tesco**, which continued to underperform during the month. It is now on a P/E ratio of 10x and a free cash flow yield of 9%. Tesco is now c. 90bp of the Fund, and we are likely to continue to add to it.

In the financial sector, which was generally sluggish, we added to **Barclays**, **Paragon**, **Standard Life Aberdeen** and **Phoenix**.

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, tightening monetary policy globally led by the Federal Reserve, conflict between Trump and China, Middle East tensions, 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, these risks, and the resultant sell-off in global stock markets in recent weeks, have created a clear anomaly. Market participants are dwelling solely on the negatives and not considering valuations, either at the aggregate market level or across sectors.

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.

Slowing global growth and an extended economic cycle means global stock markets may struggle to make much progress in the next 12 months. However, we strongly believe the Fund can make positive relative and absolute gains from here, assisted by the 5.8% prospective yield. As we have shown in our 'Mind the gap' paper, the value of the UK stock market and the Fund is very distressed versus history. All of the data points in the paper indicate that the portfolio is significantly undervalued. Whilst we wait for sentiment to change, which, as was the case in early 2009, can turn quickly, we will continue to focus on growing the Fund's dividend and companies with solid balance sheets. These low valuations and the evidence laid out above is why we are cautiously optimistic for the Fund as we enter the New Year.

Appendix

'Mind the gap – five valuation arguments for the JOHCM UK Equity Income Fund' – available at https://www.johcm.com/uk/news-views/details/1372/johcm-uk-equity-income-fund-mind-the-gap-

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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