JOHCM UK Equity Income Fund

Monthly Bulletin: January 2020

Active sector bets for the month ending 31 December 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.32	3.52	+5.80
Financial Services	8.85	4.46	+4.39
Construction & Materials	5.32	1.43	+3.89
Media	7.18	3.86	+3.32
Mining	9.55	6.36	+3.19

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.23	-8.23
Equity Investment Instruments	0.00	5.42	-5.42
Tobacco	0.00	3.85	-3.85
Beverages	0.00	3.46	-3.46
Travel & Leisure	1.45	4.60	-3.16

Active stock bets for the month ending 31 December 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	7.07	4.00	+3.07
Barclays	4.33	1.33	+3.00
Phoenix Group Holdings	3.13	0.17	+2.96
ITV	3.16	0.23	+2.93
Standard Life Aberdeen	3.15	0.32	+2.83
Aviva	3.50	0.69	+2.81
DS Smith	2.91	0.21	+2.70
WPP	2.73	0.03	+2.70
Glencore	3.67	1.09	+2.58
Lloyds Banking Group	4.36	1.86	+2.50

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.19	-4.19
GlaxoSmithKline	0.00	3.63	-3.63
British American Tobacco	0.00	3.11	-3.11
HSBC	1.97	5.03	-3.06
Diageo	0.00	3.06	-3.06

Performance to 31 December 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**4.08**	**20.02**	**308.30**	**£3,306mn**
Lipper UK Equity Income mean*	3.80	19.37	194.51	
FTSE All-Share TR Index (12pm adjusted)	2.63	19.29	206.85	

Discrete 12-month performance (%) to:

	31.12.19	31.12.18	31.12.17	31.12.16	31.12.15
JOHCM UK Equity Income Fund – A Acc GBP	**20.02**	**-13.19**	**18.11**	**16.79**	**0.96**
FTSE All-Share TR Index (12pm adjusted)	19.29	-9.06	13.10	16.05	1.25

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

Clearly the Conservative's comprehensive victory in the December election has altered the political landscape. Whilst a Tory win was broadly anticipated by markets, as we discussed last month, many investors were reluctant to price in this outcome as the hard left alternative would have brought a very different landscape for the business community. Consequently, it was not surprising to see both domestic equities and, to a lesser extent, the pound respond positively in the second half of December. However, sterling's gain was restrained by Prime Minister Johnson's subsequent commitment to the UK fully leaving the EU by 31 December 2020. Time will tell whether this commitment is legally binding or not, but it highlights that markets will periodically worry about a harder Brexit over the next 12 months. But with such a sizeable majority, it seems reasonable to anticipate that the Johnson administration will drift politically back towards the centre ground in the next couple of years. We still believe sterling is materially undervalued.

In the shorter term, the UK economy is in need of a confidence-driven pick up; during the second half of 2019, economic activity progressively slowed as the political uncertainty took its toll on business confidence. Whilst GDP grew by 0.4% in Q3, the rate is likely to have been around half of that in the last quarter. However, with wages still growing in real terms by around 1.5% annually and employment levels remaining at record highs, the capacity for a consumer spending-driven improvement in the early months of 2020 is very much in place. Complemented by a measured fiscal expansion, we would anticipate that activity will improve. As such, the Bank of England will likely resist the temptation to cut rates in response to the weaker second half of 2019. Furthermore, the imminent arrival of a new Governor is likely to increase the case for a "wait and see" approach.

Similarly in the US, we expect monetary policy to be on hold for a few months. Consumer spending continues to grow at more than 3% p.a. and housing markets are well supported, reflected in US housebuilder confidence levels hitting 20-year highs. However, despite this positive backdrop, the 10-year Treasury yield regularly struggles to break through the 185-190bps level, not least because inflationary pressures continue to be modest. Even the agreement of a phase one trade deal with China seems to have only had a modest impact on business confidence thus far, with investors still seeking more details ahead of the planned formal signing on 15th January. The attempted impeachment of President Trump is having little impact on markets or indeed the economy given the difficult hurdle to be cleared in the Republican-controlled Senate.

Economic indicators in China continue to show modest improvements from the depressed levels seen in the summer as both monetary and fiscal stimulus continue to be applied, with the latest cut in the banks' reserve ratio requirement a confirmation of the policy direction. A continued deescalation of the trade war with the US would obviously strengthen business confidence. In this regard, we will be watching the forward-looking elements of the business surveys in the coming months. This also applies to Continental Europe, particularly Germany, where in the last few months there has been a nascent recovery in many of the manufacturing PMIs while the IFO survey in December showed a marked improvement. However, Europe more broadly needs to more fully embrace an expansionary fiscal policy agenda, with Christine Lagarde needing to show some early signposts in this regard.

Performance

The market, represented by our benchmark, the FTSE All-Share Total Return index (12pm adjusted), finished the year strongly in rising 2.63% during December. The Fund continued to perform well, returning 4.08%, which was 1.42% better than the index. For 2019 as a whole, the Fund returned 20.02% against the benchmark return of 19.29%.This is a very pleasing result given the extent of the Fund's underperformance until its recovery from late August.

Looking at the peer group, the Fund was ranked second quartile within the IA UK Equity Income sector for 2019. On a longer-term basis, the Fund is ranked first quartile over three and five years and first decile over 10 years and since launch (November 2004).

The main driver of the Fund's strong absolute and relative showing in December was the outperformance of domestic shares before and after the election. We have long commented on the significant undervaluation of this element of the market and some of this value gap unwound during the month. Highlights at a stock level were **Forterra**, up 17% relative, **Morgan Sindall** up 12%, **Countryside** up 11%, **Galliford Try** up 17%, **DFS** up 23%, **U&I** up 16% and **Rank** up 6%.[*] Many of these are small caps, which highlights that despite the issues of 2019 surrounding liquidity and a high profile fund closure, small cap investing is not dead. Our small and mid caps combined added materially to performance across the year and remain very cheap in aggregate, in our view.

Financials performed slightly better than the market, with **Barclays** up 3%, **Lloyds Banking Group** up 1% and insurers up slightly. We would expect the positive performance of financials (in absolute terms and against defensives) to continue as economies continue to strengthen in line with lead indicators and bond yields rise. This also remains a materially undervalued part of the Fund. Two examples are **Barclays**, which trades on 65% of tangible book value, on 8x earnings and a yield of 5.5%, and **Aviva**, which is on a P/E and yield crossover of 7x and 7%+ respectively.

Other standout contributors were property company **Raven Group**, up 16% relative after the company agreed to acquire the largest holder's shares at a c. 50% discount to their proforma book value, which was very accretive to remaining shareholders. Recruitment group **Sthree** was up 8% following a good trading update.

The main laggards in the month were the oil sector, with **BP** down 5%, **Glencore**, which was down versus the wider mining sector following a further governmental enquiry into the company's historic activities, and **Costain**, which warned on a historic contract.

Portfolio activity

We made a number of changes to the Fund during December.

We continued to add to recent new names, including **SSE**, which was discussed in last month's commentary. This stock is now c. 1% of the Fund. It has largely been funded by reducing our oil weighting via letting our holding in **Royal Dutch Shell** drift lower. Second, we also continued to add to **Legal & General**, which is now 2.7% of the Fund.

The other areas we have added to are food retail (both **Tesco** and **Morrison**), which have been weak, and mining, which in the early part of the month lagged encouraging economic indicators from China and also the **Glencore**-specific weakness highlighted above. We also added to

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

Costain, which was weak following its warning. The Fund's average purchase price is below the current market level.

There were no outright sales during the month albeit we did adjust a number of positions reflecting sizeable price movements. We reduced our position in **Bovis** to ensure that the weight post the consummation of the **Galliford Try** transaction in early January was close to our 300bp threshold. We also reduced **Forterra**, **Morgan Sindall**, **Liontrust**, **TP ICAP** and **Rank** – all of these stocks still have good upside and, with the exception of Forterra which had a small downgrade in November, all are trading very well.

Finally we reduced our position in **Paragon** as it approached 1.5x forward book value. It also yields less than 4%.

Fund dividend

The Fund's final dividend growth in 2019 was c. 8.5%. The underlying growth was c. 7.4%, which was in line with our forecasts and previous guidance and a pleasing result following the strong growth in 2018 (c. 18%). It was also materially higher than our initial guidance of low-single-digit growth, which we made in December 2018.

The actual figure was above the underlying figure because Bovis (which acquired parts of Galliford Try's business in early January) went ex its final dividend for 2019 in December rather than in Q1 2020, which would have been the norm. This boosted the Fund's dividend growth in 2019 by 1.1% and will have the opposite effect on 2020's growth rate.

The discrete Q4 2019 dividend, which went ex at the turn of the year, was 4.1p per unit ('A' accumulation share class), which was up c. 11% year on year (including the Bovis effect).

The Fund yields 5.1% for 2019, which is now the historic dividend yield.

Our initial guidance for 2020, which we issued in September, was for low-single-digit Fund dividend growth. This remains our guidance. This includes a buffer for sterling to strengthen (which reduces both market and Fund dividend growth), which it has and which we anticipate will continue (see comments in the first section). This guidance now also includes the negative effect of the Bovis effect described above, which has narrowed the normal buffer we include for general prudence. Company managements remained cautious in terms of capital allocation decisions in the second half of 2019, which we expect to continue in the near term but start to reduce as a factor as we move through 2020 as economies strengthen and confidence returns, particularly to the UK economy.

Based on this guidance, the Fund, on a prospective basis, yields 5.2% for 2020.

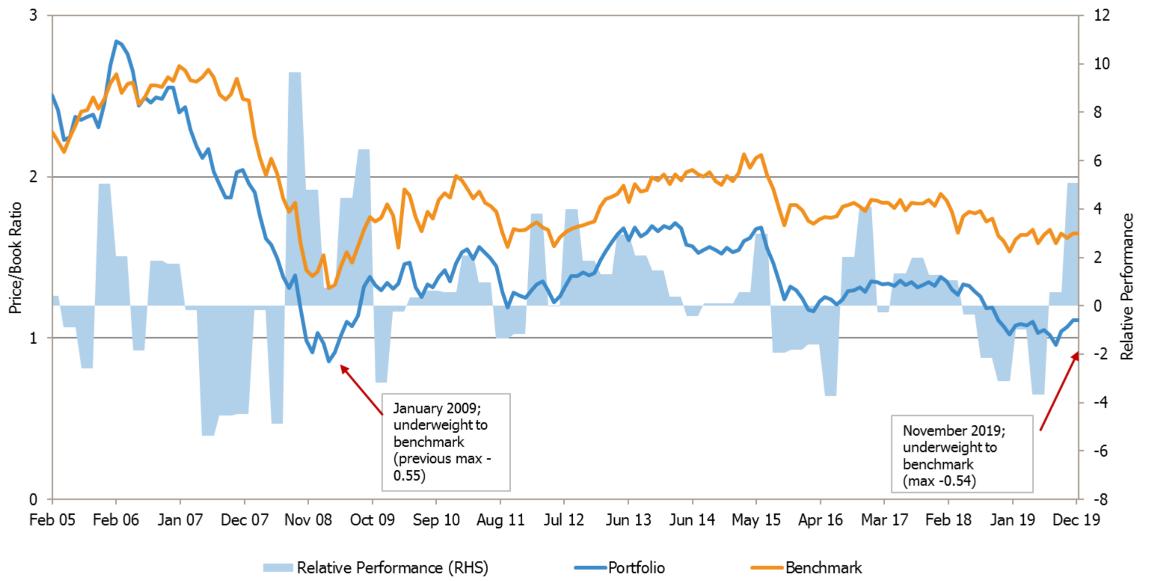
Outlook

As highlighted above, the market had a very strong year. The Fund has performed well in absolute and relative terms since the end of August. Both of these factors have partially closed the value gap that we highlighted in the two papers that we published in July and September 2019 (available here and here).

Below we have updated the two key graphs in those papers to show how much of the absolute and relative price gap continues to exist after the positive performance trends in the second half of 2019.

The first graph below shows the price-to-book of the Fund and the market. It highlights that despite being off its absolute low, which was just below 1x price to book, it remains very low versus the Fund's 15-year history. The gap between the Fund's price-to-book and the market's price-to-book also remains wide.

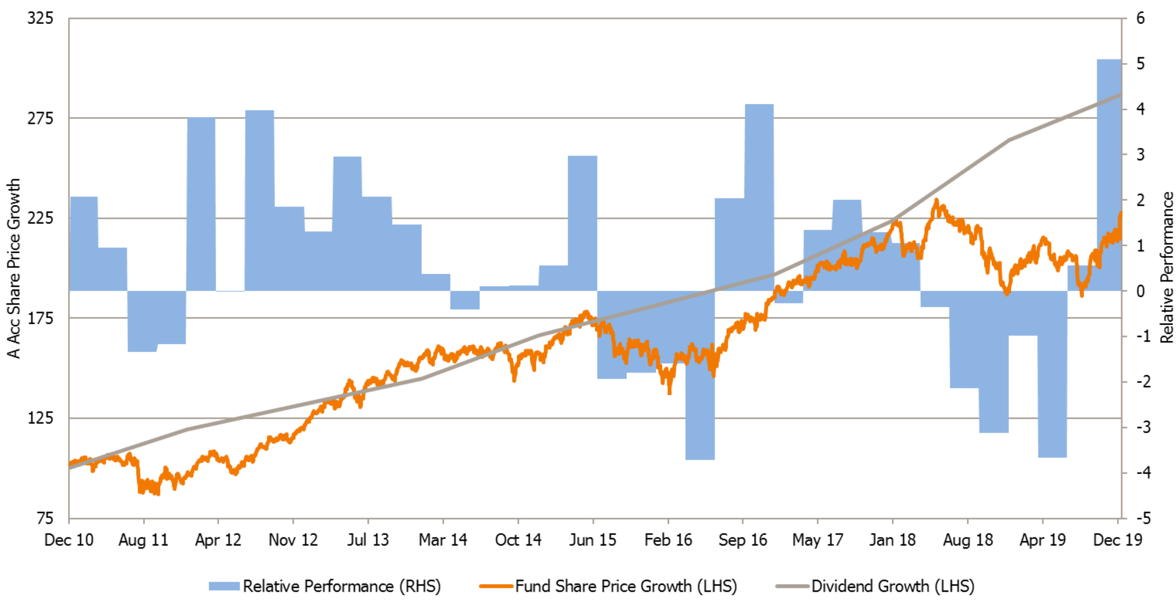
The Fund's price-to-book valuation is close to its lowest ever level



Source: JOHCM/Fund analytics as at 30 November 2019 (price-to-book valuation, LHS) and 18 December 2019 (relative performance, RHS).

The second chart shows the gap between the Fund's unit price and its dividend trajectory. The gap that existed at the peak has closed by c. 40%, but, like the price-to-book analysis, remains wide versus history. The unit price would have to rise by a further 25% to recouple with the dividend line. As we discussed above, the Fund's dividend outlook is both positive and solid.

The (unit price to dividend) gap has narrowed but remains very wide versus history



Source: JOHCM/Bloomberg as at 18 December 2019.

Both charts suggest we are only part of the way through the repricing of the Fund. This aggregate level data fits in with examples on a stock by stock basis of undervaluation, like those on Barclays and Aviva shown above. Collectively these points suggest there remains material upside for the under-owned UK market and the Fund.

In the next few months we expect a number of things to happen that would continue to unlock this valuation gap. First, the election result and progress on Brexit will unlock allocation and flows into the UK stock market. We have already seen this at an industry level and here at J O Hambro Capital Management. Anecdotally we have seen a marked increase in demand for client meetings and engagement in those meetings in the past two months. Second, as a result of the greater clarity, we expect corporate activity to increase sharply, particularly for UK-focused quoted stocks. We would not be surprised if 2020 was a record year on this front. Third, and as outlined above, we expect domestic policy action to be materially more positive than consensus expectations, which will lead to a better GDP growth outcome than is generally expected – this means forecasts at a stock level are too low and will be upgraded. Fourth, global lead indicators have turned up, which is leading bond yields higher, which should help the Fund's relative performance. Finally, we could see some progress on Trump / China ahead of the US presidential election later this year. Consequently, whilst mindful of the risks surrounding the Iran/US situation, we continue to believe that the capacity for meaningful outperformance by our portfolio is still high at present.

We would like to take this opportunity to thank you for your patience during the middle of 2019 as the Fund performance troughed. We also wish our clients a happy and prosperous New Year.

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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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.

Investments fluctuate in value and may fall as well as rise. Investors may not get back the value of their original investment.

Past performance is not necessarily a guide to future performance. Dividend yield quoted is prospective and is not guaranteed.

Investors should note that there may be no recognised market for investments selected by the Investment Manager and it may, therefore, be difficult to deal in the investments or to obtain reliable information about their value or the extent of the risks to which they are exposed.
The Investment Manager may undertake investments on behalf of the Fund in countries other than the investors' own domicile. Investors should also note that changes in rates of exchange may cause the value of investments to go up or down.

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