JOHCM UK Equity Income Fund

Monthly Bulletin: January 2022

Active sector bets for the month ending 31 December 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.35	2.94	+7.41
Industrial Metals and Mining	14.88	7.90	+6.98
Media	7.58	3.21	+4.37
Household Goods & Home Construction	5.59	1.61	+3.98
Construction and Materials	5.03	1.63	+3.40

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.15	-9.15
Closed End Investments	0.00	6.99	-6.99
Personal Care, Drug and Grocery Stores	3.04	7.18	-4.14
Beverages	0.00	4.05	-4.05
Tobacco	0.00	3.10	-3.10

Active stock bets for the month ending 31 December 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	5.61	2.57	+3.04
Barclays	4.25	1.25	+3.00
Glencore	4.97	1.98	+2.99
Aviva	3.60	0.62	+2.98
Anglo American	4.44	1.47	+2.97
Vistry Group	3.07	0.10	+2.97
ITV	3.13	0.16	+2.97
Legal & General	3.67	0.70	+2.97
Phoenix Group	3.07	0.16	+2.91
Standard Chartered	3.26	0.45	+2.81

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.36	-5.36
Unilever	0.00	4.02	-4.02
Diageo	0.00	3.70	-3.70
HSBC	0.00	3.66	-3.66
Royal Dutch Shell	1.73	5.01	-3.28

Performance to 31 December 2021 (%):

	1 month	2021	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**5.17**	**24.76**	**329.30**	**£2,159mn**	**£2,525mn**
Lipper UK Equity Income mean*	4.81	17.90	204.12		
FTSE All-Share TR Index (12pm adjusted)	4.68	17.77	226.97		

Discrete 12-month performance (%) to:

	31.12.21	31.12.20	31.12.19	31.12.18	31.12.17
JOHCM UK Equity Income Fund – A Acc GBP	24.76	-15.72	20.02	-13.19	18.11
FTSE All-Share TR Index (12pm adjusted)	17.77	-9.52	19.29	-9.06	13.10

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

Having spent all year writing in these monthlies about rising (and potentially more permanent) inflationary pressures and strong employment markets, such that central bankers would need to swallow hard and tighten policy, it seems somewhat ironic that they have now begun to move, despite the short-term uncertainty caused by the Omicron variant. In the end, the sheer scale of the inflationary prints has probably pushed them into action, with US CPI at 6.8% in November, the highest since 1982 and UK inflation at 5.1%, the highest for 10 years. Coupled with very tight labour markets and accelerating wage inflation, it has been clear to us for some time, that policy has been far too loose and will need to adjust materially in the coming months.

In the US, the Fed has begun this process by significantly accelerating the pace of tapering of asset purchases. In the space of only a couple of months, the end of the programme has shifted from Autumn 2022 to March of this year. Furthermore the "dot plots" accompanying their future economic forecasts, now assumes three rate hikes in both 2022 and 2023. The official payroll data in the US continues to paint a somewhat confusing picture, with the monthly additions to the workforce regularly disappointing, even though most firms complain that it is close to impossible to recruit new staff. The robustness of the economy is also reflected in consumer behaviour with November retail sales +0.3% on the previous month and more strikingly +18.5% versus last year. Omicron will inevitably result in some short-term disruption but as we pointed out last month, it appears to be a more transmissible but less dangerous variant. Another uncertainty has been created by the political horse trading involved around the Democrat's stimulus bill, which ironically is looking less and less necessary with each passing month.

In the UK, the Bank of England surprised most commentators by raising the bank rate by 15 basis points to 0.25% despite the short term Covid-19 uncertainties. It made for a difficult message to convey with any sense of authority, but they only have themselves to blame as they should have begun the process of tightening monetary policy some months ago. Employment markets have continued to tighten even further with 250,000 added to the paid employment cohort in November, with unemployment consequently falling to 4.2%. Average earnings rose by 4.2% year-on-year. Notably the base effects from last year have now worked their way through the system so we finally have a clean number to monitor and reflect upon. It seems likely that, given the ongoing headline inflationary pressures, particularly from energy and utility bills, workers will demand higher wage settlements during 2022 and that they will largely succeed given how tight the labour market is. This contrasts with the OBR's forecast which assumes wage inflation falls back to 1.5% in 2022; we struggle to see how that would happen. The official October GDP estimate disappointed at only 0.1% growth versus the previous month. However, as we have commented on before, the UK has a track record of significantly under-estimating GDP growth initially and subsequently having to revise the numbers higher and that looks very likely to be the case again here. Not only does all the evidence from the corporate sector suggest a much stronger economy over the last few months, but the total hours worked statistics for the three months to October grew by 1.7% versus the aggregation of the monthly GDP estimates growing by less than 1%. Unless there has been an unprecedented and unexplained drop in productivity over this period, it is highly probable that the GDP numbers will be revised higher to a similar number in time.

In China the PBOC cut its key one-year prime lending rate for the first time since April 2020 to 3.8%. although the reduction was only five basis points, the trajectory is more important and symbolic, particularly as it has also been accompanied by other stimulative measures such as improved mortgage availability beyond first time buyers. The authorities also appear to have been highly active in encouraging consolidation amongst the property developers to prevent a downward spiral of confidence following the issues at Evergrande, although newsflow there will continue to be bumpy. The Caixin manufacturing PMI rose to its highest level in 6 months.

Finally, despite the Omicron uncertainties, most commodities have been fairly stable and robust over the last few weeks. Oil fell sharply at the end of November as the new variant raised fears about travel shutdowns with Brent falling by 17%, but in December it has regained half of that fall. Within the metals space, copper has been remarkably stable throughout both November and December reflecting both confidence in a limited short-term impact from the new variant and a robust structural growth dynamic from the electrification of energy markets.

Towards the end of the month investors became more confident that Omicron was a less dangerous variant in terms of hospitalisation rates and as such bond yields began to rise once again; in the US the 10 year added 5 bps to close at 1.50% and in the UK it rose 15 bps to 0.97%. Partly helped by the December rate rise, Sterling also continued its stealthy and somewhat un-noticed recovery, with £/Euro closing at 1.19, within 1% of a 5 year high.

Performance

Stock markets rallied in December as Omicron risk was repriced. The FTSE All-Share Total Return index (12pm adjusted) finished up 4.68%. The Fund modestly outperformed its benchmark with a return of 5.17%. The Fund had a very strong 2021 rising 24.76% compared to the benchmark which was up 17.77% over the same period. Looking at the peer group, the Fund is ranked first quartile within the IA UK Equity Income sector for 2021. On a longer-term basis, the Fund is ranked second quartile over three years and five years and first quartile over ten years and since launch (Nov 2004).

Despite the more positive market context, a number of the best performers were defensive areas which the Fund does not own, such as Tobacco. In addition, some of the large sectors the Fund *is* exposed to performed sluggishly, such as large banks and oil.

Offsetting this, the mining sector started to perform better as evidence of China's stimulus became clear. **Anglo American** and **Kenmare** were the best performers over the month. The transaction between **National Express** and **Stagecoach** (both owned) was announced (see below for further details). Both rose strongly (10-25% relative to the benchmark). **Endeavour Mining** fell in relative terms due to its dual listing in Canada falling out of a number of indices there, prompting index selling.

Small-caps were mixed partly due to reduced liquidity across the holiday period. **Galliford**, **Keller** and **Lookers** were strong, whilst **Eurocell** and **Sthree** were weak. The latter issued an in-line trading update for 2021 (after a series of upgrades during the year) but announced it would invest in the business in 2022 to create a platform for strong growth in the years thereafter. Whilst this did not lead to a downgrade, it does remove the prospect of further upgrades near-term. The stock fell 18% during December but was still up 40% in relative terms over the year.

Drax was strong following a good capital markets event. The shares ended up 45% relative over the year. The group has a world-leading pellet / biomass production business in the US, produces 6-7% of all of the UK electricity (whose strategic value has been highlighted as other forms have been shown to be volatile e.g. low wind, failed French power connector), will be the largest operator of carbon capture in the UK by 2027, and owns close to 50% of 'quick' electricity generation (e.g. Hydro) which is critical in the new world of renewables (whose output, as noted above is volatile depending on the weather). **National Grid** was also strong and ended the month up 7% in absolute terms.

Portfolio activity

We made relatively few changes to the portfolio in December. As we indicated last month, we need to let the Fund 'breathe' to allow the material embedded undervaluation to be recognised.

U&I (c. 80bp of the Fund) was bid for by Land Securities in early November. This stock was sold into this bid during December.

We established a small position in **Lancashire** to augment our existing position in **Conduit Holdings**. It has been a difficult year for Lloyds insurers and similarly exposed companies due to a series of 'loss' events (e.g. European floods, hurricane Ida etc). This has eaten into current year profits and in some cases capital. Increases in insurance prices have been substantial and will be once again in 2022. In our view this will (even assuming some above normal loss activity) restore returns to reasonable levels. Lancashire, which used to be considered one of the best operators (due to its small size, nimbleness and track record since inception) is now trading at a 10-year relative low as despondency with the sector reaches extremes. The Fund made significant relative gains from this sector in the first five years of its life but sold out as the stocks became fully valued. The opposite is now true. We will keep adding to Lancashire on any weakness.

As implied above there is very little to sell or reduce in the Fund given how low valuations are. To make room for some of the additions we reduced our weights in **Tesco** and **WPP**, both of which have performed well. Whilst there remains c. 20-30% upside in each they are closer to fair value than the majority of the Fund. We also, particularly in the early part of the month, reduced a number of stocks that hit our soft 300bp active limit e.g. **Aviva** and **Vistry**.

We added to **Stagecoach** after its merger with **National Express** was finalised. This is effectively a takeover which creates a market leading position in the UK to augment National Express' two other growth engines – US school buses and its dominant position in Spain. The deal releases £45m of synergies and improves debt ratios. The combination of these two factors, coupled with higher EBITDA, means there will be more cashflow per annum to invest in growth options in the other two geographies. On proforma earnings, including normalisation post Covid-19, the stock is trading on a PE ratio of 6x. It is another stock amongst many in the Fund that could credibly double.

We also added to a number of laggards – **Curry's, Endeavour Mining, Costain, Sthree** and **ITV.**

Finally, **Savannah Energy**, which has been suspended for six months pending the announcement of a material acquisition, made the announcement in late December. We believe this deal is a game changer in that it is materially earnings and cashflow enhancing with a step change in critical mass. Whilst the stock was suspended there were also a number of positive developments in the pre-existing business e.g. a substantial reserve increase. All of these factors should feed into the share price over the coming weeks. The stock trades on a pro-forma free cashflow yield of around 50% (i.e. cash generated in 2022 and 2023 equals its equity value). To fund the acquisition there was a placing (of c. 25% of market capitalisation) at the suspended price. We added our pro-rata amount, which means at the suspension price the weight is c. 50bp. The shares were relisted on 31 December and went up 15%.

Fund dividend

We materially increased our forecast for 2021 Fund dividend growth as the year progressed. The last upward adjustment in November was to expect growth of 62-64% which compares to a start-of-year forecast of c. 37% growth. The final outturn was growth of 62%. Within this, the Q4 Fund dividend that went ex-dividend on 31 December grew 26%.

The Fund's dividend yield for 2021, which is now the historic yield, was 3.9%.

We believe that dividend growth will continue to be strong in both 2022 and 2023. As noted previously we expect to be back at the pre-covid dividend per unit level by the end of 2022, which would represent growth of c. 20-25% versus 2021. This would equate to a yield of c. 4.8%.

Outlook

The Fund recovered well in 2021 finishing 1% below its all-time absolute high which was reached at the start of Q4 2021. However, we remain c. 5% below the relative high watermark. Getting to this and beyond is the clear aspiration and objective for 2022.

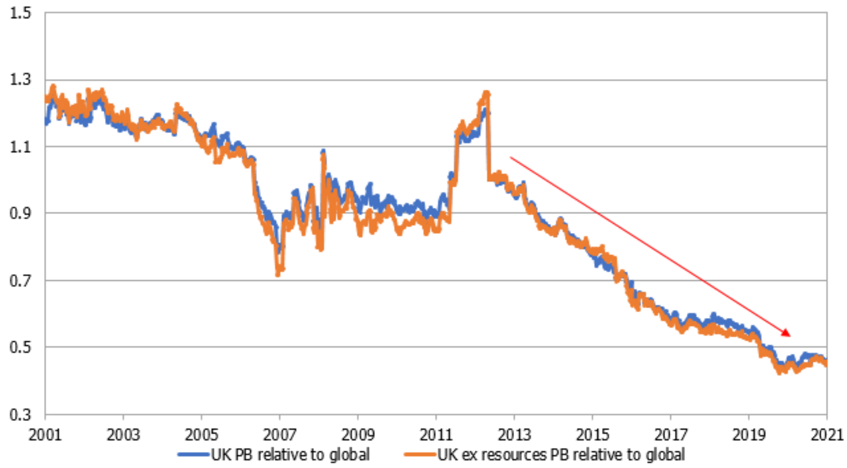
We are very confident the Fund will perform well in 2022. The two charts below show how cheap value is versus growth and how cheap the UK market is versus the world. Both value and the UK have rarely been cheaper. Most people acknowledge this but see no catalyst for it to change.

Value stocks have hardly ever been cheaper

Europe Factor Performance	PE Valuation Percentile vs. History
Value	6
... PE	6
... PB	4
... DY	14
... FCF	2
Quality	100
... ROE	97
... Earnings stability	100
... Sales growth	96
... Low volatility	100

Source: Exane as at 30 November 2021

The UK stock market has never been cheaper

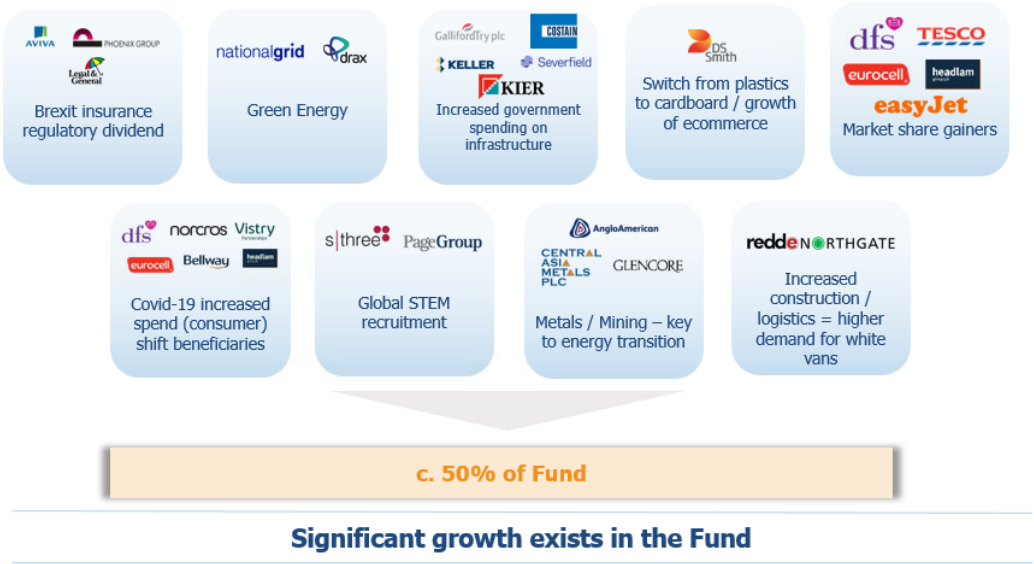


Source: Credit Suisse research as at 30 December 2021

There are numerous, increasingly visible factors that should underpin strong returns for the UK market in 2022 and in particular, given its current positioning, the Fund:

- The valuation ‘elastic’ as shown in the charts above is currently very stretched – even a slight loosening of this (as we saw in Q1 2021) would have a material effect on performance differentials given how skewed positioning is towards the winners of the last decade (growth, the US, tech);
- Inflation is here to stay - we expect it to stay elevated for longer than consensus expects. This is very different from the trend of the last 20 years;
- As a result of this, we are at the foothills of an important directional change in monetary policy – rates will rise further in 2022. Government bond yields remain too low. We expect these to rise during the next 12 months. The upward move in inflation and interest rates could be the catalyst for the valuation ‘elastic’ to snap;
- Fiscal policy globally largely remains constructive;
- The banking system in the UK (and elsewhere) is in good shape. Banks will underpin economic activity rather than (as they did following the financial crisis) constrain it;
- UK consumers have c. £200bn of excess savings built up during the pandemic. We expect this to underpin discretionary consumer spending in 2022, which will be an important driver of GDP growth. We also expect wages to rise by c. 4-5% (vs the MPC’s forecast of 1.5% which does not fit with prevailing evidence), which will also assist growth and elongate the period of higher inflation. There is a similar picture in the US;
- We could be at the beginning of the end of the pandemic – with Omicron clearly milder than previous versions and due to its prevalence and vaccines, large parts of the population now immune. This is not priced into the market;
- The quality of the Fund and the growth embedded in it feels materially higher than it has done for the 17 years we have been running it. Covid has shifted growth towards the value part of the market and towards key components of the Fund. The chart below shows this vividly;

Under-appreciated growth post Covid-19



- The profit recovery within the Fund has been powerful. The table below shows 26% of the Fund, but with tangential read-across to close to 60% of the Fund, that profits are expected to be c. 40% higher in 2022 compared to pre-Covid-19 levels. With the UK market back to only where it was pre-Covid-19, this profit growth has manifested itself in lower valuations;

Profit / performance is significantly better than before the pandemic

Sample taken from each major sector = 26% of Fund shown, c. 58% of Fund with sector read across

Stock	2019 Profit (actual)	Relevant Sector Read Across	2022 Profit (forecast)	Change	2023 Profit Expectation	Valuation
Barclays	£6.2bn PBT	13%	£7.2bn PBT	+16%	↑	7x PE / 0.6x Book
AngloAmerican	$10bn EBITDA	15%	$15.4bn EBITDA	+54%	↑	16% FCF Yield
norcros	£34m EBIT	5%	£41m EBIT	+20%	↑	9x PER
PageGroup	£147m EBIT	2%	£190m EBIT	+30%	↑	14x PER
dfs	18p EPS	3%	28p EPS	+52%	↑	8x PER
Vistry	111p EPS	5%	142p EPS	+27%	↑	8x PER
drax	30p EPS	2%	60p EPS	+100%	~	10x PER
bp	49c EPS	10%	69c EPS	+40%	~	6x PER
TESCO	18.5p EPS	3%	21.7p EPS	+17%	↑	13x PER
		c. 58%	Unweighted average	+40%		

Profit in 'value' part of market materially better than pre Covid-19 with positive momentum

- Dividends have rebounded strongly. As noted above, the Fund yields just under 4% on a historic basis and around 5% on a prospective basis. This feels wrong on an absolute basis and also compared to other asset classes e.g. fixed income;
- Balance sheets are strong – around half of the Fund's exposure is currently buying back shares – a function of the low valuation and management confidence. The strength of the aggregate balance sheet also means there is increased optionality (e.g. bolt-on acquisitions) that could create value;
- As we have highlighted many times before, in an absolute sense, valuations across our portfolio continue to look extremely undemanding – there is material upside across all parts of it (typically 50%+). Our challenge at the moment is to find sell ideas;
- Incoming M&A into the UK market has been high in 2021. In total £10bn of premia was paid in 2021 – a record high. Despite very clear messages from private equity buyers that the UK is comfortably the most attractively valued developed market in the world, the rest of the investment community just doesn't seem to be listening. The Fund received two bids during

the year – Morrisons and U&I – both at large premia of c. 65-75%. We expect more in 2022 whilst the valuation gaps remain as wide as they are.

This is a powerful cocktail of factors that could collectively create a material tailwind for the UK market and the Fund in 2022, yet very few investors seem to be interested, with weightings to UK assets continuing to fall. We would encourage all of you to have another look at the UK, and specifically the Fund, as we start the new year.

Whilst tightening monetary policy and rising bond yields are likely to provide a headwind for some parts of the equity market, particularly highly valued growth stocks and perceived compounders, we strongly believe our portfolio is poised to benefit from these conditions with its exposure to financials, commodities and very moderately valued stocks across a diverse range of industries. The potential for a strong year of relative outperformance 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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Sources for all data: JOHCM/Bloomberg (unless otherwise stated).