Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: February 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 31 January 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.39	2.95	6.44
Construction and Materials	7.40	1.52	5.88
Household Goods & Home Construction	5.98	1.05	4.93
Industrial Metals and Mining	11.82	7.90	3.92
Media	7.03	3.30	3.73

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.05	-10.05
Personal Care, Drug and Grocery Stores	0.00	7.31	-7.31
Closed End Investments	0.00	6.23	-6.23
Tobacco	0.00	3.70	-3.70
Beverages	0.00	3.60	-3.60

Active stock bets as at 31 January 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
NatWest	3.68	0.65	3.03
ITV	3.16	0.13	3.03
Barclays	4.24	1.23	3.01
Aviva	3.53	0.53	3.00
Phoenix	3.19	0.20	2.99
DS Smith	3.15	0.19	2.96
Vistry	2.95	0.10	2.85
Paragon	2.84	0.06	2.78
Glencore	5.51	2.90	2.61
Standard Chartered	3.27	0.67	2.60

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.31	-3.31
HSBC	0.93	5.01	-4.08
Unilever	0.00	4.35	-4.35
Shell	2.39	7.03	-4.64
AstraZeneca	0.00	6.53	-6.53

Performance to 31 January 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**6.58**	**6.58**	**353.60**	**1,721.00**	**2,045.00**
Lipper UK Equity Income mean*	4.21	4.21	211.54		
FTSE All-Share TR Index (12pm adjusted)	3.57	3.57	241.15		

Discrete 12-month performance (%) to:

	31.01.23	31.01.22	31.01.21	31.01.20	31.01.19
JOHCM UK Equity Income Fund – A Acc GBP	3.23	28.55	-12.40	8.18	-7.75
FTSE All-Share TR Index (12pm adjusted)	4.58	18.01	-7.28	10.81	-4.03

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

The Bank of Canada became the first major central bank to signal a pause in its monetary tightening cycle; having increased rates by 425 basis points in 10 months. They stated that they would need time to assess how effective the rapid hikes will be in dampening excess demand and ultimately slowing inflation. This trajectory is one which other central banks are likely to follow over the next few months, likely led by the Federal Reserve. Governor Jerome Powell has also highlighted that there will be a lagged impact from rate increases that have already been implemented, and as such, an extended period of flat rates or a plateau seems likely.

Inflationary pressures in the US have continued to weaken, with December's CPI falling 0.1% and slowing to 6.5% year on year versus 7.1% in November. Falls in energy and food prices more than offset stickier categories such as shelter. Producer price inflation also fell month on month by 0.5% as supply chain pressures eased and energy derivatives weakened. Forward looking indicators also softened materially in places, with the Empire Manufacturing Index moving from +11 in December to -33 in January, with weak new orders a standout feature. For now, employment has proven to be more resilient, with non-farm payrolls registering an increase for the 24th consecutive month of over 200,000 new jobs, but it seems highly likely this situation will deteriorate in 2023.

In the UK, economic data has been mixed during the last few months. Whilst housing market activity weakened after the Kwarteng mini-budget, recent feedback from housebuilders suggests a stabilisation and modest improvement in activity since the turn of the year. Similar to the US, inflation continues to fall but at a slower rate, with imported energy and food price rises largely to blame; the December CPI rose by 0.5% month on month and 10.5% year on year versus 10.7% in November. Producer price inflation was down 1.1% compared to last month, helped by a stronger sterling, but services inflation is proving somewhat stickier, particularly given the tight labour market.

Although unemployment ticked up slightly to 3.7% and vacancies fell by 75,000, there are still 1.16 million unfilled roles in the UK, which continues to give unions the confidence to push for higher wages. Nominal pay is currently growing at 6.4% and above 7% in the private sector. An economy at full employment continues to surprise the doom-laden media, and consumer spending has held up well, despite the cost of living issues. GDP grew again in November and will likely deliver a positive outcome for Q4, thus avoiding a technical recession. Indeed, if you were to ask the average person in the street, or indeed most market participants, which G7 economy grew, according to the IMF's recent World Economic Outlook, at the fastest rate in 2022, very few people would come up with the correct answer. However, despite all the noise and media hysteria, particularly in September, the UK is forecast to register 4.1% real GDP growth in 2022, above the US, Canada, China, Japan and all major European economies. For now, the IMF is forecasting the UK to be the weakest G7 economy in 2023, but with the vast pool of unspent consumer savings and falling energy prices, we suspect it will surprise positively again this year relative to consensus thinking.

In Europe, inflationary pressures have also begun to subside, with CPI falling 0.4% across the continent month on month, with energy prices down 6.6% compared to November. Energy prices continued to soften during much of January as storage levels have remained elevated, although the colder snap towards the end of the month did lead to some reversal in these short term trends. Gas prices elsewhere in the world have been particularly soft, with Henry Hub falling around 40% compared to last month, partly due to the extended closure of the Freeport LNG export terminal.

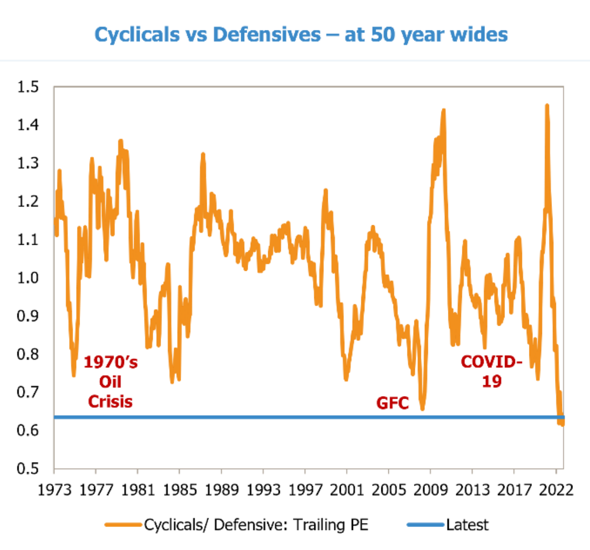
Investors were very focused this month on the dramatic COVID policy change in China, which was no doubt partly driven by the sluggish economic performance during 2022, with 3.0% GDP growth being the lowest rate since 1976 (excluding COVID affected 2020). The prospect of stronger economic activity to come has seen some sharp rises in commodities, with copper up by more than 10% and iron ore by around 7%. The COVID relaxation is already manifesting in leading indicators, with latest Chinese PMI surveys showing a significant improvement. The manufacturing PMI rose from 47.0 to 50.1 and the services equivalent increased materially from 41.6 to 54.4.

Performance

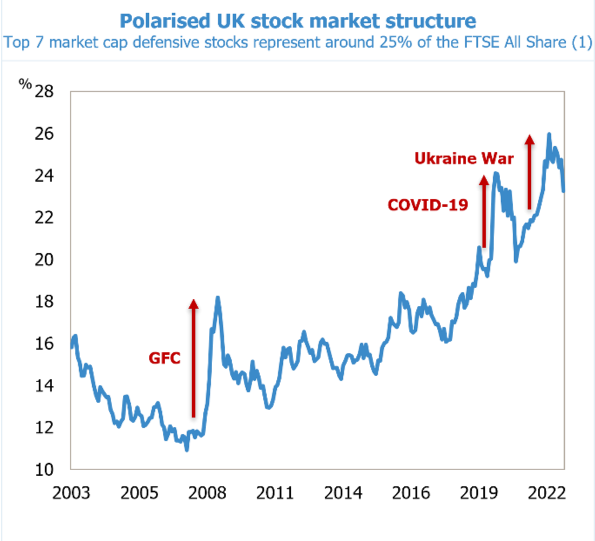
January was a very strong month for markets with the UK FTSE All Share up 3.57%. The Fund outperformed significantly – up 6.58% or 291bps better than the market. Looking at the peer group, the fund was ranked 1st decile within the UK Equity Income sector year to date. On a longer-term basis, the fund is ranked 1st quartile over three years, 3rd quartile over five years, 1st quartile over 10 years and remains the best Fund in the sector since inception in 2004.

The Fund reached an all-time absolute high towards the end of January (whilst remaining c.4% off its relative high), which was pleasing. There remains much to do though to reach clear blue water, which we are focused on.

There were multiple drivers of the Fund's relative performance, which along with the points made elsewhere in this report on valuation, gives some confidence that it will be enduring. We have previously discussed the polarised UK stock market structure, where the seven largest defensive stocks dominate the indices. At the turn of the year, as the chart below on the right shows, they constituted around 25% of the FTSE All Share. The chart also shows how this percentage has increased since Covid 19 started and subsequent development of the Russia / Ukraine war– both of which led to heightened risk aversion. The Fund does not own any of these stocks since they are very expensive, typically trading on a PE of more than 20x, compared to the rest of the market, which is very cheap on all valuation measures and where the Fund is positioned. The chart on the left shows the same point but from a wider market perspective. During the fourth quarter, cyclicals were at a 50 year low, as shown by the chart, but in the last couple of months, the situation has begun to change but has a very long way to go. This dynamic started to shift more markedly in January, driven by a greater risk tolerance (most likely caused by a wider assessment of some of the economic points made above) but also due to a consistent trend of downgrades across the defensive sectors. For example, Diageo was down 10% relative, following disappointing US sales growth and currency / interest rate related downgrades. In our view, we are at the foothills of a journey that will close the valuation gap between these two sides of the market. This is a major opportunity for the Fund. Around a third of the Fund's relative performance year-to-date was sourced from the underperformance of the seven stocks noted above.



Source: Exane as at 30 November 2022.



Source: Bloomberg, JOHCM as of 31 December 2022 (1) AZN, GSK, DGE, ULVR, RKT, BATS, RELX

Looking specifically at where the Fund is positioned, the strongest sectors were banks and domestically orientated stocks. On average, banks were up 10% relative, with **Barclays** and **Natwest Group** particularly strong. **Standard Chartered** was also robust, with takeover rumours helping intramonth price movement. Within domestically orientated stocks, notable performers were **Vistry** (+17% relative), **Currys** (+15% relative), **ITV** (+5% relative) and **Lookers** (+7% relative). As noted above, the UK economy is performing stronger than the bearish consensus expectation. Within that, small caps, a significant laggard in 2022, started to move higher, with **Kier** up 17% relative and **Norcros** up 13% relative. These moves appear large but need to be put in the context of valuation, eg Kier is still cheap, having moved from a PE of 3.5x to a PE of 4x, again highlighting the valuation gap across the market.

Newsflow at a stock level remained encouraging; Lookers, **EasyJet**, **Ibstock**, **DFS** and **Paragon** upgraded forecasts with trading update announcements. Easyjet rose 60% in January, reflecting the low starting valuation, an earnings upgrade and the clear sense that the industry has some pricing power, given capacity withdrawal through the Covid years.

We had a few negative performers in January. We have written before, covered in our new presentation (available on request), that based on our forecasts and analysis, **Keller** could triple from its current share price. However, in January, **Keller** identified and reported fraud in its Australian business; the stock finished down around 5% relative. The Australian issues were offset by an underlying upgrade so this negative issue should fade away as the year progresses. The recruitment stocks were also weak following modest downgrades. Finally, as the gas price collapsed, the oil sector and related areas (eg **Drax**) underperformed.

Portfolio activity

In last month's bulletin, we highlighted 2022 as a year for patience, locking in low valuations and preparing the Fund for changes in investor sentiment. As this started to happen in January, we became more active and made several changes, including adding two new stocks to the Fund, **Energean** and **HSBC**.

The banking sector has been a strong performer year to date. Two of our holdings, Barclays and NatWest Group**,** are at our 300bps maximum active position. Marking them to this level led to a significant amount of capital being freed up, and we recycled the proceeds into **HSBC,** ensuring our bank overweight remained high. HSBC is one of the main beneficiaries of the rise in global interest rates, and post the announced sale of its Canadian operations, the bank will have meaningful excess capital and will be one of the UK's largest dividend growers in 2023/24. Its expensiveness (one of the reasons behind our decision to sell the stock when we owned it in 2019/20) has eroded. It currently trades on a PE of 6.5x, yields 7% and trades on a discount to book value. Following its strong run and reflective of its lowest yield in the subsector, we reduced our position in Standard Chartered and moved the proceeds towards HSBC.

The other change in financials was a one-third reduction in our **Legal & General** weighting. This reflects (in our view) the near term profit headwinds in two of their divisions; the asset management business started the year with lower assets under management due to the rise in bond yields and fall in LDI assets, whilst Legal General Capital (LGC), and the real asset division, which is dominated from a profits perspective by housing related activity, where the main exposure is the Cala house building business. Consensus forecasts are underestimating the pressures on both businesses, eg analysts have profits rising in LGC. The announcement of the retirement of Sir Nigel Wilson towards the end of January will also create some uncertainty as a successor is identified. We have not sold more of the position as the stock is very cheap, with a PE of 7x and a yield of 7%. We again moved proceeds to our new HSBC position.

In the commodities sector, we slightly reduced our position in **Anglo American** and **Central Asia Metal**. However, the reduction was offset by the addition of **Energean**, a gas producer in the Mediterranean. Energean is large, with a market cap of over £2bn, and more importantly, is under-researched and under-owned by UK institutions. The company has a strategic position in these Mediterranean markets where there is a shortage of gas, given their location. The main operations are on fixed price contracts, which creates visibility. The stock is on a PE of 3-4x with a dividend yield of 7-8% in 2023, which doubles in 2024. We also increased our position in **Kenmare**.

We also added to our position in **Ibstock**, a brickmaker that trades around the level last seen during Covid and after the Brexit vote. During the month, Ibstock provided a strong update with a slight increase in profit expectations and significantly better cash performance, meaning closing debt levels were low, creating optionality as we look forward. We also added to **Keller** following the fall in share price noted above.

Easyjet, the strongest performer of the month, was marked to 100bps active position. Given the extent of the share price move, this was a meaningful sale.

Outlook

Equity markets have started the year positively, and several factors have driven this.

First, it is increasingly clear that we are nearing the end of the monetary tightening phase by western central banks; they will not all pause at the same time, but in North America, it is likely to be during the first quarter, whilst in the UK and particularly Europe, it could be a little later. Whilst some market participants appear to be anticipating rate cuts before the end of 2023, we would be very surprised if central banks change course that quickly, with an extended plateau more likely.

Secondly, investors have clearly been encouraged by the resilience shown by economies, particularly in the UK and Europe, despite the increases in energy and food costs. As we enter February, the end of winter begins to come into view, and energy rationing or other extreme policies look highly unlikely to be required.

Finally, large parts of the equity market have been anticipating recessionary type conditions for some time, and as such, an outcome which is better than that could see significant share price appreciation. The trend of our stocks beating forecasts is partly driven by this – analysts are expecting very bad outcomes, which are not transpiring.

Whilst value stocks have begun to perform better, we think this process has only just begun, and we have many years ahead of us as we re-adjustment back to a normal equilibrium as the memory of zero interest rates for over a decade begins to fade. Because of this, we continue to believe that investing in Index funds at the moment is quite dangerous; many of the larger stocks in the Index, as we showed in the chart above, such as AstraZeneca and Diageo, are still very highly rated (partly driven by the decade of low discount rates) and in some cases carry quite a considerable amount of debt which is now becoming more expensive and have a high proportion of their earnings generated in US dollars which may now become a headwind too. The recent 5-6% downgrades following Diageo's trading update this month are a stark illustration of all of these points, which, when combined with a P/E of over 20x, make for an unpalatable combination. In contrast, many of our stocks in the financial sectors are seeing significant upgrades, partly driven by higher interest rates and net interest income and multiples there are still close to decade lows.

As well as the 'value versus growth' angle, there is also the UK vs US valuation discrepancy, which is beginning to slowly close. Events in Autumn 2022 may take some time to fade from investors' minds, but the valuation anomalies are considerable and need to be reassessed. By way of consideration, let us give you a couple of examples. The five banks in the FTSE100 (Barclays, HSBC, **Lloyds**, NatWest and Standard Chartered) have a combined market capitalisation of around $285bn, and for 2023, are projected by analysts' to earn around $63bn in EBIT (earnings before interest and tax). By way of comparison, Mastercard, a US financial found in the vast majority of Global Equity funds, has a market capitalisation around 26% higher than the 5 UK banks combined, at $360bn and yet is forecast to earn around $14.5bn of EBIT in 2023, which is less than a quarter of that earned by the UK banks. Secondly, Microsoft, another much owned darling of the Global Equity fund community, is forecast to earn EBIT of around $84bn in 2023, 33% more than the UK banks and yet its market capitalisation is $1.82 trillion, which is over 6x greater than the UK banks. Now clearly, Mastercard and Microsoft have very different business models compared to the UK banks and we are not suggesting they should trade on the same multiples, but the valuation gap is wide, and yet we see many Global Equity funds have more in Microsoft and Mastercard than they do in the whole UK market, let alone the UK banks.

The year has started well both in absolute and relative terms, but the valuation gap between our stocks and those considered to be 'growth', either in the UK Index or elsewhere in the world, remains extraordinarily wide and will close further. Given this likely re-assessment and re-rating, combined with the healthy running yield on the

Fund (c.5.3%), we hope to be able to deliver further absolute and relative returns in the near future. Our only regret is that we seem unable to convince many new investors to take advantage of this opportunity, as these circumstances will not last forever.

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).