

JOHCM UK Equity Income Fund

Monthly Bulletin: July 2017

Active sector bets for the month ending 30 June 2017

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction & Materials	7.24	1.56	5.68
Banks	16.03	11.28	4.75
Oil & Gas Producers	15.24	11.23	4.01
Life Insurance	8.54	4.72	3.82
Financial Services	6.16	2.66	3.50

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.58	-5.58
Pharmaceuticals & Biotechnology	3.87	8.28	-4.41
Equity Investment Instruments	0.49	4.44	-3.95
Support Services	2.51	5.24	-2.73
Beverages	0.00	2.72	-2.72

Active stock bets for the month ending 30 June 2017

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Rio Tinto	4.68	1.66	+3.02
Standard Life	3.33	0.33	+3.00
Aviva	3.87	0.92	+2.95
Barclays	4.43	1.49	+2.94
BP	6.49	3.71	+2.80
DS Smith	2.98	0.19	+2.79
Lloyds Banking Group	4.77	2.05	+2.72
ITV	2.77	0.29	+2.48
National Express Group	2.52	0.07	+2.45
Brewin Dolphin	2.22	0.04	+2.18

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.15	-4.15
GlaxoSmithKline	0.00	3.40	-3.40
Diageo	0.00	2.42	-2.42
Unilever	0.00	2.13	-2.13
Reckitt Benckiser Group	0.00	2.05	-2.05

Performance to 30 June 2017

	1 month (%)	Year to date (%)	Since inception (%)	Fund size
JOHCM UK Equity Income Fund	-1.27	7.93	258.10	£3,223mn
Lipper UK Equity Income Mean*	-2.42	6.48	163.61	
FTSE All-Share TR Index (adjusted)	-2.21	6.77	167.04	

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

Ten years on from the global financial crisis, has a co-ordinated central bank withdrawal of stimulus begun? We are cognisant that there have been many false dawns on this front in the last few years, however the mounting evidence around the globe in the last few weeks suggests this time (finally) it could be for real.

In the US, Janet Yellen has continued to push ahead with her series of interest rate increases, despite the shorter-term fall in core inflation. The fact that the Federal Reserve is prepared to look through the distorting impact of price cuts for prescription drugs and telecom plans indicates a desire to push rates closer to neutral whilst economic growth is supportive.

In Europe, the significant improvement in economic momentum, particularly in previous laggard countries such as France (which saw a 29% increase in job vacancies year-on-year in May), has materially changed Mario Draghi's perspective. In his speech at Sintra on June 27th, he stated that "deflationary forces have been replaced by inflationary ones". Again, the fact that he is prepared to look beyond short-term weakness in inflation, caused by recent falls in energy prices, is particularly striking. What form the withdrawal of stimulus takes in Europe is at present unclear, but a reduction in the size and duration of the remaining asset purchase programme seems a likely place to start.

Even in the UK, where shorter-term political uncertainty has exacerbated a short-term economic slowdown, policy makers are moving towards a withdrawal of stimulus too. Whilst the current inflationary dynamic is stronger in the UK, due to the post-Brexit fall in sterling, the fact that three members of the Monetary Policy Committee (MPC) voted for an interest rate rise and the chief economist, Andy Haldane (previously the most dovish member of the committee), is leaning that way too is a highly significant change of stance. "A partial withdrawal of the additional policy insurance the MPC put in place last year would be prudent relatively soon. Certainly, I think such a tightening is likely to be needed well ahead of current market expectations." (20 June, 2017). By the end of the month, even Mr Carney was acknowledging that a reversal of last August's emergency rate cut might be appropriate.

Stimulus withdrawal can take many forms, and the reintroduction of a counter-cyclical buffer for the banks and a more hawkish attitude towards consumer credit growth are already steps in the same direction. Having argued for some years that UK policy makers should have been withdrawing stimulus whilst economic growth was robust, it is somewhat ironic that they appear to be moving in that direction now that growth has slowed – but I guess it's better late than never!

It was another month where politics took centre stage in the UK. In many respects the most striking market reaction has been the relative resilience of sterling. Whilst it has fallen a touch against the euro, it is in fact 2% higher against the dollar than it was in mid-April, before Mrs May called the election. It feels like the Conservative-DUP coalition has plenty of alignment over most key issues and as such should hold together longer than the sceptical media suggest. However, the slim effective majority, the rise of Corbyn's popularity and the tragedy at Grenfell Tower, mean that policy will shift away from austerity towards a more fiscally expansive agenda, probably funded by some selective tax rises for the higher earners. The short-term impact on consumer confidence, in particular, is still too early to conclude upon. Whilst spending on some big-ticket items, such as cars and furniture, has seen a slowdown, elsewhere activity has been robust, particularly areas benefiting from a scorching June, such as supermarkets and clothing. Business

confidence remains fragile, with the Brexit path uncertain, although the fall in sterling relative to the euro over the last 12 months continues to provide a useful offset.

Performance

After a strong May, the market was down during June, with the unexpected UK election outcome, weakness in commodity markets in the first part of the month and other geopolitical factors (e.g. Qatar) weighing upon the index.

The FTSE All-Share Total Return Index (12pm adjusted) recorded a loss of -2.21%, whilst the Fund outperformed in returning -1.27%. Year to date the Fund is up 7.92% versus the benchmark return of 6.77%. Looking at the peer group, the Fund is ranked first decile within the IA UK Equity Income sector over one year to 30 June 2017. On a longer-term basis, the Fund is ranked first decile over ten years and since launch (November 2004), first quartile over five years and second quartile over three years.

Recent market performance trends such as lower bond yields, defensives/bond proxies up, financials/cyclicals down (all of which have been present since mid-December 2016) reversed in the latter part of June, following the changes in monetary policy commentary highlighted above. This shift was the main driver of relative performance in the month.

Elements of the Fund performed well, particularly our construction-related names (especially **Morgan Sindall**, which had a very positive capital markets day), small caps (**Vitec** and **Randall & Quilter**) and the life assurance sector, with the **Standard Life/Aberdeen** merger finally starting to gain share price traction. **CMC** also bounced (up c.20% relative) from a very oversold position. **DS Smith** (up 12% relative) also performed well following strong results and a good US acquisition, which was financed by a placing.

Offsetting these trends were weakness in the parts of the Fund most exposed to the UK election result (**ITV** and banks, although the latter strengthened towards the end of the month after the Draghi comments noted above). The Fund also held two stocks which had profit downgrades during the month (**DFS** and **Northgate**).

Elsewhere, the oil and mining sectors were weak for much of the month, but strengthened towards the end of the month as the oil price steadied and iron ore rallied.

Portfolio activity

We sold one stock from the Fund during June (**Tarsus**) and whilst there were no new additions, we made a number of changes within the Fund. We have also in this section dissected our UK exposure in a little more detail so investors can see where our main exposures are after the election result.

Tarsus was owned for five years, during which time its share price more than doubled, as the company, which manages exhibitions like the Dubai Air Show, grew strongly, both organically and via acquisition. We sold the stock on valuation grounds, with the dividend yield falling below our criteria and also earnings-based valuations moving towards those we would expect to see on a takeover. Tarsus was a small position in the Fund (<50bp) and added 20bp to relative performance whilst it was owned.

The election result, as explained above, creates near-term uncertainty. At the same time, valuations of domestic stocks are flashing green. Our positioning and the subtle changes we have and will continue to make are focused on trying to access this valuation opportunity in the most sensible manner given the greater uncertainty.

One of the main pillars of our UK domestic exposure is the construction/house building sector. At an aggregate level (collating exposure that resides in different sub-sectors) c.9.5% of the Fund is in the construction sector, which covers contracting (names like **Morgan Sindall** and **Costain**), house builders (**Bovis** and **Countrywide**) and manufacturers of building products (**Severfield**, **Ibstock** and **Forterra**). Following the election result and the sad events at Grenfell Tower, it is likely that housing policy and in particular social housing will become an increasing focal point for government. At the same time, discretionary spending (e.g. extensions) may slow. Reflecting this,

we increased our exposure to Bovis (where the new CEO acquired c. £2m of shares during June) and slightly reduced our brick exposure (where c.40% of end demand is repair and maintenance rather than new-build). A small holding in **Marshalls**, which we had recently added back to the Fund, was sold. This part of the Fund should continue to be well placed given government policy, strong balance sheets, recovery from self-inflicted problems and good pricing power.

Outside of the construction sectors, our main UK exposure is within the financial sector which we cover below. The residual is in the media, leisure, transport and retail sectors. For context, our exposure to these four sectors combined is not dissimilar to the construction exposure noted above, which highlights the concentration and the importance of the latter. In retail, (the most challenged amongst these four sectors due to the shift to online retailing) we are generally lightly weighted, with only three holdings: **DFS**, which had a profit warning during June as highlighted above, **Sainsbury** and **Halfords**. All three of these are very cheap, trading on a c.10x price/earnings multiple and a 5% yield, on average. Following the profit warning, we added to DFS as the positives we highlighted earlier this year are still relevant. The valuation is now cheaper and, as we have seen over the decades with DFS, in good times and recessionary times trading patterns can be volatile. We also added to Halfords where trading is benefiting from 'staycation'. It is gaining market share within cycling and should benefit from an ageing 'car park' (where the average age of a car is around eight years now). These holdings represent in aggregate less than 3% of the Fund. In travel/leisure, our main exposure is through bus operators. We moved some exposure from **Go Ahead** to **National Express**, with the latter being 70% overseas compared to the 100% UK-exposed Go Ahead. In media, our main exposure is **ITV** (c.250bp overweight), which is one of the most exposed stocks in the Fund to the change in sentiment highlighted above. It is also the stock that has been under the most pressure since Brexit, so the resultant valuation is low (c.11x price/earnings multiple). The undervalued content division, the exposure to positive regulatory change (which could mean Sky and Virgin have to pay to have ITV on their platforms), the growth in audience share and the perennial takeover rumours which resurfaced towards the end of the month mean we will keep ITV as a core position.

Financials represents the third leg of UK exposure, with the main elements of this being banks, life assurance and UK property. Following the recent sale of New River Retail (which is heavily exposed to retail), our property holdings are now focused on logistics - for example, **Segro** is benefiting from the growth in online retailing/distribution requirements and specific situations like **Real Estate Investors** focusing on Birmingham - a city which will see a general uplift from the HSBC relocation and HS2. Life Assurance (**Aviva**, **Standard Life** and **Phoenix**) should be relatively insulated from UK political uncertainty. Banks, (c.16% of the Fund) similar to ITV, are the Fund's other main headline exposure to the change in sentiment. Here, the valuation agenda is very supportive, particularly for **Lloyds** and **Barclays**, which we added to during the month. Barclays trades on 0.7x book value and is moving towards delivering a double-digit percentage return on capital employed. It also successfully exited South Africa during June (which materially enhanced its capital position). Whilst several legacy issues remain (SFO and US Mortgage settlement), these relate to historic management action, and we believe they will be addressed by the current board, with finality seen in the next 12/18 months. A large part of our banks weighting (6.5% of the 16% total) is represented by **HSBC**, which is largely driven by non-domestic factors. Over the last 1-2 months we have become more confident about HSBC's ability to move towards appropriate returns.

Elsewhere in the Fund, the commodity sectors were weak. This has been a theme for much of the year (as mentioned above). Here, we added to our four stocks, particularly **Glencore**. During the month we attended a **BP** capital markets day, which focused on the downstream business where the company expects to see strong growth in free cash flow as its retail, chemical and lubricant businesses respond to cost reduction and expansion strategies. Consensus forecasts still do not give credit for this profile, which, if delivered, would underpin a large part of the cost of the dividend independently of the upstream business, which is more oil price dependent. BP remains in our top five active positions. We are in the process of adding a fifth name to this area, which we will highlight next month.

Fund Dividend

The Fund went ex-dividend on 30 June 2017, with the Q2 dividend being up c.7% on the equivalent quarter last year. Across the first half as a whole, the Fund dividend rose by c.10% year-on-year. As we have highlighted before, quarterly changes are not indicative of the underlying

annual growth rate, because they depend on the ex-dividend calendar profile of the stocks held in the Fund, which evolves over time.

The Fund's dividend base remains robust, helped by our larger holdings growing their dividends materially and the annualisation of the post-Brexit vote weakness in sterling.

We continue to purposely construct our estimates for 2017 and now 2018 cautiously, particularly for the domestic elements of the Fund where Brexit-related uncertainty and the more recent wider political uncertainty are likely to moderate dividend growth discussions around many boardroom tables.

Our initial guidance for 2017 (set in December 2016) was for mid-single-digit percentage growth in the Fund dividend. Following a better-than-expected first half, we are upgrading guidance for the Fund's dividend growth to 6-8%. This continues to be a prudent estimate versus current trends. This would mean the Fund would yield 4.25% on a 2017 prospective basis. We will update this guidance at the end of Q3.

We have recently, formally, moved our dividend forecasts, stock by stock, out to 2018. We will make our first formal comment on our estimate for 2018 Fund dividend growth later this year, but the initial glimpse is very encouraging.

Outlook

The path to policy normalisation has categorically begun in the US and is moving nearer in the UK and Europe. The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, without doubt it has pushed many assets or individual instruments to elevated levels that will be hard to justify, if the cost of capital rises. Within the equity markets, we strongly believe that this overvaluation is most apparent in the world of consumer staples and other defensive sectors such as utilities and pharmaceuticals. The fact that the likes of Nestle and Unilever have found themselves the target of activist shareholders, despite the shares trading at all-time absolute highs, smacks of euphoria and/or bubble mania. Furthermore, the fact that Nestle's response has been to lever themselves up, with interest rates at all-time lows (but rising from here), compounds the sense of how late we are in this particular style cycle.

As regular readers know, we have no investments in the staples area or indeed in most of the bond-proxy sectors. However, despite the fact that global monetary policy tightening will make it hard for equity market indices to make much progress from here over the next few months, we believe that many of the areas that we are exposed to will respond well to this change of leadership, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also still selective opportunities in the UK domestic arena too, despite the challenging macro. We continue to be encouraged by the dividend growth that our companies are exhibiting and believe that the 2017 dividend yield of the Fund of around 4.25% is attractive relative to other asset classes.

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.co.uk.

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