Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: July 2018

Active sector bets for the month ending 30 June 2018:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.13	3.11	+6.02
Banks	15.65	10.60	+5.05
Oil & Gas Producers	18.01	14.06	+3.95
Mining	10.22	6.49	+3.73
Construction & Materials	5.35	1.67	+3.68

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	2.32	7.74	-5.42
Tobacco	0.00	4.69	-4.69
Equity Investment Instruments	0.54	4.60	-4.06
Beverages	0.00	3.02	-3.02
Personal Goods	0.00	2.37	-2.37

Active stock bets for the month ending 30 June 2018:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.82	0.82	+3.00
Lloyds Banking Group	4.80	1.83	+2.97
ITV	3.16	0.26	+2.90
BP	7.49	4.63	+2.86
Standard Life Aberdeen	2.77	0.36	+2.41
Glencore	3.96	1.71	+2.25
Vodafone	3.98	2.00	+1.98
DS Smith	2.16	0.21	+1.95
National Express Group	1.94	0.07	+1.87
Morgan Sindall Group	1.88	0.02	+1.86

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	3.60	-3.60
GlaxoSmithKline	0.00	2.99	-2.99
Diageo	0.00	2.69	-2.69
Unilever	0.00	1.95	-1.95
Prudential	0.00	1.83	-1.83

Performance to 30 June 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-0.93**	**3.29**	**304.80**	**£3,867mn**
Lipper UK Equity Income mean*	-0.31	1.47	179.64	
FTSE All-Share TR Index (12pm adjusted)	-0.14	2.58	190.17	

Discrete 12-month performance (%) to:

	29.06.18	30.06.17	30.06.16	30.06.15	30.06.14
JOHCM UK Equity Income Fund – A Acc GBP	**13.04**	**30.31**	**-9.31**	**7.29**	**16.74**
FTSE All-Share TR Index (12pm adjusted)	8.66	21.37	-0.60	3.39	12.75

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

Further evidence emerged in June that the very wintry weather of February and March exacerbated the slowdown in UK GDP growth in Q1. Consumer activity, in particular, has bounced back strongly so far in Q2. Retail sales were up almost 4% year-on-year in May, a reading supported by robust Barclaycard data (spending +5.1% in the month) and a very strong CBI retail survey for June. The sunny weather over the two Bank Holidays, combined with a boost from the Royal Wedding, has clearly been helpful, albeit these are obviously transitory factors. Happily, the sun has continued to shine in June, and the patriotic flag-waving has found another cause to support (so far!) in Russia. Furthermore, whilst the latest wage inflation data showed that the pace of wage growth had stalled, all of the anecdotal evidence suggests growing labour shortages and building wage pressure. The combination of these factors led three members of the Bank of England's Monetary Policy Committee to vote for an interest rate rise, including Andy Haldane, the Bank's influential chief economist. A rate rise in the next three months now looks very likely.

The fact that the consumer-orientated parts of the UK economy have bounced back in the last few months is all the more impressive given the insipid progress in the Brexit negotiations. In that respect, the public statements from Airbus and other high profile companies are a welcome intervention, and one hopes they will force more active decision-making in the interests of the wider economy. Unfortunately, the need for progress coincides with an uncertain period in Europe's domestic politics. In particular, Germany is struggling to find a solution to its migration issues, leaving Mrs Merkel with a somewhat tenuous hold on power. However, despite this uncertainty, the ECB has continued to slowly edge towards the withdrawal of monetary stimulus, with its timetable for the end of QE now published.

President Trump has continued to cause volatility in financial markets, particularly with his policies on trade tariffs. Clearly many of the industries that he has targeted, such as steel and autos, represent his heartland in terms of political support. However, the risk of a wider escalation in global trade tensions has inevitably risen in the last few weeks. His tactics in achieving results are somewhat unconventional, as evidenced by his behaviour at the G7 summit, but his results thus far have continued to surprise on the upside. Nevertheless, his lack of diplomacy skills does increase the danger of a trade war that has a meaningful impact on global economic growth. In the meantime, domestic economic performance in the US has continued robustly, with a strengthening labour market and firm retail sales contributing to another rise in the federal funds rate during the month. More importantly, the outlook statement from the Fed was relatively hawkish and implied two more rate rises before the end of 2018. Regular readers will know that we believe this is the right policy. It will give Governor Powell ammunition to ease policy in future years, as and when economic activity fades.

The combination of trade war fears, political instability in Europe and pressure on emerging market currencies from a stronger dollar led to a more cautious tone from markets during June. Evidence of this weakness is widespread: corporate credit spreads are at their widest level for 18 months; Western government bond yields have fallen despite robust domestic activity; and the Chinese central bank's move to ease monetary policy by cutting the reserve requirement ratio for banks has compounded the weakness in renminbi.

Simultaneously, though, there is evidence that global inflationary pressures are rising rather than falling. Labour pressures are building; commodity price rises are causing industrial supply chain prices to rise; and trade tariff increases could be short-term inflationary, even if they dampen medium-term growth rates. On top of that, some of the medium-term structural changes, such as the requirement for the global shipping industry to cut sulphur emissions, will reinforce inflationary pressures in globally traded goods. Despite the current headlines, then, we continue to see price pressures building and expect monetary policy to continue to be tightened in most parts of the world. As discussed many times before, this environment is likely to cause more volatility in markets. This will make it harder for equities to make meaningful progress, especially in comparison to the period of very easy monetary policy which is now behind us.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) was flattish, down 0.14% during June. The Fund modestly underperformed in returning -0.93%. Year to date the Fund is up 3.29%, ahead of the index, which has returned 2.58%.

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

The 'risk off' tone during June was a headwind to Fund performance. Financials were weak, despite the likelihood of an August interest rate rise increasing, as noted above, whilst some of the stocks which would be negatively affected by this (e.g. housebuilders) fell. The mining sector also performed poorly. In contrast, some of the more defensive stocks the Fund does not own performed well.

A very good month of stock specific news flow partially offset these negative trends: **Norcros** (up 11% relative), **Severfield** (up 18% relative), **Sthree** (up 11% relative), **CMC** (up 12% relative) and **Polar Capital** (up 23% relative) all had strong results or trading updates. All of these are small cap names, highlighting the importance of the c. 15-20% of Fund assets invested in small caps in terms of their contribution to performance and Fund dividend growth. Other stocks that performed well included **ITV**, which recovered from a long period of underperformance, and **Eurocell**.

In the debit column, **Countrywide**, a position that we have been reducing for much of the year, warned on profits and announced a rights issue. The stock cost us c. 12bp during the month. We subsequently sold the rest of our holding.

Portfolio activity

We added one new stock to the Fund in June, **Lookers.** We owned the stock before in the Fund (2012-14) and have reacquired it, 30% below where we sold it.

Lookers is one of the largest owners of car dealerships in the UK. Whilst the share price is moved around by headlines surrounding the new car market (now showing signs of recovery), the majority of its profits are sourced from its more stable used car franchise and servicing. It is being encouraged by the large vehicle manufacturers to consolidate the market and invest in showrooms, backed up by a strong online presence. The multiples paid for these acquisitions and management's high return hurdle rate mean this process is very earnings accretive.

The group has a strong balance sheet, with good property backing and a forecast of net cash on an 18-24 month basis. The stock trades on a P/E of 7-8x and yields over 4%. This is another example of how cheap UK assets are within the domestic side of the equity market. Its addition to the Fund is part of our careful increase in domestic exposure.

There are a number of ongoing rights issues from stocks we own consummating over the next month: **DS Smith,** paying for an acquisition in Spain; **Phoenix Group**, funding the purchase of the **Standard Life Aberdeen** assets; and **Diversified Gas and Oil**, financing the purchase of assets in the US. All three deals look strategically sensible, well priced and are earnings accretive. The valuations of these stocks are very low: 11x EPS for DS Smith; a 7% dividend yield for Phoenix Group; and a free cashflow yield (on a pro-forma basis) of over 20% for Diversified Gas and Oil.

To finance these additions, we sold **Vitec** and **Hollywood Bowl** to zero, two stocks that have been good performers for the Fund over the last few years. Vitec, which we had owned for four years, more than doubled whilst the Fund held it, contributing c. 80bp to relative performance. We owned Hollywood Bowl for less than two years, during which time it rose by c. 40%, contributing 20bp to relative performance. We acquired both stocks on very low valuations and both re-rated significantly during our period of ownership, becoming two of our most expensive stocks upon exit.

We also sold **Laird**. It has been a volatile stock whilst we owned it, with a material profit warning in 2016 making it the worst contributor that year. This was preceded by strong share price performance and succeeded by a takeover announced earlier this year.

We also continued to reduce **AstraZeneca** and **Brewin Dolphin**, which are at the higher end of the valuation levels in the Fund. We also marked **ITV** to a 300bp overweight after it recovered from a long period of sluggish performance.

As highlighted above, the mining sector came under pressure during the month. We added to **Central Asia Mining** and continued the shift within the names we own towards more base metal exposure, slightly trimming **Rio Tinto** and adding to **Glencore**.

Financials were weak, which continued the trend seen in May. We added to **Barclays**, **Lloyds Banking Group**, **Paragon**, **TP ICAP** and **Standard Life Aberdeen** amongst others. Housebuilders were also weak. Here we added to **Bovis** and **Galliford Try**.

Fund dividend

We have updated our analysis of the Fund dividend for 2018 and conducted our first detailed modelling (stock by stock) for 2019.

The Fund's underlying dividend dynamics for 2018 remain strong, with a number of stocks beating our forecasts, particularly at the small cap end of the market. The outlook also looks robust. Firstly, there are indications that both our large oil stocks (**BP** and **Royal Dutch Shell**) could start to increase their dividends modestly over the next 12 months. Secondly, the banking sector is in clear dividend growth territory as legacy issues finally fade. Thirdly, the risk remains clearly to the upside in the mining sector.

Sterling's recent weakness against the dollar has also bolstered this solid underlying position. The combination of these factors means we increase our forecast for Fund dividend growth for 2018 to 9-10% - our previous estimate was 5-7% growth.[1] This remains a prudent estimate and allows for the recent trend in currency rates to reverse. Using the midpoint of this range would suggest a dividend per unit of c. 17.75p, which would mean a Fund yield of 4.4%.

Our first look into 2019, driven by the sector comments above, looks positive. As regular readers know, we continue to think sterling will strengthen as the Brexit trajectory becomes clearer and as the UK growth outlook proves better than the bearish consensus – we will factor this into our forecasts. Each 5¢ move in the £/$ rate has a +/- 2% impact on the Fund (and market) dividend level. Net of this, if it were to occur, reasonable growth is still likely. We will provide a first formal update on the 2019 Fund dividend at the end of Q3.

The Q2 dividend (the Fund went ex-dividend on 29th June) grew by c. 15%.

[1] All Fund dividend forecasts based on 'A' accumulation share class.

Outlook

With the uncertainties highlighted above likely to persist for some time, markets may find it difficult to make material headway. However, with labour markets tight in many parts of the Western world and inflationary pressures rising, the bias to tighten monetary policy further in the US and UK will remain. Central banks still need to progressively withdraw stimulus when possible, so as to further the process of policy normalisation and provide ammunition for future policy easing. This process of policy normalisation, in addition to causing market volatility, will in our view lead to a mix change within the equity market. Defensives, which have benefited from falling interest rates over the last 20 years, will see a headwind while financials, which have been pressured by the low rate environment, will see a tailwind. This change in market leadership would help Fund performance.

The Fund's long-term performance is highly correlated to its dividend growth and the resulting absolute level of the dividend. The delivery of 13.4% growth in 2017, which continues a track record of strong growth since the Fund's launch, and our confidence in 2018's dividend outlook (with upgraded guidance to 9-10% growth) is an important driver of the unit price, which would mean the Fund's prospective yield for 2018 is c. 4.4%. This yield, strong dividend growth and low valuations embedded across the portfolio, allied with the shift in monetary policy, leave us cautiously optimistic in our outlook for the Fund's relative and absolute performance.

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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