Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: July 2019

Active sector bets for the month ending 30 June 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	10.36	3.29	+7.07
Banks	14.71	10.15	+4.56
Oil & Gas Producers	17.60	14.04	+3.56
Construction & Materials	4.91	1.61	+3.30
Life Insurance	6.68	3.78	+2.90

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.51	-7.51
Equity Investment Instruments	0.13	5.18	-5.05
Beverages	0.00	3.82	-3.82
Tobacco	0.00	3.48	-3.48
Personal Goods	0.00	2.68	-2.68

Active stock bets for the month ending 30 June 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Standard Life Aberdeen	3.51	0.31	+3.20
DS Smith	3.40	0.20	+3.20
BP	7.84	4.73	+3.11
Aviva	3.77	0.70	+3.07
Barclays	4.12	1.11	+3.01
Lloyds Banking Group	4.60	1.73	+2.87
Glencore	4.16	1.32	+2.84
ITV	2.93	0.17	+2.76
Phoenix Group	2.91	0.16	+2.75
Paragon Banking Group	2.08	0.05	+2.03

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	3.66	-3.66
Diageo	0.00	3.42	-3.42
GlaxoSmithKline	0.00	3.34	-3.34
British American Tobacco	0.00	2.72	-2.72
Unilever	0.00	2.31	-2.31

Performance to 30 June 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**2.20**	**7.76**	**266.60**	**£3,379mn**
Lipper UK Equity Income mean*	2.48	10.49	173.24	
FTSE All-Share TR Index (12pm adjusted)	3.65	12.96	190.58	

Discrete 12-month performance (%) to:

	28.06.19	29.06.18	30.06.17	30.06.16	30.06.15
JOHCM UK Equity Income Fund – A Acc GBP	**-9.44**	**13.04**	**30.31**	**-9.31**	**7.29**
FTSE All-Share TR Index (12pm adjusted)	0.14	8.66	21.37	-0.60	3.39

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

The removal of the word "patient" from the Fed's commentary around decision-making on future interest rate movements and its replacement with the phrase "act as appropriate to sustain the expansion" led markets to assume that a rate cut is just around the corner. Ten-year US Treasury yields fell to around 2.0% and market participants appear to be discounting one or two reductions in the remainder of 2019. This view has been reinforced by a material softening in a series of economic indicators, such as the Empire State Manufacturing Index having its biggest monthly decline on record and the Conference Board Consumer Confidence Index falling to its lowest level for two years. Of course, many of these shorter-term confidence readings have been heavily impacted by the uncertainty around trade talks and tariffs, particularly between the US and China. Any positive resolution on this front would likely lead to a significant reappraisal of the path of future interest rate movements.

In the UK, whilst the political circus rolls on, economic data has continued to be mixed. On the negative side, business confidence remains understandably subdued, and Q2 GDP growth will be heavily affected by the reversal of March's Brexit-related stockbuilding. The wet summer thus far is also likely to see year on year declines for retailers and leisure groups, particularly since the comparable period last year was so hot. However, more positively, there are clear signs that activity has begun to pick up in the second-hand housing market, including in London. Both new buyer enquiries and the house price index have both risen to their highest levels for nine months. Commentary from these markets suggests that Brexit fatigue has been replaced by a sense of just wanting to move on. Whether this nascent recovery is affected by comments from Boris Johnson about potential stamp duty cuts and reform in September needs to be watched carefully; it could lead to short-term deferment over the next three months but then be followed by a material pick-up in activity. In the meantime, the labour market in the UK has continued to tighten. April's data showed the largest single-month rise in annual pay for 11 years at 3.8%.

In China, a similar pattern of mixed economic releases has continued to emerge. The US trade dispute has seen some of the business confidence indicators roll over, but the economic stimulus has seen strong impacts in areas such as steel production (which had its highest rate of growth for five years) and new home price inflation (+11% year on year). Linked to this, most commodity prices rose during the month, although the further 10% increase in iron ore was partly driven by supply outages. Oil also made progress, with the rising US-Iranian tensions also having an impact. European economic indicators have generally continued to reflect a soft economy, although both German and French manufacturing surveys have shown a modest improvement in the last three months, probably linked to the Chinese economic stimulus.

Performance

Markets moved higher during June, with the Fund's benchmark, the FTSE All-Share Total Return Index (12 pm adjusted), returning 3.65%. The Fund underperformed the market in returning 2.20%. Year to date the Fund has returned 7.76% vs the benchmark return of 12.96%.

Looking at the peer group, the Fund is ranked fourth quartile / ninth 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, 10 years and since launch (November 2004) and second quartile over five years.

Once again, the main driver of the Fund's relative underperformance was the continued strength in growth/momentum stocks at the expense of value names. As we have highlighted recently, the performance differential between these two types of stocks is currently more extreme than it was at the height of the TMT bubble. At some stage, it will surely reverse. However, for now, momentum is dominating flows and valuation is getting little attention from the investment community. Whilst it is disappointing and somewhat disheartening to report another month of underperformance, now is not the time to panic or lose sight of the valuation credentials in our Fund and our process.

It was another month in which the perceived compounders performed strongly, with the likes of Diageo up by another 10%. Consequently, our void in this area hurt our relative performance. At the same time, some stocks were hit hard by relatively modest news events: car dealership chain **Lookers** underperformed by 40% during the month, predominantly due to the disclosure that the FCA is investigating the sales process of some of its regulated activities. Whilst there is the risk of a fine, the company has already implemented changes to its processes in the area concerned and has been sharing its findings with the FCA for some time. The share price fall looks disproportionate to the scale of the news, particularly since it leaves the company trading on a 40% discount to its net assets and a P/E of around 5x, but uncertainty is never welcomed by markets. **Diversified Gas & Oil** underperformed by 20% during the month despite the rise in oil prices, due to some healthy profit taking and some negative commentary from a subscription share tip service. In general, financials struggled to perform, held back by lower bond yields and political uncertainty.

On the positive side, it was pleasing to see **Norcros** rise over 15% following another set of strong results It is a company that continues to look very modestly valued on around 6x earnings. Similarly, **DS Smith**, **Liontrust** and **Northgate** all rose by over 10% following the release of full-year results, with Liontrust's 29% increase in the full-year dividend being a noteworthy feature.

Portfolio activity

We sold one stock in June, namely **Bloomsbury**. We held this small cap for about two years, over which time its share price rose 50%. We sold it on yield grounds as it fell out of our dividend yield criterion due to its strong performance. Interestingly, this was one of the more illiquid stocks within the portfolio that would theoretically take 391 trading days to sell our entire position, based on typical daily trading volumes in the stock. The reality was we sold out in full at the prevailing market price over the course of just two days. We remain very happy with the overall liquidity of the Fund.

We also continued to pare back positions in a number of stocks that have done well and / or are on higher valuations compared to the rest of the Fund. **Ibstock** and **National Express** are good examples. Although both are cheap on an absolute basis (c. 12x P/E), they are in the top decile of valuations within the Fund. In relation to Ibstock, we added to our other brick-maker **Forterra**, which is on a lower P/E (10x). We also reduced **Rio Tinto**, which has been buoyed by the high iron ore price (we don't factor this into our longer-term valuation) and **Standard Chartered**, which has performed better of late, partly due to sterling weakness.

Elsewhere, we added to **Brewin Dolphin** and **Tesco**. The latter had a positive capital markets day where it outlined continued confidence in growth, cost reduction and cash generation. The stock remains on a low valuation on the aspired earnings and cashflow forecasts. Wealth manager Brewin Dolphin is languishing near lows despite the fact markets (which obviously correlate into revenue / profits) are close to highs. We also continued to add to two of this year's new additions, **WPP** and **Easyjet**.

We also added to **Hammerson** and **DS Smith**, both of which were weak. The latter had strong results during the month, trades on a P/E of 9.5x and is at the heart of positive ecommerce and environmental (plastics to cardboard) trends. The market is fixated on what is happening to paper prices (which are falling) and overestimating the impact this will have on profitability. Hammerson hosted a positive capital markets event in Lisbon, which we attended. It showcased its value retail business, which includes Bicester Village. The stock is trading at less than half our trough NAV estimate.

We have had a number of requests asking about our overlap with the gated Woodford Equity Income Fund. We have limited overlap, owning just three stocks in common: **Eurocell**, **Raven Group** and **Countryside.** Raven Group has announced that the company will acquire the stock held by Woodford at a discount of c. 10% to the start of June price. Given this is at a large discount to the NAV (c.40-50%), it is very accretive to the NAV and hence the valuation of our position. On Countryside, we had run our position at half the weight we were targeting, so are using the opportunity of the overhang and share price weakness to move to our desired position. In summary, we have limited overlap and where we do have common ownership it has been and likely will be more of an opportunity than a threat.

Fund dividend

As we move into Q3, the Fund's dividend growth for 2019 is clearer. Our previous guidance of low to mid-single-digit growth year on year remains intact. As we have said before, the growth rate should be seen in the context of a strong 2018, when Fund dividend growth was +18%.

Thus far, 2019 has mainly seen a reasonable delivery of results from our holdings. However, the cautious environment caused by the fall in global markets in Q4 2018, coupled with ongoing political risks (primarily Brexit and China / US trade concerns), has tempered capital allocation decisions, resulting in slower dividend growth in a number of stocks. In some cases, share price weakness has led management teams to switch course, from what would have been stronger dividend growth to share buybacks (which we do not include as income). This cautiousness can be seen in many of our holdings working to more conservative net debt to EBITDA / target solvency ratios. Some of this will unwind as the political trajectory becomes clearer and these safety buffers are used. We had built an allowance into our original guidance to account for such a theme developing during the year, given the nature of some of the risks coming into the year.

At the start of the year we also built into our forecast a dividend cut from Vodafone, which by the time it occurred in May had become a 'known known'. The eventual cut of 40% was slightly higher than the 33% for which we had budgeted.

The Fund's Q2 dividend went ex-dividend at the end of June. For the 'A' Accumulation class, the dividend per share was c. 7.1p – up c. 5% year on year. Based on current forecasts, the dividend per unit will be flattish in Q3 before moving back into positive territory in Q4. Quarterly movements are not indicative of any trend as they are distorted by the changing mix of stocks in the Fund and when each stock goes ex dividend.

Based on our current guidance of low to mid-single-digit growth, the dividend for 2019 would be 19.84p per unit ('A' accumulation share class), which would represent a forward dividend yield of 5.4%*.

Outlook

Few investors that worked through the TMT bubble ever expected leadership and relative valuations within stock markets to ever return to the same extremes. Yet that is the point at which we find ourselves at the mid-point of 2019. How did we get here?

A combination of many factors are at play, including nervousness about global growth/trade disputes, technological change creating a perceived binary list of winners and losers, Brexit uncertainties and incremental flows into passives and ETFs. Whilst many market participants observe the current status quo as unsustainable, they also understandably question what will force

* This is not guaranteed and figures have not been audited.

a change in this dynamic in the coming months. Of the factors listed above, the one with most scope to change is the perceived risk around President Trump's Chinese trade agenda, particularly because he will increasingly have an eye on his own electoral cycle as 2019 progresses. Any sense of progress or even a less antagonistic dialogue could see a material shift in the bond market's view on risks to global growth and commensurately the need for monetary policy easing.

In the meantime, we will continue to focus upon valuation rather than momentum, an approach that has served us well over the last two decades, but which has reaped little reward in the last 18 months. We continue to anticipate another year of dividend growth for the fund in 2019, albeit more in the mid-single-digit zone this year. This would leave the Fund yielding around 5.4% for 2019, which for a diversified portfolio of around 60 stocks, continues to look like a very attractive level both in absolute terms and relative to other assets such as 10-year UK Gilts at 0.82% or even Greek 10-year government bonds at 2.30%. Whether the Brexit fog will clear somewhat once the new Prime Minister is chosen is a matter of debate, but with this in mind, it is notable that the level of private equity activity in the UK market has begun to pick up of late, even with this uncertainty around. The take-private transactions of the likes of BCA and Merlin Entertainments are clear evidence of the mismatch between private and public valuations and hopefully will mark the start of a meaningful trend, particularly for the moderately rated UK domestically facing stocks.

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

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.