Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: July 2020

Active sector bets for the month ending 30 June 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.74	3.30	+6.44
Mining	13.13	7.11	+6.02
Media	8.21	3.74	+4.47
Food & Drug Retailers	6.34	2.09	+4.25
Financial Services	8.35	4.29	+4.06

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.48	-10.48
Equity Investment Instruments	0.00	6.38	-6.38
Tobacco	0.00	4.40	-4.40
Beverages	0.00	3.55	-3.55
Personal Goods	0.00	2.84	-2.84

Active stock bets for the month ending 30 June 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix Group	3.35	0.17	+3.18
Tesco	4.31	1.15	+3.16
Standard Life Aberdeen	3.42	0.31	+3.11
Legal & General Group	3.70	0.66	+3.04
Glencore	3.89	0.93	+2.96
WPP	3.26	0.38	+2.88
Barclays	3.87	1.01	+2.86
BP	6.02	3.19	+2.83
Anglo American	3.92	1.17	+2.75
Vistry Group	2.66	0.08	+2.58

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.73	-5.73
GlaxoSmithKline	0.00	4.19	-4.19
HSBC	0.00	4.00	-4.00
British American Tobacco	0.00	3.66	-3.66
Diageo	0.00	3.16	-3.16

Performance to 30 June 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	**2.01**	**-29.19**	**189.10**	**£1,840mn**	**£2,239mn**
Lipper UK Equity Income mean*	0.97	-20.44	134.80		
FTSE All-Share TR Index (12pm adjusted)	0.72	-17.20	154.07		

Discrete 12-month performance (%) to:

	30.06.20	30.06.19	30.06.18	30.06.17	30.06.16
JOHCM UK Equity Income Fund – A Acc GBP	**-21.14**	**-9.44**	**13.04**	**30.31**	**-9.31**
FTSE All-Share TR Index (12pm adjusted)	-12.56	0.14	8.66	21.37	-0.60

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 recovery in both the UK and global economies has come somewhat sooner, and has been materially faster, than in the Monetary Policy Committee's May scenario - indeed, sooner and faster than any other mainstream macroeconomic forecaster."

These might sound like the words of a glass-half-full UK equity fund manager trying to drum up support for his or her view and portfolio positioning, but they were actually spoken by the Chief Economist of the Bank of England, Andy Haldane, in a speech on 30 June 2020. Indeed, it is for exactly these reasons that Haldane did not vote for further QE at the June MPC meeting (all eight of the other members voted for another £100bn).

What evidence is Haldane seeing that the wider stock market seems to be ignoring? Well, it is there for all to see, if they are open-minded enough to actually read it. In May, UK retail sales rose by 12% month-on-month, whilst the UK PMI surveys recovered from the April lows to above 50 (expansionary territory) for manufacturing and 47.6 for the whole economy. Furthermore, the British Chamber of Commerce's weekly survey suggests that employment intentions have recovered equally quickly.

Feedback from companies has also consistently reflected better than expected trading over the last two months. It is for these reasons that the Bank of England has already increased its Q2 2020 GDP forecast by 7% (from -27% to -20%) and that Haldane suggests that, if the current trajectory continues, the cumulative loss of GDP would more than halve from the initial forecast, to around 8%.

Clearly there are risks ahead which need to be navigated. In particular, these risks include localised virus flare ups and, more critically, the danger that unemployment spikes once the furlough schemes are withdrawn, and the danger that this creates a negative feedback loop. Equally, though, there are upside risks, given that the savings ratio has risen sharply this quarter as consumers have been forced to save as hospitality and holidays have been out of bounds. This enforced saving led credit card lending to fall by 10% in May, a situation which could quickly reverse.

If anything, the situation in Continental Europe is even more encouraging. The pandemic has been brought under control earlier and with less short-term damage to the economy. The V-shaped recovery in the PMI surveys across Europe was stark, with the French Composite PMI, for example, above 51. This is the same level it registered in February 2020, despite recording a low

of 11.5 in April. Similarly, Chinese PMI surveys suggest an economy that is growing again, including China's service sector.

The situation in North America is more complicated, partly because the trajectory of virus infections varies so much by region. From a public health perspective, it seems that the lockdowns have been loosened too soon. But from an economic angle, this has led to a very sharp bounce back in activity over the last few weeks. Retail sales were up 18% in May versus the previous month and are now only down 6% for the year-to-date. Weekly mortgage applications have risen to an 11-year high, spurred on by 30-year fixed rate mortgages of under 3.5%.

Crucially this nascent recovery continues to be supported globally by the largest fiscal support measures we have seen since the Great Depression, spending packages often equivalent to double-digit percentages of GDP. The policy backdrop is likely to remain supportive for a considerable period of time.

Performance

Style leadership was very volatile during June. This was somewhat reflected in our relative performance. The month began with value stocks posting a strong recovery as European lockdowns were eased, further stimulus measures enacted and clearer evidence of a nascent economic recovery emerged. However the latter part of the month saw a partial reversal, as virus case numbers accelerated in a number of the southern states in the US. Overall the Fund outperformed the market across the month in returning 2.01% versus 0.72% for the Fund's benchmark, the FTSE All-Share Total Return index (12pm adjusted). This actually meant that over the second quarter the Fund only slightly underperformed in returning 11.54% versus 11.79%. However, it is significantly behind year to date at -29.19% versus -17.20%.

Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector for June. On a longer-term basis, the Fund is ranked fourth quartile over three years, third quartile over five years and first quartile over ten years and since launch (Nov 2004).

The volatile intra-month leadership is also reflected in a mixed set of stocks driving relative performance. In general, the mining sector continued to perform well, with **Anglo American** and **Glencore** both up around 10% relative[i], helped by the recovery in the copper price. Life insurers also continued to regain ground lost earlier in the year as concerns about their exposure to weakening corporate credit receded; both **Aviva** and **Legal & General** were up 8% relative. Evidence that the downturn in Asia was bottoming out also helped **Standard Chartered** outperform by around 15%, whilst elsewhere in financials strong results from **Polar Capital** (+16% relative) and **Randall & Quilter** (+15% relative) were notable features. A resilient update from **SThree** helped it to outperform by 14% relative. Finally, a strong operational update from **Hipgnosis** led to 7% outperformance relative during the month.

The underperformers were a mixed bag, although a number were small companies that suffered from some selling of positions by other managers. In that regard **Headlam** (-16% relative), **Redde Northgate** (-10% relative), and **U&I** (-11% relative) were somewhat harshly dealt with by the market. **National Express** (-12% relative) was hit both by concerns about the development of the virus in North America and the departure of its CEO to Persimmon. **ITV** underperformed by 10% relative, partly because it had recovered strongly in May, and partly due to some uncertainties around short-term advertising trends and possibly the lack of progress in the Brexit negotiations.

Portfolio activity

After a busy few months in terms of changes, portfolio activity was muted in June. This is because we now feel we have a strong portfolio of high quality value names - please see our recent paper The Value Puzzle for more details. Having made changes to reduce the direct risk that Covid-19 created in small parts of the Fund (e.g. commercial property) whilst introducing several new names during the initial market sell-off and after recapitalisations (at compelling valuations), it is time to let the portfolio breathe. We see tremendous value in the portfolio (more on this in the outlook section

[i] All mentions of relative performance refer to the Fund's benchmark, the FTSE All-Share Total Return index (12pm adjusted).

below). We are still working on a list of new ideas and will test the upside (and risk dynamics) of these versus the stocks with the least upside in the Fund.

The reductions in weights were largely driven by marking positions back towards our maximum active position guideline of 300bp. Several stocks in our top 10 performed well at the start of June in the brief value rally highlighted above, and were trimmed accordingly. These included **Tesco**, **Legal & General**, **WPP** and **Standard Life Aberdeen**. We also reduced **ITV** slightly at 90p in early June. The fact this stock ended the month closer to 70p shows the current extreme volatility in the market.

Emphasising this point, **Easyjet** rose 40% from the start of the month, at which point we reduced our position. Its share price then dropped back and it finished the month broadly flat. During the month, EasyJet raised more equity, which is a positive move (which we had been calling for the company to do). Lockdown restrictions are being relaxed and the airline's cash burn during lockdown was reported to be slightly better than previously expected. We added back what we sold in the placing.

As we laid out in The Value Puzzle, we only own one stock in the leisure and travel sector (which along with property is the sector most affected by Covid-19). In our view, Easyjet has been and will be a long-term winner, as other capacity exits and demand starts to recover.

We also added to recent additions **Keller** and **National Express**. Elsewhere, we moved **Page Group** to a 1% position.

Fund Dividend

We have published a separate paper on the Fund's dividend, which can be read here.

Outlook

Before the Covid-19 pandemic, we had positioned the Fund to benefit from the Conservative party's election victory and the subsequent market clarity and likely strengthening of the economy associated with its clear win. We anticipated that this, along with other global developments, would lead to a narrowing of the huge gap in valuations between growth and value stocks. At the time, the dividend yield of the Fund was close to its highest ever level and the Fund's price-to-book ratio was close to its lowest ever level. At the end of 2019, we were just 4% below our high watermark having delivered 308% absolute performance versus 207% for the FTSE All-share (Total Return Index) and 195% for the Lipper UK Equity Income Universe since we launched the Fund 16 years ago in 2004[ii].

We were not positioned for a pandemic that accentuated the chasm that already existed in the stock market. Growth, defensives, pharmaceuticals, bond proxies, perceived safe stocks and the technology sector have all performed very well. On the other hand, financials, cyclicals and stocks affected in the short term by Covid-19 have underperformed significantly. In our 'Positioned for Recovery' paper published a month ago, we showed the impact Covid-19 has had on the performance differential between growth and value stocks and where resultant valuations of the two factors lie. As a result (and also perpetuating the divide), asset allocators' positioning is skewed heavily towards the areas that have done well.

In the first 10 days of June, as laid out above, there was a brief value rally. Over that period, the Fund outperformed dramatically (by 341bp). Unfortunately, most of this outperformance was lost over the rest of the month after negative news flow surrounding the risk of a second wave of Covid-19 in southern US states. This allowed growth stocks to regain their poise. The scale of these moves in a short time frame is another indicator of the market's extreme positioning and how a slight change in the narrative (which we had in early June) can have a material impact. As we also showed in 'Positioned for Recovery', this is similar to what happened at Newton, where Clive managed the Higher Income Fund.

[ii] Source: JOHCM. 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.

In 'The Value Puzzle' published 2 weeks ago we looked at the Fund sector by sector and, within each sector, stock by stock. The main message from that paper is that the Fund has a diversified exposure within the value universe. It showed we have large exposure to sectors that are clearly on the front foot:

- mining companies benefiting from China's recovery and medium-term demand for clean metals;
- construction firms being boosted by UK government policy and infrastructure spending, as most recently evidenced by Boris Johnson's 'build, build, build' speech;
- food retail enjoying increased sales as people eat out less;
- the paper & packaging sector profiting from e-commerce growth and the accelerating decline in plastic usage;
- clean energy (**SSE**, **Drax**), music streaming (**Hipgnosis**)

In other sectors more affected by the pandemic, there is now increasing evidence of our holdings bouncing back strongly. **DFS** and **Eurocell** have capitalised on competitor failings and will increase their market shares; **Vodafone** and **WPP** have adopted new methods of working to reduce structural costs; and broker/dealer **TP ICAP** and recruiter **SThree** (the latter due to its exposure to STEM markets) are benefiting from the likely or actual acceleration of their end use markets. These are just a few examples.

Our underlying holdings had low levels of debt coming into the crisis. And where fresh equity was needed (e.g. DFS), it has been raised. None of our holdings have liquidity issues, nor do we think any clearly need fresh capital. We also had very little exposure to the high-beta Covid-19-affected sectors such as restaurants, leisure and travel (where, as we indicate above, we have just one stock, Easyjet).

In commercial property, the one area of the Fund where we do think there will be permanent damage due to structural changes, large valuation falls and consequently higher debt, we have reduced our position to c. 1% of the Fund and rotated the capital into the themes highlighted above. We believe we have one of the best quality portfolios (within the value part of the market) that we have had since the Fund's launch in 2004. It is also one of the cheapest.

As we move forward, what catalyst(s) will change the market dynamics discussed above? There are many possibilities: a recovery in the global economy; a wave of M&A activity that exploits cheap stock market valuations; companies executing their plans well and delivering the improvements we expect; a vaccine for Covid-19; evidence of the virus coming under control in the developed world; or unprecedented fiscal and monetary policy gaining clear traction. The market is currently positioned for none of these things to happen – we think this is unlikely.

The big change that would definitively alter market leadership is a return to modest inflation. We will be monitoring this factor closely. There are some signs (e.g. food prices, used car prices, supply-constrained industries putting prices up, the China PMI survey price gauge and iron ore and copper price rises), that suggest there is the possibility of a modest pick-up in inflation. There is also likely to be a clear reversal of the trends that created low inflation over the last two decades e.g. globalisation and the closure of the inequality gap via higher minimum wages and government spending. This would, of course, also be useful for policy makers. It is too early to conclude whether these nascent inflationary pressures will become sustained. In the meantime, as we show in our Fund dividend update, we believe the Fund's dividend will return towards 6% in 2021. Furthermore, the Fund looks very cheap, in our opinion, while the vast majority of our portfolio companies are increasingly operating on the front foot.

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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