



JOHCM UK Equity Income Fund

Monthly Bulletin: July 2022

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 for the month ending 30 June 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.83	2.60	7.23
Industrial Metals and Mining	13.28	6.90	6.37
Construction and Materials	6.36	1.29	5.07
Household Goods & Home Construction	5.71	1.18	4.53
Media	6.71	3.01	3.70

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	11.71	-11.71
Personal Care, Drug and Grocery Stores	0.71	7.11	-6.40
Closed End Investments	0.00	6.27	-6.27
Tobacco	0.00	4.31	-4.31
Beverages	0.00	3.78	-3.78

Active stock bets for the month ending 30 June 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	6.40	3.28	3.12
Standard Chartered	3.76	0.67	3.08
Vistry	3.15	0.08	3.07
Legal & General	3.69	0.63	3.07
Glencore	5.63	2.60	3.03
Phoenix	3.21	0.19	3.02
NatWest	3.54	0.52	3.02
Barclays	4.13	1.13	3.00
ITV	2.97	0.11	2.86
DS Smith	3.02	0.16	2.86

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
GSK	0.00	3.87	-3.87
Unilever	0.00	4.12	-4.12
Shell	2.59	7.08	-4.49
HSBC	0.00	4.80	-4.80
AstraZeneca	0.00	7.39	-7.39

Performance to 30 June 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	-9.44	-7.45	297.30	1,829.2	2,143.6
Lipper UK Equity Income mean*	-6.10	-5.41	212.97		
FTSE All-Share TR Index (12pm adjusted)	-6.15	-4.41	212.57		

Discrete 12-month performance (%) to:

	30.06.22	30.06.21	30.06.20	30.06.19	30.06.18
JOHCM UK Equity Income Fund – A Acc GBP	-1.44	3.76	-21.14	-9.44	13.04
FTSE All-Share TR Index (12pm adjusted)	1.64	5.09	-12.56	0.14	8.66

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

Evidence of building inflationary pressures were evident across the globe, with annualised increases typically in the 8-10% range across the Western world. With the conflict in Ukraine becoming ever more attritional, it feels likely that product supply shortfalls will persist into the second half of the year, particularly in food and energy. As a result, it is unlikely to be until the end of the first quarter of 2023 before annual inflation rates will mathematically begin to fall in a meaningful manner as the base effects improve. It is against this backdrop that central banks have been attempting to tighten policy sufficiently quickly to engineer a significant slowing of demand. During July, we saw the Fed increase rates by 75 bps, the largest single move since 1994. Other notable changes included a 50 bps increase by the Swiss from minus 0.75% to minus 0.25%, whilst closer to home the Bank of England continued its path of steady 25 bps increases, although three of the nine members of the Monetary Policy Committee voted for a 50 bps move.

In response to this data and associated monetary tightening, bond yields generally moved higher across duration curve; in the US, the 10-year yield increased 35 bps to 3.10% whilst the UK was up 27 bps to 2.37% and the Swiss 33 bps to 1.16%. In most countries two-year bond yields increased by a similar 20-30 bps despite the spectre of slowing economic momentum. The outliers in a global context were Japan, which is persevering with its ultra-easy monetary policy, and China, where policy measures continue to be loosened in an attempt to offset the impact of rolling COVID restrictions.

Evidence continues to build of a slowdown in economic activity albeit for now it has tended to be confined to areas of consumer-related activity. In the US, new housing starts fell in May by 14% to their lowest level in a year, clearly impacted by the increase in 30-year mortgage interest rates to above 5.5%. Elsewhere, consumer confidence surveys are hitting new lows, with France, for example, registering its lowest reading for 10 years. In the UK, April GDP was reported as having declined by 0.3% month-on-month, although this fall was entirely due to the wind-down of test and trace and vaccine administration; without this impact, it would have risen modestly, although underlying growth is clearly slowing. However, the continued shift in consumer spending away from goods towards services and experiences as COVID restrictions have eased, makes the underlying trajectory hard to read. Evidence of this is clearly shown by the fact that UK consumer credit growth has turned positive for the first time since 2019, as consumers book summer holidays on their credit cards.

Thus far, other parts of the economy have proven more resilient, with PMI surveys in the industrial sectors still above 50 in most regions of the world and growth still being exhibited in the broader services sectors. Business confidence has begun to slip in most regions and it will be interesting to see if this begins to be reflected in more subdued job hiring intentions. For now, employment markets in the US and UK remain extremely tight and wage demands continue to rise as employees attempt to protect the real value of their wages. Vacancies in the UK are still above 1.3 million, a record high, and average earnings growth, excluding bonuses, is running at around 5%. Public sector wage growth is still below 2% which explains the growing levels of industrial action from the unions.

The imposition of COVID restrictions in various parts of China as well as concerns about a global economic slowdown, led to weakness across most parts of the commodity complex during the month, with iron ore, copper and thermal coal all 10-12% lower. The one exception to this was oil, which despite a 10% fall intra-month, was broadly unchanged during June. However, in most cases, supply remains extremely tight across the range of commodities and as such further meaningful weakness feels unlikely.

Performance

The UK market had a difficult month in June with a large fall during the first three weeks (c - 8%) partly offset by a rebound in the last few days of the month. Across the month the FTSE All Share total return index fell by 5.98%. The fund underperformed during the month, recording a return of -9.44%. Year to date the fund is down 7.45%, behind the index return of -4.57% the peer group average of -5.41%. Looking at the peer group, the fund is ranked 3rd quartile within the UK Equity Income sector so far in 2022. On a longer-term basis, the fund is ranked 2nd quartile over three and five years and 1st quartile over ten years and since launch (Nov 2004).

The month was marked by a significant increase in risk aversion, which led to a material outperformance of defensive sectors eg pharmaceuticals, tobacco, beverages. This impacted relative performance, given they are large voids in the Fund, for reasons we have articulated regularly (and touch on briefly in the Outlook below). The stocks we do have in the 'defensive' categories outperformed – amongst them **Tesco** and **Vodafone**, which we have been reducing (see next section) to reflect the fact that they are now pushing to the edge of the valuation envelope within the Fund.

The oil and mining sectors underperformed following a period of reasonable performance, reflecting some profit-taking but also market worries regarding recession risk. The banks and insurance sectors, where the Fund has large positions, performed in line with the market. Some of these stocks, like **Standard Chartered**, traded near recent relative highs. Small caps underperformed – typical of risk-off environments – eg **Kier** and **Eurocell**.

The majority of the newsflow relating to Fund holdings remains positive. We had a number of companies upgrade guidance eg **Sthree** and **Paragon** and a number of strong sets of results (where there were risks such as passing through inflation in raw material prices) – **DS Smith**, **Norcros**, **Keller**. The tone in management meetings across the month has also been positive. Forecasts in the market are reasonably cautious – obviously there will be downgrades (which are more than reflected in valuations) but the starting point is by and large prudent forecasts. We had one negative statement in the month – **DFS** – which noted a (unsurprising) slowing in customer intake and a corresponding reduction in forecasts. The share price fell but is above where it was in mid-May reflecting the point just made – that large falls in share prices have factored in a recessionary environment. We have a small number of stocks that have been or could be more impacted by the prevailing environment – DFS is one of them. Portfolio construction is a balance between factoring this in, understanding what is embedded in valuation and positioning in the best franchises in the market (of which DFS with a market share approaching 40% is one). Meanwhile DFS continues its share buyback.

Portfolio activity

As we have highlighted for several months, it is hard to find sell ideas given the materiality of the upside that currently resides in the Fund, which itself is a function of the ultra-low valuations across the parts of the market in which we are invested. The selloff and the Fund's underperformance in June made this situation even more acute.

We continued to reduce a number of stocks that have less upside compared to the majority of the Fund and / or have held up well during this phase of market weakness. **Tesco** and **Vodafone** fit into both of these buckets and were reduced accordingly. At the start of the month, before it fell, we also continued to reduce our position in **Rio Tinto**. It is now close to 135bp compared to > 400bp of the Fund before we started this process around the turn of the year. A number of stocks that performed well during the month hit our 300bp maximum position and we top-sliced accordingly (**Standard Chartered**, **Barclays**, **Natwest Group**, **Phoenix**).

We noted last month that we had re-established a position in **Land Securities**, where new management has articulated a strategy of selling 'dry' fully priced assets like London Offices (where prices are at record highs) and reinvesting in mixed use urban regeneration assets. We continued to add to this position during the month as the price weakened. Our entry prices range from 700-740p vs a current net asset value of c 1060p and our expectation that this will rise towards 1200p on a 2-year view. We also re-established a position in **Tyman**. This position was sold on valuation grounds a year ago at c 400p. It then rose to 500p and has since halved to < 250p. Led by a relatively new management team that has dramatically improved the positioning and the performance of the business, it continues to hold market leadership positions in its segments in various construction markets. These markets will be under pressure in the near term (which is why the share price has halved) but the valuation has now over discounted this – on a yield of 6%. We will slowly build this position given the prevailing pressures but this is the time, as noted above, to build holdings in strong franchises like Tyman. We have seen these periods before – post the Global Financial Crisis, after the BREXIT vote, during Covid etc – much of the Fund's outperformance has occurred after these events, when opportunities like this can be taken.

As noted above the oil and mining sector weakened during the month. We added to a number of names such as **Savannah Energy**, **Petrofac** and **Glencore**. This was largely funded from the continued sale of Rio Tinto at the start of the month as noted above.

The step down in the market has created a large gap between share prices, intrinsic value and the internal (ie Board) view of valuation. This has led to a step up in director share purchases – to name a few in the Fund this month – **Eurocell**, **DS Smith**, **International Personal Finance**, and Tyman. We added to all of these names. As we remind readers in the Fund dividend commentary below, around 50% of the Fund is also currently under active share buyback.

We also continued to add to **Ashmore**, a recent new addition. We have, as with Tyman, taken it slowly in building up this position given the (well known) prevailing headwinds. At around 220p half the market cap equates to cash / seed investments, leaving just c £800m of market cap for the c \$80bn of assets under management and c. £150m of EBIT. The stock yields more than 7.5%.

Finally we added to **Easyjet** (now 110bps of Fund) as it weakened on newsflow re labour shortages and a reduced footprint across the summer to create operational resilience. Behind this it is quite clear, as readers will have seen in their own experience, that ticket prices are rising materially due to a shortage of capacity coupled with strong demand after two years of Covid lockdowns.

Q2 Dividend Update

Balance sheet strength across the Fund remains very strong, with only 4 stocks with a net debt to EBITDA > 2x, representing c 7% of the Fund. Half of this is represented by **Vodafone**, where higher leverage makes sense given the nature of its business. **National Express** and **Diversified Energy** are the other two main stocks. The strength of balance sheets has manifested itself in two ways (a) a strong recovery in dividends and (b) significant buybacks. On the latter, around 50% of the Fund continues to be under active buyback, including most companies in the oil, mining and banking sectors.

At the end of March we upgraded our forecast for Fund dividend growth for calendar 2022 from 20-25% to 25-30%. Following continued strength in dividend newsflow with a large number of our holdings exceeding our forecasts (eg **DS Smith**, **Paragon**, the mining sector, **Norcros**), we are increasing this again to growth of 30-35%. This will bring the Fund dividend close to 10% above where it was pre-Covid (in 2019), that is more than fully recovered.

As we have said before, this dividend flow should be valued more highly than it was pre-Covid due to the strength of balance sheets, the buffer (to dividends) that large buybacks

create, a lower payout ratio (closer to 40% than 50% pre-Covid) and the fact any company that needed to cut its dividend did so over the Covid period.

For the Q2 2022 dividend, which the Fund went 'ex' at the of June, growth was c 55%. We expect a fall in the Q3 dividend (of between 10-20%), before a strong rise in the Q4 dividend which will in aggregate leave the dividend as described above for the full year. We would remind readers to ignore the quarterly phasing of the dividend, as this depends on the stocks the Fund holds at any one point in time and differential ex-dividend dates, and instead focus on year-on-year changes.

The Fund yield is estimated to be 5.5% for 2022. As we showed in our paper, Get Paid Whilst You Wait (see [here](#)), this yield has only been higher twice in the Fund's 18-year history – most notably during the financial crisis. We also continue to expect the Fund dividend to grow in 2023, with current modelling suggesting mid-to-high single digit growth. This would leave the estimated dividend yield close to 6% for 2023*.

Outlook

June was a difficult month for the Market (and the Fund). This adjustment has come at a point when the market valuation strata was already very polarised. We covered this in recent papers including The Return of Low-Cost Income – see [here](#). The market dynamics in June have accentuated this position.

As we look into the second half of this year we make five simple points:

- As noted above, the dividend dynamic remains positive. The Fund's end-June 2022 yield of 5.5% was at a level seen only twice in the Fund's 18-year history. As also noted, 50% of the Fund is under active buyback;
- The UK market valuation structure remains polarised. Seven stocks – AstraZeneca, the two tobacco stocks, Glaxosmithkline, Reckitt Benckiser, Diageo and Unilever currently make up a quarter of the UK market. They are all on very high valuations – in many cases 4x higher than the stocks in the Fund. The biggest danger at the moment remains 'valuation' risk – with all these heavily owned stocks trading on extreme relative ratings. Now is not the time to buy an index tracker;
- The gap between the operational performance / newsflow at a stock level and share prices is close to the widest it has ever been. With the odd exception, as noted in the Performance section above, the majority of our holdings are delivering strong performance despite the external pressures that all market participants are well aware of. Part of this is due to the amount of non-cyclical growth we have embedded in the Fund, which we have discussed before – 'growth in a value jacket', which includes plastics to cardboard, clean energy, infrastructure and the like. And part of it is being driven by rising interest rates which is a major tailwind to certain financials. Obviously we are aware that the stock market is a forward looking mechanism that is anticipating sharply deteriorating economic growth, but in most cases this looks to be more than discounted in share prices;
- Valuations remain eye-wateringly cheap across the Fund – there are no stocks to sell on an absolute basis. There are multiple PE / yield crossovers, many stocks trading at or close to all-time lows, and most stocks are visibly cheap on a vanilla absolute basis. We have highlighted some examples elsewhere in this report. Others include Aviva – which has just given back 20% of its market cap as a special distribution on a yield of 8% -- Glencore on a free cashflow yield of 30%+, Kier on a PE of 4x, DS Smith on a PE of 8x, Barclays on a PE of 5x / 0.45x book value and the list goes on;

* The dividend yield forecast and commentary is an estimate of future performance based on evidence from the past on how the value of this investment varies and current market conditions and is not an exact indicator. Returns will vary depending on how the market performs and how long the investment is held.

- As a result of these dynamics the 'bids' keep coming. According to Peel Hunt data around 35 UK-listed companies are in offer periods, the highest number since the start of the Covid pandemic. Excluding investment trusts and closed-end funds (but including real estate investment trusts), more than 7% of the domestically focused FTSE 250 index is under offer. Notable bids during June were for Biffa, Go Ahead and Euromoney. This trend will continue whilst other investors continue to reduce UK weightings.

When there are periods of 'panic' we know the Fund tends to struggle as the focus moves away from the micro, away from specifics and away from valuation. We also know that these times tend to be a prelude to very strong performance eg the TMT bubble, post the Global Financial Crisis and more recently following the initial six weeks of Covid. We believe we are at one of those points in time. Both Fund Managers added to their holding in the Fund at the end of the month.

We cannot over-emphasise that in our experience this is the time to be looking at a Fund like this.

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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Investments include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.

The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

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