Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: August 2023

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 positions as at 31 July 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.11	2.57	6.54
Construction and Materials	8.32	1.82	6.50
Household Goods and Home Construction	5.92	1.05	4.87
Industrial Metals and Mining	11.15	6.41	4.74
Banks	14.08	9.51	4.57

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.61	-10.61
Personal Care, Drug and Grocery Stores	0.00	7.72	-7.72
Closed End Investments	0.00	6.09	-6.09
Beverages	0.00	3.57	-3.57
Tobacco	0.00	3.24	-3.24

Active stock bets as at 31 July 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
DS Smith	3.26	0.17	3.09
Standard Chartered	3.76	0.73	3.03
Glencore	5.43	2.48	2.95
Phoenix	3.11	0.17	2.94
NatWest	3.50	0.58	2.92
Barclays	3.93	1.03	2.90
Aviva	3.36	0.46	2.90
Paragon	2.91	0.05	2.86
BP	6.31	3.50	2.81
Bellway	2.74	0.12	2.62

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.24	-3.24
HSBC	2.09	5.51	-3.42
Unilever	0.00	4.51	-4.51
Shell	2.29	6.83	-4.54
AstraZeneca	0.00	6.97	-6.97

Performance to 31 July 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**4.81**	**2.42**	**335.90**	**1,579**	**1,868**
Lipper UK Equity Income mean*	2.61	2.73	211.77		
FTSE All-Share TR Index (12pm adjusted)	2.61	4.91	245.58		

Discrete 12-month performance (%) to:

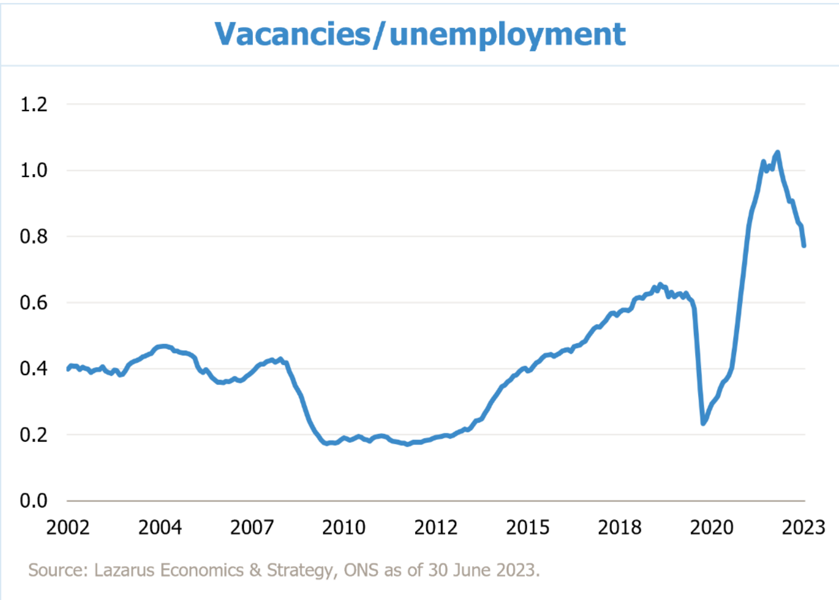
	31.07.23	31.07.22	31.07.21	31.07.20	31.07.19
JOHCM UK Equity Income Fund – A Acc GBP	5.11	1.92	49.98	-25.28	-9.50
FTSE All-Share TR Index (12pm adjusted)	6.39	5.23	24.84	-16.81	1.33

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

The UK's June CPI inflation rate showed its first meaningful decline, coming in at 7.9% versus 8.7% in May and an expectation of around 8.2%. The impact of softer input and producer prices has begun to impact the annual number and food inflation was 140bps lower at 17.3%. Critically, the July CPI number will move meaningfully lower too, as the OFGEM quarterly price cap fall comes into effect and as the rate of food inflation is set to slow further, partly because of base effects from last year's steep price increases. Consequently, the July CPI print will likely fall below 7% and on a path to below 5% during Q4 2023.

Some commentators continue to focus on elevated levels of inflation in the services sector and in that regard, the latest UK labour report showing 7.3% regular pay growth has attracted attention. However, elsewhere in the same report, we see clear evidence that the UK labour market is beginning to show signs of returning to a more balanced equilibrium. Whilst the number of people employed in the UK grew by 80,000 in the three months to June, the number of people claiming unemployment grew to 180,000. This reflects an acceleration in the increase in participation as more people in the 18-25-year-old and 55+ cohorts return to the labour force after the COVID-induced reduction three years ago. Clearly, the higher inflation rate and cost of living issues are somewhat driving this behavioural change and are making labour markets less tight. This can be best seen in the ratio of vacancies to unemployment below, which has moved lower in the last few months and looks to be on a path back towards the 2019 level. This greater supply of labour is likely to see a reduction in the price of labour and, as such, we anticipate a progressive fall in wage inflation.



These two data points saw a meaningful reassessment by markets of the future path of interest rates in the UK, with the 2-year bond yield ending the month at 4.96%, having touched 5.49% earlier in July. Whilst the Bank of England is still likely to tighten monetary policy somewhat from here, they should be able to see that inflationary pressures are already dissipating, and as such, the requirement for further action is relatively modest.

In the US, headline inflation has already fallen back to 3% as energy and food prices fade; this is the lowest level since March 2021, whilst the core measure of CPI has also fallen, albeit less dramatically, to 4.8%. Short-term economic indicators are mixed, with housing starts falling back in June after the unexpected increase in May. But more forward indicators, such as the Philadelphia Fed manufacturing outlook survey, hit a 23-month high on expectations for future growth. Jerome Powell is trying to keep markets guessing as to whether the Fed has finished its phase of monetary tightening - that will depend, to some degree, on data releases over the coming weeks; however, it is likely that we are at, or are close to, the end of the rate increases.

In Europe, whilst the European Central Bank has continued to tighten, inflationary pressures have also continued to track lower this month in several countries, whilst GDP growth has been negative both in Germany and Italy, with manufacturing still in decline. This is partly attributable to soft demand from China, where Q2 GDP of 6.3% undershot expectations (7%) and where policymakers continue to add stimulus, particularly to the housing and property sectors.

Performance

From mid-July, markets pivoted higher, driven by inflation data and the consequent impact on interest rate expectations discussed above. These trends enabled the value in the Fund that we have long articulated to start to be realised. The UK FTSE All Share was up 2.61% and the Fund outperformed this, up 4.81%. Year-to-date, the Fund is up 2.42%, whilst the FTSE All Share is up 4.91%.

Despite a modest recovery in the absolute and relative performance of the Fund in July, the valuation elastic is close to as stretched as it has ever been, between value and growth, defensives versus cyclicals, and large versus small, which we have extensively commented on in recent reports. Looking at the peer group, the Fund is ranked in the 3rd quartile within the UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked 1st quartile over three years, 3rd quartile over five years, 1st quartile over 10 years and is the best Fund in the sector since inception in 2004.[1]

Financials performed well, particularly banks, as most of our holdings were up c.5% in relative terms, with **Standard Chartered**, one of the cheapest stocks in the sector, being the best performer. Insurers also outperformed but more modestly. The mining and the oil sectors also both performed well. In the mining sector, **Anglo American** and **Glencore** both rose c.5% in relative terms. In contrast, our two small-cap names (**Central Asia Metal** and **Kenmare**) underperformed. This should iron out in time as the drivers are similar.

Our largest void sector is pharmaceuticals, and the most significant void at a stock level is AstraZeneca. This stock fell after issuing a disappointing drug trial result, but largely rebounded post results at the end of the month. Its net contribution to relative performance was c.30bps.

As UK interest rate expectations fell rate sensitive elements of the Fund rose strongly. Our two housebuilders, **Bellway** and **Vistry**, rose 10% and 20% in relative terms, respectively. **Land Securities** was also strong (up 10% in relative terms) for similar reasons.

[1] Source: Lipper

Strong results were another positive theme in the month, with **Keller** up 18% relative, after an upgrade trading update. **Kier** was up 14% relative following a trading update that guided to a stronger balance sheet. **Wickes** was up 9% relative following a stronger-than-expected sales trend in the second quarter, a maintained dividend and the announcement of a new share buyback. **Tyman** was up 22% relative following results which guided full-year results to the top of the consensus.

On the negative side, **Redde's** results, which we viewed as strong, were met with disinterest (down 6% relative) and **WPP** weakened post several peers reporting sluggish outlooks. Two weeks after the result, Redde, who also felt their results were strong, announced a share buyback. **Lookers** which we reported had been bid for last month, fell c.20% to halfway between where the bid was struck at and the pre-bid price during the month. Towards the end of the month a new, higher offer was made. The fall was stimulated by the largest shareholder withdrawing its support for the transaction. Finally, **Hipgnosis** was weak and continues to trade at around half its stated book value. Pressure is growing on the Board ahead of the continuation vote later this year to close this gap.

Portfolio activity

The news flow surrounding Lookers was volatile across the month, as noted above. Having sold more than half our holding, post the first bid we added back to the position after the fall in the share price intra-month. At the end of the month and after the new bid approach, we had c.115bps in the stock compared to c.230bps on the day after the initial bid approach was announced.

Other reductions included **Standard Chartered**, to keep at our maximum 300bps overweight. This stock has been regaining its poise before the First Abu Dhabi Bank six month bid moratorium ends in August following the well-publicised skirmishes in mid-February. We also reduced **First Group** reflecting the strong move in its share price. Based on 10-12x PE for bus earnings and 5x for rail earnings, our new target price remains c.40-50% above the current share price The holding is now c.1% of the Fund.

The housebuilders were very strong, and after adding to them last month, we marked our positions to target weights - c.5.5% across Bellway and Vistry, to control risk. We also marked our position in **Diversified Energy** to 2.25%, its target weight.

A number of stocks we would put in the top decile compared to all Fund holdings, in terms of long-term fundamentals and structural growth were weak during the month. We added materially to **EasyJet** – which we covered in last month's bulletin, **Sthree** (STEM recruitment), **Inchcape** and Redde. As we travel through the market 'V' for cyclical value, we have looked to ensure more capital is allocated to this type of stock. We feel the aggregate quality of the Fund is the highest it has ever been, but all at an extremely low valuation.

We also added to other laggards, such as Kenmare and Central Asia Metals.

One of our new additions this year has been **Marks & Spencer's**, which has seen persistent upgrades since we acquired it. In the brief periods it has been weak, we have carried on adding to the name, which is now c.80bps of the Fund.

Outlook

As noted above, July saw positive absolute and relative performance for the Fund. We gave a detailed overview in last month's bulletin of how cheap the Fund is. The scale of the undervaluation depicted there and the drivers of it (two decades of low interest rates and low inflation, allocations away from the UK) means any regime shift when it happens will take years rather than months to fully develop.

The driver of the shift in performance dynamics in July was primarily macro, with inflation falling and interest rate expectations moderating. As the year moves towards a close, as noted above, we think inflation will continue to fall and interest rates will have been seen to have peaked. This will likely underpin a continuation of the trends seen in July. It will also likely lead to a reduction in the narrowness of leadership which we see in all global markets, eg the large tech names in the US and, closer to home, UK defensives. The chart below from JP Morgan shows the recent market cap concentration change in the US has been the most aggressive in the last 60 years – making the TMT bubble look like a modest event.

Other encouraging features of July included largely positive news flow (vs consensus expectation) and more buyback announcements, a definitive contrast with the Global Financial Crisis (GFC) when the news flow was very poor. This is likely to result from high nominal growth, better management, stronger balance sheets and several sectors with positive tailwinds (eg energy transition investment).

We provided an update on the Fund dividend in last month's bulletin, reaffirming our guidance over the last nine months of 1-5% growth in the 2023 Fund dividend. We are currently running around the middle of this band. There continues to be active debate amongst Boards and investors regarding the appropriate balance between buybacks and dividends. Ultra-low valuations are making buybacks very attractive. We favour a balanced approach, which is available given the strength of balance sheets. A good example is Standard Chartered, whose first half dividend cost of c.$150-200m compared to a new buyback of $1bn. This has taken the edge off dividend growth in the near term but will likely accelerate dividend growth in the medium term when valuations improve and buybacks are less persuasive. The yield on the Fund for 2023 at the end of July was c.5.5%, with between 40-50% of the Fund, by value, currently engaged in share buybacks.

Further information

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