+Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: June 2018

Active sector bets for the month ending 31 May 2018

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.81	3.00	+5.81
Banks	15.40	10.68	+4.72
Mining	10.50	6.69	+3.81
Oil & Gas Producers	17.28	13.69	+3.59
Construction & Materials	5.28	1.74	+3.54

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	2.53	7.79	-5.26
Tobacco	0.00	4.56	-4.56
Equity Investment Instruments	0.53	4.50	-3.97
Beverages	0.00	3.01	-3.01
Personal Goods	0.00	2.37	-2.37

Active stock bets for the month ending 31 May 2018

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	7.48	4.47	+3.01
ITV	3.20	0.25	+2.95
Aviva	3.75	0.83	+2.92
Lloyds Banking Group	4.64	1.85	+2.79
Standard Life Aberdeen	2.79	0.38	+2.41
Glencore	3.94	1.75	+2.19
DS Smith	2.31	0.22	+2.09
Vodafone Group	4.05	2.10	+1.95
Morgan Sindall Group	1.96	0.02	+1.94
Rio Tinto	3.90	2.01	+1.89

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	3.52	-3.52
GlaxoSmithKline	0.00	2.98	-2.98
Diageo	0.00	2.68	-2.68
Unilever	0.00	1.96	-1.96
Prudential	0.00	1.90	-1.90

Performance to 31 May 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**2.33**	**4.26**	**308.60**	**£3,858mn**
Lipper UK Equity Income mean*	2.12	1.77	181.67	
FTSE All-Share TR Index (12pm adjusted)	2.66	2.72	190.57	

Discrete 12-month performance (%) to:

	31.05.18	31.05.17	31.05.16	29.05.15	30.05.14
JOHCM UK Equity Income Fund – A Acc GBP	**12.66**	**27.85**	**-11.12**	**11.14**	**14.33**
FTSE All-Share TR Index (12pm adjusted)	6.41	24.51	-6.80	8.23	8.97

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 detective work around how affected by severe weather the UK economy was in Q1 continued during May. As highlighted previously, March's extremely wintry conditions clearly had a substantial influence upon the first quarter's very modest GDP growth of 0.1%. Further evidence emerged during May that many parts of the economy have returned to their prior higher growth trajectory: consumer credit growth rebounded to around +10% in April having been flat in March; UK construction returned to growth having shrunk during the cold snap; and consumer confidence indicators improved, too. The indicators from the retail sector are harder to interpret, however. Not only were there wild swings in the weather to contend with, but Easter moved from April to March too during 2018. It's easy to alight upon poor trading updates from the likes of Dunelm and Dixons Carphone as evidence of further weak activity, but, on the flip side, many clothing specialists (such as Next) had a much better April and all the food retailers benefited from the warmer weather.

As ever, there are winners and losers in retail, but the overall picture is less bearish than the picture painted by much of the media, and a decent rebound in Q2 GDP seems likely. Indeed, Governor Carney expressed this view during the Inflation Report press conference, with many of the Bank's local agents picking up an improvement in activity levels. Employment markets remain very tight, with strong growth in total employment, the biggest decline in EU nationals employed in the UK for eight years and consequently accelerating nominal and real wage growth. Focusing purely upon the path of the domestic economy, further tightening in monetary policy still looks likely during H2 2018, despite the uncertainty of the tortuous Brexit negotiations and relatively weak business confidence.

A potential UK rate rise could get delayed though if the political instability in Italy threatened wider contagion across Europe. It is easy to dismiss the latest election result as par for the course for a country that has had over 65 different governments since the Second World War (we shall see how long the odd marriage of Five Star and League survives). Nevertheless, the result was in keeping with the wider global support for anti-establishment and populist leaders and causes over the last few years. In the short term, the dramatic widening of Southern European bond spreads versus Germany has hit investor confidence across the world. This uncertainty also contributed to US 10-year Treasury yields pulling back from their mid-May peak of 3.11% to finish the month at around 2.86%. Whether the risk of contagion is, at this stage, sufficient to alter the Federal Reserve's tightening path is hard to gauge, but the crisis in Italy also coincided with the publication of less hawkish Federal Open Market Committee minutes, which suggested that the trajectory of further rate rises in the US may begin to fade a little from here.

The significant rise in the oil price may be a factor at play here, as the 50% rise over the last 12 months begins to hurt consumption and activity in parts of the economy, with the US particularly sensitive to this issue, given the lower tax environment and higher miles driven in that economy. Whilst shale operators have contributed some increases in production, the firm resolve of OPEC combined with Trump's treatment of Iran and further economic issues in Venezuela have left the oil market tighter than many had predicted a year or two ago. With oil prices above $75/bbl, it would not be a surprise to see some major oil-producing nations such as Saudi Arabia and Russia begin to release a little more product into the market to try and prevent demand destruction from the higher price.

Finally on the macro front, tentative signs of the Chinese economy responding to the looser monetary policy adopted earlier in the year began to emerge during the month. There was a tick up in the official manufacturing PMI data whilst anecdotal evidence suggests that stock levels for some commodities are quite low.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) posted an increase of 2.66% during May. The Fund modestly underperformed in returning 2.33%. Year to date the Fund is up 4.26%, ahead of the FTSE All-Share Total Return Index which returned 2.72%.

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 market was volatile during May, with strength early in the month being partly offset by weakness relating to the Italian situation towards the end of the month. The latter (along with sterling weakness versus the dollar) also led to defensives outperforming and financials weakening, which was a headwind for the Fund's relative performance. This was partly offset by strength in the oil/mining sectors, which benefited from the decline in sterling.

There were a higher-than-average number of variances at a stock level under the surface during the month. On the positive side, **Morgan Sindall**, our largest small cap position, outperformed (up c. 20% relative) following a strong trading update; **Northgate** (up 10% relative) was higher following a trading update that indicated its UK business was starting to see traction from new management actions; and **Bloomsbury** (up 30% relative) had strong results. **ITV**, which had been a laggard for a number of months, responded well to a trading update that was in line and that better articulated the business. Its largest shareholder, Liberty Media, will receive a large cash inflow from the sale of its European assets to Vodafone (see below) which sparked some M&A commentary. Property developer **U&I** was also strong following good results, a solid outlook and a record dividend.

On the negative side, **Halfords** (down 12% relative) underperformed following an announcement that the new CEO would make a modest P&L investment to underpin service/differentiation, which led to EPS downgrades. **Vodafone** (down 10% relative) fell following the announcement of the acquisition of Liberty Media's European assets. **Ibstock** (down 9% relative) fell following a small downgrade due to higher energy costs.

A number of our financials were also sluggish for individual reasons. **TP ICAP** and **Paragon** fell after results which, in our view, were largely in line. **Standard Life Aberdeen** was also weak as the market remains mono-focused on near term AUM outflows/GARS underperformance. During the month it announced a larger-than-expected return of capital (£1.75bn) associated with the sale of its life insurance operations to Phoenix and also an additional £100m of cost reduction that can be accessed as the life insurance business leaves the group. These are material positives. Stripping out the two Indian businesses that the group owns (one of which is quoted in India and the other of which will IPO in the next few months) leaves the residual business on a P/E ratio of 5-6x. The stock also yields 6.5%.

Portfolio activity

We added two new stocks to the Fund during May, **Urban Exposure** and **Petrofac**.

We have owned Petrofac before, selling for an average price of c. 750p just over a year ago following the announcement of an SFO inquiry into a specific contract which was undertaken about 10 years ago. Since then, whilst the outcome of the inquiry is not known (and is unlikely to be known for at least two years), the board has taken a number of actions that create a strong platform for the business to move forward from.

First, despite the SFO inquiry, the order book has been rebuilt, which suggests that its customer base, which included Shell, BP and various Middle Eastern national oil companies, has not been perturbed from allocating work by the SFO inquiry. The amount of work and opportunities have also grown significantly as a result of the rise in the oil price and the backlog of works created by the capex famine during the low oil price years (2015-2017).

Second, the board has moved the focus onto cash flow and balance sheet strength. Assets outside its core area of contracting have, or are, being sold and the dividend has been rebased. This means the company should move to a net cash position on a c.18-month timeframe. The stock, despite the dividend cut, still yields c. 5%.

Third, there have been various improvements in the governance of the business and its transparency/communication with stakeholders. The stock is currently 20-25% lower than when we exited, despite the improvements noted above. The underlying valuation looks very attractive with a free cash flow yield of c. 15%.

Elsewhere in the oil sector, we reduced **Royal Dutch Shell** in the first half of the month (before the oil price fell) and added to **Diversified Gas & Oil**, a recent addition.

Urban Exposure was an IPO of a strong franchise with cautious forecasts at a good price – having all three elements of these present in an IPO remains a rarity. The company provides debt for small housebuilders and developers. This fits exactly into current government policy that is targeting an increase in the aggregate number of new homes, mainly from this segment of the market. The large banks have reduced (and are unlikely to increase) exposure to this area as the risk-weighted asset load and therefore capital requirements are too high. The return on capital that companies like Urban Exposure can generate is thus attractive (c. 15% p.a.). As well as investing its own balance sheet, it has a small fund management business focused on the same segment that should grow. A successful execution of this strategy will lead to material share price upside. It also starts on a cheap rating – 1.05x book value, a P/E of 7x and a yield of c. 5%.

We sold **Huntsworth** and **Costain** to zero, two stocks that had been good performers for the Fund over the last few years. Both stocks, which were owned for two and four years respectively, more than doubled from our initial entry price. This was partly driven by the very low initial valuations that we paid for each stock but also by a number of earnings upgrades as the underlying businesses performed better than market expectations. The Fund made c. 50-60bp of relative performance on each stock.

As noted above, defensive overseas earners performed well during the month. We took this opportunity to continue to fade our **AstraZeneca** weighting, where we are now underweight. We also trimmed our **DS Smith** position to a 200bp overweight (from c. 235bp). Conversely, **Vodafone**, which would have normally been expected to outperform in the market conditions of May, underperformed materially, as noted above, after the transaction to acquire part of Liberty Europe and sluggish results were taken poorly. We materially added to our position, moving it into the top 10 active positions in the Fund.

Financials were very weak, particularly towards the end of the month as the Italian situation developed. We added to **Barclays**, **Lloyds Banking Group**, **Paragon**, **TP ICAP** and **Standard Life Aberdeen** amongst others.

We continued to reduce our position in **Laird**. It is currently subject to a takeover offer, with the share price hovering c.1p below the offer price (200p). The deal is due to consummate in August/September.

Finally, in the UK domestic sectors, we continued to trim stocks that have performed well (**Forterra**, **Bovis**, **Countryside**) and added to retail names **DFS** (after a strong capital markets day) and **Halfords**.

Outlook

As highlighted above, the US 10-year Treasury yield retreated from above 3%, as the political crisis in Italy combined with less hawkish comments from the Fed about inflation led investors to conclude that the path of future monetary tightening might be a little shallower than previously expected.

With the political uncertainty in Europe likely to persist for some time, as well as forward economic indicators softening further in that region, this conclusion is probably correct in the short term. However, with labour markets tight in many parts of the Western world, it is still likely that there will be a bias to tighten further in the US and UK. Central banks still need to progressively withdraw stimulus when possible, so as to progress the process of policy normalisation and to provide future ammunition for future policy easing as and when it may be needed.

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 (a current expectation of 5-7% growth) is an important driver of the unit price, which would mean the Fund's prospective yield for 2018 is c. 4.2%. This yield, strong dividend growth and low valuations embedded across the portfolio, allied with the shift in monetary policy, leave us 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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