JOHCM UK Equity Income Fund

Monthly Bulletin: June 2020

Active sector bets for the month ending 31 May 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.65	3.08	+6.57
Mining	12.76	6.80	+5.96
Media	8.51	3.81	+4.70
Financial Services	8.25	4.33	+3.92
Food & Drug Retailers	6.03	2.11	+3.92

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.62	-10.62
Equity Investment Instruments	0.00	6.18	-6.18
Tobacco	0.00	4.56	-4.56
Beverages	0.00	3.88	-3.88
Personal Goods	0.00	2.78	-2.78

Active stock bets for the month ending 31 May 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Standard Life Aberdeen	3.52	0.31	+3.21
Phoenix Group	3.33	0.17	+3.16
Legal & General Group	3.77	0.63	+3.14
Barclays	4.20	1.08	+3.12
WPP	3.43	0.39	+3.04
Tesco	4.11	1.16	+2.95
ITV	3.10	0.16	+2.94
Glencore	3.76	0.87	+2.89
BP	6.00	3.20	+2.80
Vistry Group	2.80	0.09	+2.71

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.85	-5.85
GlaxoSmithKline	0.00	4.23	-4.23
HSBC	0.00	3.99	-3.99
British American Tobacco	0.00	3.83	-3.83
Diageo	0.00	3.49	-3.49

Performance to 31 May 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	**0.11**	**-30.59**	**183.40**	**£1,870mn**	**£2,270mn**
Lipper UK Equity Income mean*	1.27	-21.10	132.51		
FTSE All-Share TR Index (12pm adjusted)	2.17	-17.79	152.26		

Discrete 12-month performance (%) to:

	31.05.20	31.05.19	31.05.18	31.05.17	31.05.16
JOHCM UK Equity Income Fund – A Acc GBP	**-20.99**	**-12.21**	**12.66**	**27.85**	**-11.12**
FTSE All-Share TR Index (12pm adjusted)	-10.02	-3.52	6.41	24.51	-6.80

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

Reported economic activity reflected the severe impact of the effective lockdown across most developed economies. There have been significant increases in unemployment in all affected countries, despite many governments doing their best to mitigate such outcomes via support schemes, such as the furlough operation here in the UK. Unemployment in the UK rose by 856,000 in April to over 2 million, a rate of around 5.6%, whilst in the US, where the safety net is less evident, unemployment rose to around 15%. In both cases these numbers will rise further over the coming months.

However, whilst we may not have reached the peak in unemployment, it looks increasingly likely that we have already passed the worst point in the contraction of economic activity during the second half of April. Weekly available data on spending trends from the likes of Barclaycard suggests that activity picked up around the end of April in the UK. Electricity consumption has been recovering across Europe over the last month and is now running around 10% below normal compared to 20+% a month ago. In the US, driving data has picked up materially and weekly mortgage applications are almost flat year-on-year. In China, traffic congestion is largely back to normal and car sales are flat year-on-year, whilst industrial production was higher year-on-year in April, compared to the 14% fall in February.

Furthermore, the soft data, principally the purchasing managers' surveys, also points to a global economy which was less weak in May than in April. The UK composite PMI improved from the unprecedented 13.8 to 28.9 and in the eurozone from 13.6 to 30.5. Given the progressive relaxation of the severe lockdowns, these readings will improve further in June as they measure whether conditions have improved or deteriorated from the month before. However, they still reflect a European economy that will suffer a severe GDP contraction in Q2, even if May and June prove to be less bad. The consequence in the UK, for example, is that the GDP contraction is more likely to be in the 18-20% range rather than the 25-35% spoken about by the Bank of England and the Office for Budget Responsibility.

This environment of a progressively improving trajectory of the global economy has also been evident from conversations with a number of our portfolio holdings over the last 2-3 weeks. **Barclays** was seeing little short-term distress from the behaviour of its credit books; **ITV** observed that the demand for advertising was less bad than it was a month ago; and a number of house builders have seen encouraging levels of new reservations, limited cancellations and, thus far, only modest downward pressure on house prices. Commodity prices also moved higher, reflecting

the improving demand/supply dynamics, with oil in particular rising around 40% this month after the prior months' weakness.

Clearly for this improving picture to continue, developed nations need to avoid meaningful second spikes in virus infections as they unlock their economies, but so far the evidence has been very encouraging on that front, with very few meaningful increases from the early-mover nations in Europe in particular.

Meanwhile, central banks and governments have continued to provide very loose and supportive policy for their economies, including the extra £200bn of QE in the UK, the €750bn recovery fund across Europe and large incremental stimulus programmes in Japan and North America. Combined with co-ordinated actions in the corporate bond markets, these policies are likely to stay in place for some time, even after economies have definitively bottomed and, as such, may herald rising inflationary pressures in future years, particularly as de-globalisation and policies to lower wage and wealth inequality push up the wages of the lower earners.

Politics remains volatile and difficult to predict. In that regard the lack of progress on the Brexit negotiations and the deteriorating relations between the US and China are issues that will need to be watched carefully and navigated around over the coming months.

Performance

May was a story of two halves. The Fund significantly underperformed in the first half of the month, primarily because our portfolio voids (AstraZeneca et al.) continued to be very strong versus the market. The end of the month saw this trend reverse somewhat. The market, represented by our benchmark, the FTSE All-Share Total Return index (12pm adjusted), continued to rebound during May. The Fund underperformed the market over the month in returning 0.11**%** versus 2.17**%.** This is reflected in the portfolio's year-to-date performance, with the Fund down 30.59% versus a 17.79% fall in the benchmark.

Looking at the peer group, the Fund ranked fourth quartile within the IA UK Equity Income sector for May. On a longer-term basis, the Fund is ranked fourth quartile over three years and five years, second quartile over 10 years and first quartile since launch (November 2004).

The strongest sector in the Fund during the month was mining (c. 13% of the Fund). It is clear, as discussed above, that China is recovering from the pandemic and the government's increased infrastructure spending here helped underpin the mining sector. Iron ore prices are close to a one-year high and **Anglo American** and **Rio Tinto** were both up c. 10% relative[*]. In contrast, the oil sector was sluggish, albeit **Diversified Gas & Oil** (up 16% relative[*]) continued to outperform.

There is more differentiation coming through in performance at a stock level. Pleasingly, four of our five largest active bets outperformed during the month (adjusting for the ex-dividend in the case of **Legal & General / Phoenix**). Some outperformed significantly e.g. **Barclays** and **Standard Life Aberdeen** both up c. 10% relative[*]. Stocks that have clearly made moves to position themselves for a post-Covid-19 world either through a fund raise, business remodelling, or both, started to show traction e.g. **DFS** (up 10% relative[*]). Whilst this is positive and normally a good sign that stock selection differentiation within sectors is coming back into the picture, many anomalies remain.

The majority of our UK domestic stocks underperformed, particularly **Countryside**, **Vistry** and **Tesco**. Outside our two largest financials noted above, the wider sector was weak.

Vodafone produced solid results. Despite the wider pressure on dividends and sector peer, BT removing its dividend, Vodafone did not follow suit; the stock was up 11% relative[*]. Elsewhere, **DS Smith** was also strong.

Portfolio activity

We added two new stocks to the Fund during the month and materially increased a third – **National Express**, **Keller** and **Costain** respectively.

[*] Relative to the Fund's benchmark, the FTSE All-Share Total Return index (12pm adjusted).

Costain has been a difficult stock for the Fund since we re-acquired it following a profit warning in Q4 last year. It announced a rights issue just prior to the Covid-19 situation developing. The pandemic and the subsequent market volatility led to the stock severely underperforming as its advisors tried to lock the funding in. The new funding was eventually done at 60p. The shares are currently 80p. We acquired more in value than we had before, which means it is c. 100bp of the Fund, and on a relative performance basis, it is now close to a flat contribution to the Fund. With net cash, in a sector (infrastructure spend) that is likely to see strong demand due to the Covid-19 policy response, recent contract awards of c. £2bn including High Speed 2 and a material shift in the terms of trade in the contracting sector, Costain is in a very strong position. It is also very cheap, in our view. On cautious forecasts and assuming a low exit P/E of just 10x, the stock should more than double from its current price. If management deliver their aspired margin, it should triple on the same basis.

National Express was one of the best contributors to Fund performance since inception before we sold it on valuation grounds at. c. 450p in November last year. We have reintroduced it into the Fund at a share price c. 50% lower than this via a placing. This placing strengthens its balance sheet and puts it in a strong position to emerge in good shape from the pandemic. The reasons we had it in the Fund previously are still present – it has the strongest management team, the most invested fleet and it is a leader in technology within the sector. It also has the best business mix with its US school bus service and a dominant position in Spain, the two largest contributors to its earnings. It should be able to (and we have already seen evidence) enhance market share as weaker competitors are hurt by the effects of Covid-19; the US school bus operation is a prime example. With these new contracts, the management expects 2021 earnings to recover close to 2019 levels. Were this to happen, the stock would have 50-75% upside by our calculations.

We have also owned Keller before. Like National Express, we previously sold it on valuation grounds. Its shares are now c. 45% lower than when we sold it. It has a stronger balance sheet than it did when we left it and it also has a new (and, in our view, better) CEO, whom we know from his previous executive roles. Keller is the market leader globally in infrastructure piling and foundation preparation. Its major source of profits is the US where it has a c. 10% market share. As we have discussed in previous reports, we think infrastructure as a sector will come out of the pandemic strongly as governments globally look to stimulate economies. Keller trades on c. 5-6x previous pre-Covid-19 EPS and c. 8-9x current Covid-19-affected EPS. The strength of its business coupled with Covid-19 being slightly less damaging for it than originally feared means its board has a desire to pay the dividend that they initially deferred, with a decision due in late Q2.

These are three further examples of the capital reallocation that we have been doing across the Fund over the last three months since the crisis started. The indiscriminate selling and share price falls have enabled a material improvement in the quality of the Fund across this time period and, from a valuation perspective, to its upside potential. To fund these moves we finished selling Hammerson, which, as we mentioned last month, was the stock most affected by Covid-19 within the portfolio from both a short- and long-term perspective. This leaves just 2% of the Fund in our 'worry basket': two small-cap property stocks and **Easyjet** (which we think has ample liquidity but will need to raise equity at some point). We also reduced **SSE** to a more neutral position pending its results (which we think are a risk due to the impact from Covid-19). The market is not currently focused on this and it could create dividend risk. Towards the end of the month, as value rallied a little, some of our large positions hit our limit of 300-320bp overweight, and we reduced them accordingly; **Legal & General**, **Barclays** and **ITV** are in this basket.

Elsewhere we added to **Standard Chartered** on 0.4x price-to-book. Given its Asian footprint, in our view this should be one of the fastest growing banks across the next cycle. We also added to **Diversified Gas and Oil** as it raised money to fund two acquisitions. It is likely, given its strong relative performance and the new equity, that this stock will move out of the small-cap bucket to the FTSE 250 at the next index review. This would move our overall small cap weighting back to c. 16% (currently at c. 17.5%).

We also added to **Countryside**, which fell sharply following its results but partly recovered towards the end of the month. Countryside is the market leader in partnership housing, where it has c. 8-10 years' visibility of land supply in partnerships with local authorities. This is one of the most mispriced assets in the Fund.

Fund Dividend

In last month's bulletin we provided a detailed update on the Fund dividend and the impact of Covid-19. Our guidance was to expect a fall of between 45-55% in the Fund dividend (vs. 2019) for 2020, followed by a strong bounce back in 2021, which would leave the level of the dividend (in 2021) closer to 2019's than 2020's. This guidance remains unchanged.

We are close to finalising our detailed modelling of 2021 dividends on a stock-by-stock basis. As we said last month, there is a high degree of uncertainty around such analysis and the range of outcomes will be wider than normal. We will provide a detailed overview of this analysis in next month's bulletin.

Assuming a 50% fall in 2020 (the mid-point of our guidance), and then a strong bounce back in 2021 to a level that is closer to the 2019 Fund dividend than 2020's, this would leave the following dividend yield metrics for the Fund, based on the unit price at the end of May:

- The 'A' accumulation share class price on 29 May 2020 was 283.4p
- The historic 2019 Fund yield is 7.3%
- The yield for 2020, assuming the mid-point of the above -45% to -55% range, is 3.6%
- The yield for 2021 and beyond: our initial view is it will be closer to 2019 than 2020

Outlook

In most respects, the key issue is when global GDP will return to pre-pandemic levels. Many commentators are very sceptical about how long it will take and the risks of second spikes of the virus. The negative consequences of the rise in unemployment should also not be dismissed lightly.

However, with the unprecedented scale of fiscal and monetary support, as well as innovative government measures to support the most affected companies, it is probable that the recovery will be relatively quick and that global GDP could return to end of 2019 levels by around the middle of 2022. With this outcome looking increasingly likely as lockdowns are eased, we strongly believe that a number of the cyclical/value-orientated sectors look highly attractive and have the scope to produce very meaningful returns from here. In the past these stocks have performed strongly when PMI surveys begin to improve (as they did in 2009). We believe a similar phase has already started.

It is important to note that whilst our investment style has always had a value tilt, we have never sought to be 'deep value' investors; indeed our record over much of the last decade bears that out. However, over the last couple of years the increasing polarisation in valuations across the market spectrum between 'growth' (big tech/perceived compounders/defensives) and 'value' (pretty much everything else) has become so unsustainably wide that we positioned the Fund with a greater value bias than hitherto, both before the Covid-19 crisis and even more so now.

We have published a separate paper today which can be found here, which discusses this valuation dichotomy in more detail. We firmly believe that this stance will bring its rewards in the coming months as economies progressively emerge from this crisis and that we will be able to regain the lost performance ground, and more, over time. We appreciate our investors' patience over what has been a difficult phase, but look forward to greener pastures ahead.

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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