



JOHCM UK Equity Income Fund

Monthly Bulletin: June 2021

Active sector bets for the month ending 31 May 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.40	3.26	+7.14
Industrial Metals and Mining	15.08	8.31	+6.77
Media	7.90	2.81	+5.09
Household Goods & Home Construction	5.95	1.75	+4.20
Banks	11.50	8.01	+3.49

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.89	-7.89
Closed End Investments	0.00	6.64	-6.64
Beverages	0.00	3.66	-3.66
Tobacco	0.00	3.29	-3.29
Travel & Leisure	0.68	3.67	-2.99

Active stock bets for the month ending 31 May 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.36	1.34	+3.02
Vistry Group	3.13	0.12	+3.01
Legal & General	3.71	0.71	+3.00
Aviva	3.65	0.68	+2.97
Glencore	4.41	1.46	+2.95
ITV	3.14	0.20	+2.94
Anglo American	4.56	1.62	+2.94
BP	5.49	2.56	+2.93
Phoenix Group	3.03	0.17	+2.86
WPP	3.31	0.48	+2.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Unilever	0.00	4.48	-4.48
AstraZeneca	0.00	4.47	-4.47
HSBC	0.00	3.86	-3.86
Diageo	0.00	3.27	-3.27
GlaxoSmithKline	0.00	2.78	-2.78

Performance to 31 May 2021 (%):

	1 month	Year to date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	2.70	19.33	310.60	2,212	2,597
Lipper UK Equity Income mean*	2.10	12.66	190.62		
FTSE All-Share TR Index (12pm adjusted)	1.74	10.91	207.94		

Discrete 12-month performance (%) to:

	31.05.21	31.05.20	31.05.19	31.05.18	31.05.17
JOHCM UK Equity Income Fund – A Acc GBP	44.88	-20.99	-12.21	12.66	27.85
FTSE All-Share TR Index (12pm adjusted)	22.07	-10.02	-3.52	6.41	24.51

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

In many senses May was a month of two halves. The first two weeks were characterised by continued strong economic prints, rising commodity prices, increased inflationary expectations and steepening yield curves. However, the latter part of the month witnessed central banks trying to downplay the sustainability of the pick-up in inflationary pressures with lots of dovish comments, focusing upon the perceived transitory nature of the increase due to soft comparables. This debate around whether the increase will be transitory or persistent is likely to dominate the airwaves throughout the summer. But, in the short term, there is no doubt that the trajectory of economic recovery is accelerating across most of the world.

Evidence of the robust recovery is everywhere. In the UK, May's composite PMI reading of 62.0 was the highest level ever recorded, with services now recovering strongly, too, as restrictions have eased. These levels of activity imply GDP growth in Q2 2021 of 4-5% for the quarter alone. If sustained, this would see the UK regain its pre-pandemic GDP level before the turn of the year. Furthermore, April retail sales were +9% month on month; vacancies are now only 15% below their pre-pandemic high; and debit and credit card spending is running 6% above the levels seen in February 2020.

One of the key debates about inflation later in the year will centre upon where unemployment will peak once furlough schemes end in September. In that regard it is encouraging that the current rate remains below 5%, and there are shortages of labour in a number of areas, particularly hospitality. These shortages are also being seen in the US, with some McDonald's stores offering \$50 for just showing up for a job interview. Indeed, the relatively weak non-farm payrolls print during the month appears to have been driven by the difficulty of finding new workers (some of whom seem happy to stay at home and collect Covid-enhanced benefits) rather than a lack of demand for labour. As regular readers know, we strongly believe that the greater focus upon income and wealth inequality will, over time, drive accelerating wage inflation in most Western economies.

Whilst most commodity prices retreated from their mid-May highs, with iron ore and lumber giving back around 20%, it is worth noting that many important metals such as copper were still higher over the month of May as a whole. The annual increases they have all registered will continue to drive strong input cost inflation. Furthermore, chronic shortages of many building materials, such as sand, cement and timber, can only fuel the shorter-term input cost pressures.

Bond yields exhibited a similar intra-month path to commodities. The drops seen in the last fortnight have followed blatant attempts by central bankers to play down inflation concerns and to carry out implicit yield control on markets. Only time will tell how successful this policy can be, but with a strong economic recovery, large infrastructure programmes being enacted and pent up consumer demand now beginning to kick in, they will struggle to keep the genie in the bottle over the summer months unless there is a significant setback in the effectiveness of vaccines against new variants of the virus. It has also been encouraging that many European countries have dramatically picked up the pace of their vaccination programmes over the last month. This is reflected in the Continent's own composite PMI hitting a 3 year high of 56.9, which augurs well for a strong economic recovery in the coming months.

Performance

Stock markets continued to edge higher across the month, with the FTSE All-Share Total Return index (12pm adjusted) returning 1.74%. The Fund outperformed its benchmark with a return of 2.70%. Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked third quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

As noted above, bond yields were under pressure during the latter part of the month, which meant the pause in the rotation towards areas of the market where the Fund has higher exposure continued. The comments above on recent economic data coupled with continued positive stock specific news flow (see below) suggest this is a lull before another move forward in both bond yields and further rotation. In this regard, it feels a bit like February.

Company-specific news flow remained upbeat, with **Lookers**, **Redde** and **Eurocell** all warning to the upside. Common themes in their narratives were shortages, raw material pressures and consequent selling price increases or the imposition of surcharges. The widespread commentary from companies around cost pressures and price rises, together with the durability of the economic recovery, supports our central case that inflation will be more enduring than policy-makers expect.

Other strong performances came from **ITV** (up 6% relative), recent new addition **International Personal Finance** (up 10% relative), **Drax** (up 10% relative) and our two recruitment stocks (**Sthree** and **Page Group**).

Sector-wise, the large oil stocks performed a little better, with **BP** outperforming Royal Dutch Shell. We remain very positive about BP's pivot towards new energies, and think it is underappreciated by the market. The mining sector, which has been strong year to date, weakened during the month.

Banks were mixed, with **Barclays** down 5% relative at one end of the spectrum and **Lloyds** up 10% relative at the other end. This enabled us to continue our re-positioning within the sector (see below).

There were two specific areas of weakness, **Vodafone** (where increased capex guidance was poorly received) and **Randall & Quilter** (which changed its dividend policy to fund growth prospects).

Randall & Quilter was extremely disappointing given the company's history and forward-looking free cashflow profile of the business, which is very clear and highly positive. In our view, the board should have grown into the current dividend rather than setting it on a 'look back' basis and confusing the 'stock of capital' with the 'annual flow of capital'. However, we believe the dividend will quickly grow back to where it was while the stock remains very cheap, in our opinion.

We will provide an update on the Fund dividend in next month's update, with current overall trends running ahead of the guidance we published in January.

Portfolio activity

We added one new stock to the Fund during the month: **Kier**. We have owned Kier before, selling it in the first half of 2017 (at c. 1,300p) on concerns about accounting issues, increased debt and the excessive use of exceptional items, amongst other factors. These issues manifested

themselves and led to the need for a rescue rights issue at the end of 2018. Our assessment at the time was the amount raised was not enough, hence we did not participate.

New management were put in place in 2019 and have done an excellent job at changing the culture, improving controls and rectifying the reputation of the firm. Kier retains market-leading positions in several markets, such as highways and rail, which are now showing strong growth. The final element of the investment proposition that was lacking was a robust enough balance sheet. This was rectified, firstly, by the sale of Kier Living for c. £100m in mid-April, and then by an equity raise of £240m, announced during May.

The price of the new equity was very attractive at 85p, with a pre-raise market cap of c. £175m. Both the price of the issue and the pre-rights market cap were weighed down by the need to raise new equity, which is now locked in. On recovered earnings, which we expect to be achieved in c. 3 years, the stock is on a P/E of c. 3x, with close to an average net cash position. It also has c. £500m of tax losses to use, which means free cashflow conversion will be high.

We believe this stock could triple from its artificially low starting price. This is a good example along, with last month's addition **International Personal Finance**, of the value that still exists in our part of the market, despite the market rally from the Covid-induced Q2 2020 lows.

The position in Kier was largely funded by the continued reduction of Lloyds Bank. It continued to perform well and is now close to our target price of 0.9x book value. The other banks (particularly Barclays and **Standard Chartered**), which reside on 0.5-0.7x book value, have material upside compared to Lloyds.

We also slightly reduced our position in **Hipgnosis** reflecting the negative effect of the recent strengthening of sterling, and **Polar Capital**, which has performed well. **ITV** continued its recent recovery and we marked our position back towards 300bp overweight.

Other additions included the participation in a placing by **Diversified Energy Group** (formerly Diversified Gas & Oil), which was an existing position. The proceeds raised will be used to fund an acquisition that was announced at the same time as the placing, but also forward raises for other acquisitions in the pipeline. The latter will be very accretive given the funding is already locked in. The stock yields 9%. Elsewhere, we added to **TP ICAP** after it continued to perform poorly. We also increased our food retail sector exposure, where recent performance has also been lacklustre.

Outlook

As we discuss above, there has been a pause in the rise in bond yields and therefore the continued transition in the market mix away from still highly valued elements of the market towards areas where the Fund is positioned. It is positive that the portfolio has more than held its own as this stabilisation has occurred

As we have alluded to earlier, whilst this has happened economic data and corporate results have continued to exhibit strong momentum. It is clearer now than in early April when the pause started that growth and inflation will accelerate and likely be much stronger than already rising consensus expectations. This will lead to a further rise in bond yields, which remain very low.

In our view, as this happens it will again, like it did in November and like it did in March, be the catalyst for a further turn of the key that unlocks more of the significant valuation upside that exists in the 'value' part of the market and more specifically the Fund.

We noted last month that the most frequently raised issue in the many meetings we have had with management teams over the last couple of months is that there are cost headwinds building, and that prices of end products are being increased accordingly. The majority of our meetings during May had a similar narrative. These trends are spreading across sectors and, as mentioned above, to certain parts of the labour market. It is very rare that you can see so vividly in real time the change that is happening. That one can see evidence of the strength and hence significance of the change. It adds weight to our view that this is not a transitory increase in inflation.

Central to the inflation debate is the Fed has radically changed its policy priorities, driven by a strong desire to reduce income and wealth inequality. Such a change is a huge regime shift from

the last 30-40 years and will also be supported by the Biden administration's levelling up agenda. Similar principles are at play elsewhere in the world, including the UK, where higher minimum wages and more generous pay settlements for key workers or employees in the gig economy are evident for all to see.

The majority of the Fund is in the 'green' zone on valuation metrics. We have been disciplined in removing stocks that hit our target multiple – currently 12.5x normalised EPS. Forterra and Tyman, which we sold in April, were evidence of this. At the same time, we are still finding compelling new ideas with significant upside, like Kier. This is a good time in the cycle as there are more than the normal number of anomalies like this or late-cycle recapitalisations. These create opportunity and also allow us to keep the valuation trajectory of the Fund very low.

The confluence of a very strong economic recovery, low valuations and forecasts that are materially too low should bode well for the Fund's absolute and relative performance. Whilst we have recovered the majority of the underperformance associated with Covid-19, we remain c. 3% below both our absolute and relative high watermarks. The above observations make us confident we can reach new ground in due course.

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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