Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: July 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 30 June 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.26	2.59	6.67
Construction and Materials	7.85	1.74	6.11
Banks	14.09	9.35	4.74
Industrial Metals and Mining	10.99	6.29	4.70
Household Goods and Home Construction	5.60	0.95	4.65

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	11.02	-11.02
Personal Care, Drug and Grocery Stores	0.00	7.61	-7.61
Closed End Investments	0.00	6.09	-6.09
Beverages	0.00	3.57	-3.57
Tobacco	0.00	3.25	-3.25

Active stock bets as at 30 June 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.49	0.47	3.02
Barclays	4.05	1.03	3.02
Standard Chartered	3.69	0.69	3.00
Glencore	5.38	2.40	2.98
NatWest	3.54	0.57	2.97
DS Smith	3.11	0.15	2.96
Phoenix	3.12	0.17	2.95
Paragon	2.94	0.05	2.89
BP	6.34	3.46	2.88
ITV	2.69	0.11	2.88

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.24	-3.24
HSBC	2.02	5.44	-3.42
Unilever	0.00	4.51	-4.51
Shell	2.41	7.00	-4.59
AstraZeneca	0.00	7.31	-7.31

Performance to 30 June 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**0.17**	**-2.28**	**315.90**	**1,535**	**1,812**
Lipper UK Equity Income mean*	-0.68	0.10	204.11		
FTSE All-Share TR Index (12pm adjusted)	0.12	2.24	236.79		

Discrete 12-month performance (%) to:

	30.06.23	30.06.22	30.06.21	30.06.20	30.06.19
JOHCM UK Equity Income Fund – A Acc GBP	4.68	-1.44	39.43	-21.14	-9.44
FTSE All-Share TR Index (12pm adjusted)	7.75	1.64	21.04	-12.56	0.14

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 main economic focus in June was UK inflation data and associated moves in interest rates and interest rate expectations.

UK inflation printed at 8.7%, 30bps higher than consensus expectations. Within this, core inflation was also higher than expected, with food price inflation being stickier than expected at c. 18.4%. This disappointing data release led to the interest rate changes noted below.

It is worth considering some points in the detail, that will determine where inflation numbers will move to in the second half of this year and into 2024.

First, we think inflation will fall towards 5% as we move through the rest of this year as base effects on energy prices and petrol prices feed through. Second, we observe the path of producer price inflation, a lead indicator of overall inflation. UK PPI inputs into manufacturing peaked at 24.3% in June 2022, was running at 16.2% in December 2022, 4.2% in April 2023 and was close to flat in the most recent report (0.5%). Thirdly, we must examine food prices and question whether they are increasing by 18.4%. In its latest quarterly update issued mid-June, Tesco (c.27% market share, a good barometer) highlighted like-for-like sales up 8.8% year on year. For food prices to be up 18.4%, volumes would need to be down 10%, which is unlikely to be the case. The sales data from all the supermarket operators does not correlate with ONS inflation data on food. Tesco also indicated 'there are encouraging early signs that inflation is starting to ease across the market'. We also note that the wheat price has halved from the post-Ukraine / Russia high and is now below where it was before the war started and on-shelf milk prices have started to fall. Food price inflation is likely to fall markedly over the next 12 months, which the latest British Retail Consortium report concurred with: 'if the current situation continues food price inflation should drop to single digits later this year'.

Whilst the focus was understandably on the 8.7% inflation print, these points collectively suggest the narrative and the actual position will be very different later this year when we look at the actual inflation numbers in Q4 and the trajectory into 2024.

Of course, underlying price pressures have been driven by the economy actually being stronger than expected in H1 2023. We can see this in recent positive trading updates from the likes of Next, **Marks & Spencer** and Mitchells & Butler. The continued strength in employment markets, wage growth and high levels of excess savings all underpin these trends. The net result of these factors is likely to be a fall in inflation to c. 5%, with a slower move down thereafter, with less likelihood that 2% will be achieved. 3% may become the new 2% in terms of the acceptable inflation number in the years ahead. This could be a global phenomenon.

The 8.7% inflation print led to a knee-jerk (in our view) 50bp increase in interest rates by the Bank of England and a sharp increase in 2-year interest rate expectations, from 4.3% to 5.1%, with 5-year rates rising by c.50bps. This has led to much commentary regarding mortgage pressure on household free cashflow. Whilst this is correct, it will take time to season through, given the majority of the mortgage market is now on 5-year fixed rate products.

We also note there is a higher quantum of savings in the UK than mortgage debt and with saving rate deposit beta (i.e. the pass through by banks to savings rates) now closer to 1, there is a partial offset economy-wide in terms of interest income. We also note only around one third of UK households have a mortgage. This is not to dismiss the impact, there will be one, and we have built it into our thinking on related areas, but it is important to look at the wider context rather than merely focusing on sensational headlines.

The upshot of all the above points is that the terminal peak in interest rates is likely to be higher than it was before the month started but, in our view, will be lower than current market expectations. If the above scenario occurs, it will be a positive tailwind to the Fund.

In the US, despite Powell's hawkish comments last week, it still looks likely that interest rates have peaked. There are mixed signals from the economy with employment data likely to weaken somewhat from here. It is worth pointing out that the US market has looked through this, whilst the UK market, due to issues covered elsewhere in this report, has not. This is shown in the diagram below, which plots UK housebuilders vs US housebuilders.

In Europe, there is a widening gap between Northern and Southern Europe mainly due to weak manufacturing in Germany; this makes calling future European Central Bank policy difficult, as different regions require different approaches.

Performance

Markets remained sluggish in June, with some of the issues noted above dominating, like rising bond yields and the UK economic developments. The UK FTSE All Share was flattish (up 0.12%), the Fund performed in line with this, up 0.17%. Year-to-date, the Fund is down -2.28%, whilst the FTSE All Share is up 2.24%. The Fund performed well in the first half of the month, but this was reversed in the second half

following the UK inflation data / rise in interest rates, despite the benefit to Fund performance from the **Lookers** bid (discussed below), which happened at the same time.

Following a strong start to the year, the Fund has struggled since the Silicon Valley Bank (SVB) news in February, which led to a strong risk-off mentality across markets. This latest bout of risk aversion has left the valuation elastic as stretched as it has ever been, between value and growth, defensives vs cyclicals, large vs small, which is discussed throughout this report. Looking at the peer group, the fund is ranked 4th 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, 2nd quartile over 10 years and is 2nd best Fund in the sector since inception in 2004.[1]

Our largest small cap position, Lookers, was bid for during the month. The premium to the undisturbed share price was c.45%. The exit price was (just) 20% above the combined value of property and net cash. The exit profit multiple was also low, a PE of 8x. These statistics and this outcome reflect the present broken nature of the UK stock market in terms of valuation architecture, which is getting increasing focus from mainstream media and politicians. You may ask why we supported the deal given these points; first pragmatism, as we have to consider where share prices can realistically move to in these market conditions and, second, the re-investment opportunity, as we illustrate throughout this report, there are plenty of opportunities at very attractive valuations to rotate proceeds into.

First Group (up 25% relative) posted strong results, beat forecasts at the profit level, announced a better net cash position, a dividend c.20-30% above our forecast and a new share buyback.

Most UK domestic stocks were weak (except Lookers). This was primarily driven by the inflation print and subsequent interest rate moves discussed above. The share price moves were triggered by the newsflow with little consideration for the starting valuation. Our two housebuilders (**Vistry** and **Bellway**) and brickmaker (**Ibstock**) were all down c.10% relative. Bellway now trades on 0.6x book value (with net cash, ongoing buyback), whilst Ibstock is trading below where it was post Covid and below where it was in relative terms in the week after the Brexit vote. It then had a high net debt position. Now this is closer to a net cash position. **Marks & Spencer** continued to perform well post good results in May.

Banks were mixed, with our overseas banks performing well, such as **Standard Chartered**, up c.7% relative. **Paragon** produced strong results, with a subsequent increase in the share price (9% relative), but the large domestic banks (eg **NatWest Group**) underperformed due to the reasons noted above on housebuilders.

DS Smith fell 12% relative. It is another stock below the Covid low and yet another stock that produced better-than-expected results and a higher-than-expected dividend; we've commented on its valuation below.

Oil and mining were mixed as some stocks performed well (**Glencore**, **Kenmare**), whilst others struggled (**Central Asia Metal**).

[1] Source: Lipper

Portfolio activity

As noted above, the bid for Lookers was one of the main features of the month. Post the announcement and the associated move in the share price, the weight in the fund stepped to c.230-240bp. Given weakness elsewhere, particularly in UK domestics, we reduced our weight in the stock to provide liquidity and added to some of these names. Our weight at the end of the month was c.125bp. There is a chance of a counterbid which, together with the movement in other UK domestic share prices, will determine the trajectory of any subsequent change in our Lookers holding.

Other reductions included Standard Chartered, to keep at our maximum 300bp overweight. This stock has been regaining its poise before the First Abu Dhabi Bank 6 month bid moratorium ends following the well-publicised skirmishes in mid-February. We also reduced First Group reflecting the strong move in its share price. Our new target price, based on 10-12x PE for bus earnings and 5x for rail earnings, remains c.40-50% above the current share price.

As noted last month, certain small caps started to outperform. **Galliford Try** moved to a 3-year high and **International Personal Finance** (IPF) to an 18-month high. We kept our target weights of 110bp and 85bp, respectively, via top-slicing. The valuations of these stocks remain compelling and illustrate, as we do elsewhere in this report, the persistent low valuation across the Fund. Galliford trades below net cash / the value of PFI assets and IPF trades on a PE of 6x and a yield of 9%, both names also had positive newsflow during the month. We also sold fellow small cap position Randall & Quilter, which has been a disappointing performer.

In terms of additions, we continued to add to two of our recent new names, Marks & Spencer and **Inchcape**. There were also several laggards, DS Smith, as noted above, where we moved our position to the maximum 300bp overweight. The stock is now back to where it was in the weeks after the COVID outbreak, its balance sheet is now stronger, the dividend is restored and growing, the company made record profits last year, the plastics to cardboard revolution is now gaining traction, which is a material tailwind and it is taking market share from smaller players. Despite these dynamics, the stock languishes on a PE of 7.5% and a yield of close to 7%.

We also added to **Land Securities**, where the new management team continue showing good management of the cycle, having sold many dry London office assets at good prices in recent years and now recycling the proceeds into various interesting, distressed value opportunities. After a very positive meeting with the Chairman, we added to **Aviva**, where we were reminded that higher interest rates, Solvency 2 reforms, and current life expectancy trends were powerful tailwinds that the business is or will benefit from. This stock is on a PE of 6x and yields 9%.

Other additions include **Conduit**, as the shares were depressed by an overhang of stock relating to the Odey asset management unwind. NatWest which was weak and Central Asia Metals which also underperformed.

Dividend

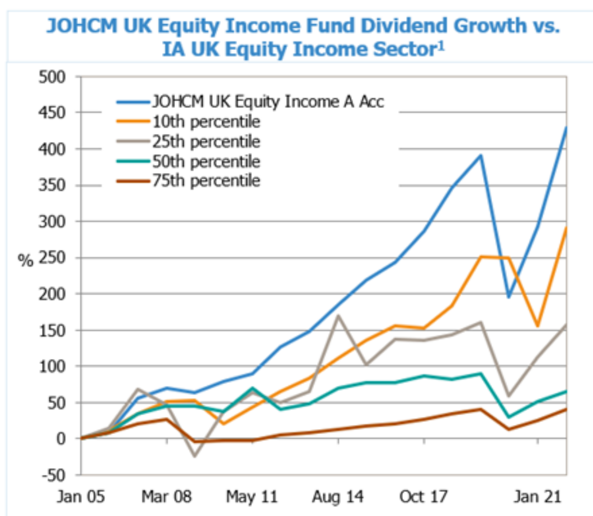
Dividend newsflow in Q2 was largely positive; notable dividend upside surprises included First Group, Paragon and **Shell**. **EasyJet** and Marks & Spencer also confirmed they would return to the dividend list in 6-12 months. There were some offsetting negative changes, for example, we have stripped out additional return (over

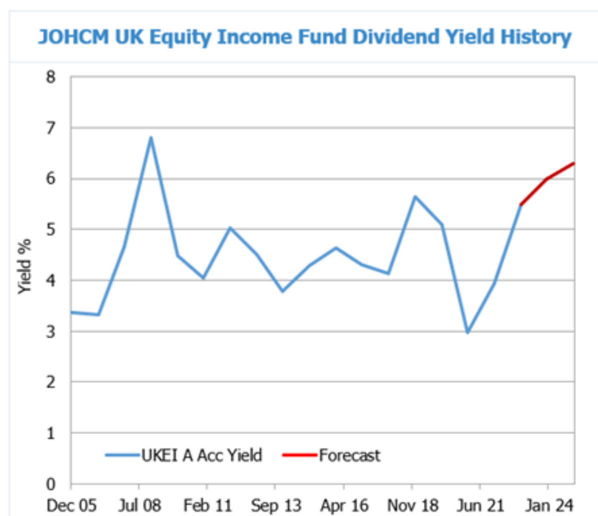
the base amount) for **Glencore**, reflecting the potential cost of any Teck acquisition. We have also added a degree of prudence into our forecasts for certain UK domestic stocks. Sterling has also continued to rally, which is a headwind for UK dividend flow at a system and Fund level, given the quantum of US dollar-denominated dividends.

Our previous guidance for Fund dividend growth for 2023 was 1-5%. We believe that this forecast remains valid, with our current 'live cast' running in the top half of this band. The discrete Q2 2023 dividend, which went **ex** on 30 June, was c.1-2% above Q2 2022, bringing H1 2023 growth to c.6%. The prospective calendar year 2023 dividend Fund yield, based on the above guidance, is now c.6%, which we would expect to grow further in 2024.

At times when performance has been challenging, as it has been in 2023 to date, it is useful to stand back and look at longer-term trends and current valuation versus its history. The first chart (LHS) below shows our dividend growth track record compared to the wider Lipper UK Equity Income universe. We are in the top decile of income growth delivered over the Fund's history, which is approaching two decades, with a CAGR over this time of c.9% a year. Given this has included close to 15 years of zero inflation, the Global Financial Crisis, Brexit and Covid, amongst other challenges, it seems fair to say that this is a solid outcome. This income track record is the main driver behind the Fund being highly ranked in the Lipper UK Equity Income sector since inception on a total return basis.

The second chart (RHS) shows the Fund dividend yield since inception. It was only higher for a brief period during the GFC and the two following years were among the best in the Fund's history, with an absolute return of 87.7%, 11.4% above the benchmark.



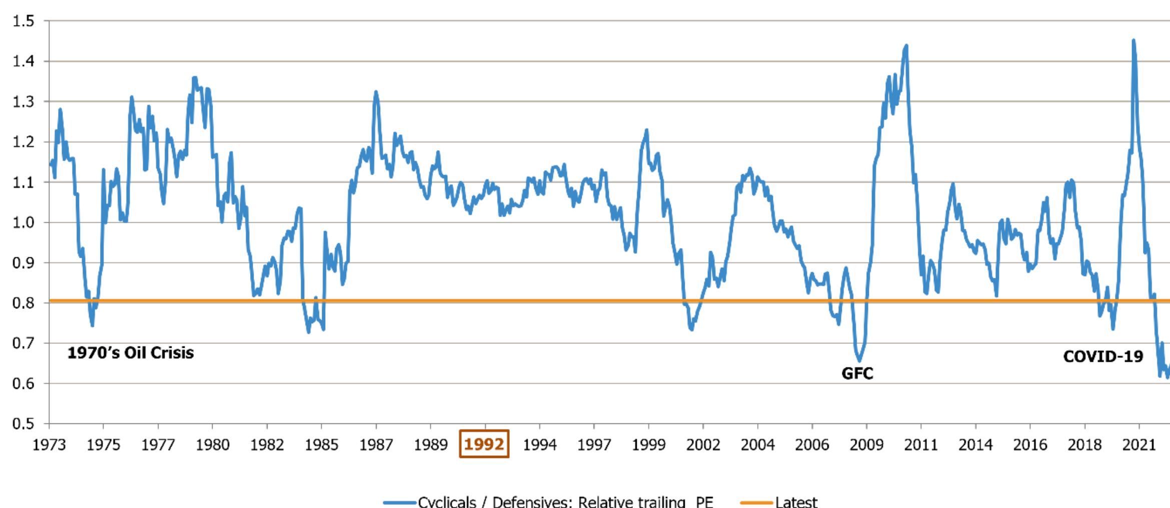


Source: JOHCM/Lipper as of 31 March 2023. Data to 31 December 2024 includes JOHCM estimates. JOHCM estimates of future performance based on evidence from the past performance and current market conditions and is not an exact indicator. Based on 'A' Accumulation share class price on 31 March 2023 (430p). Thomson Reuters Lipper, JOHCM UK Equity Income A Acc vs. IA UK Equity Income sector.

Outlook

As shown above the Fund is close to the cheapest it has ever been on a dividend yield basis. It is also close to the lowest it has ever been on a price to book basis as the chart below shows. This position is driven by severe risk aversion, which is clear in the second chart below, a chart our avid readers have seen before.

Source: JOHCM/Fund analytics as of 31 May 2023.



Source: Exane as at 4 June 2023.

In June, we presented at a J O Hambro Capital Client event focusing on UK equities, and articulated the valuation opportunity embedded in the Fund (LINK to Presentation). During our presentation, we exposed the valuation opportunity which we have discussed at an aggregate level above, at a stock level, focussing on EasyJet, **Keller** and Standard Chartered.

If we focus on EasyJet, we saw it benefit from capacity withdrawal from competitors during COVID, and now excess demand is creating rising prices (we have all seen this phenomenon when booking holidays). Incidentally holiday price increases were one of the drivers of the 8.7% inflation print discussed above. Post Covid Easyjet has an even more dominant position in their key airports (Gatwick, Geneva) due to this capacity withdrawal, creating price tension and cost efficiencies. Margins are improving rapidly towards their pre-COVID levels. We assume they make c.£9 a seat on a recovered basis in 2025, which is less than the cost of a packet of cigarettes. Incidentally, we think that the continued increase in the cost of cigarettes which in the

UK are now c.£13 a packet will accelerate demand decline - this is one reason why we do not own the UK-listed tobacco names. Coming back to EasyJet, the company launched a holiday business c. 3 years ago, leveraging off the airline and filling the void left by the collapse of Thomas Cook. This new business, built on modern systems alongside a low-cost backbone, is now taking market share off legacy operators like Tui. This business is expected to make £80-90m this year, with our expectations for profit in c.3 -5 years focused around £250-300m. EasyJet has a strong balance sheet, will return to the dividend list in the next 12 months, and trades on PE of 9.5x, based on current consensus numbers but 5x our numbers based on the above drivers. We believe the shares could double over the next 2 years. The other examples in our presentation are just as compelling, as are those elsewhere in this report. We believe that there is strong value potency in the Fund. What could change this? Examples include (a) more M&A; in June, the Fund had its first taste of corporate interest after a quiet 18 months, with the announcement of a bid for Lookers. We expect there will be more M&A activity - stocks will be picked off one by one if the low valuation environment continues; (b) a policy change that leads to a dramatic shift in allocations to the UK, the 'mood music' from both Labour and Conservatives suggests there could be such a change in the offing, (c) an economic clearing event that changes the narrative on the UK economy, with the trajectory of UK inflation over the rest of this year acting as a catalyst, (d) a reduction in the risk aversion context which is driving leadership, or (e), just the absence of new issues (e.g. no more events such as Silicon Valley Bank). Whilst we wait for a change, which is likely at some point, the running yield on the Fund remains attractive, balance sheets are strong and most of our stocks are still showing good operational performance.

Further information

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