Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: July 2024

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 2024:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction and Materials	10.64	0.46	10.18
Life Insurance	9.51	2.15	7.36
Banks	15.56	9.97	5.59
Industrial Metals and Mining	9.38	6.30	3.08
Retailers	4.13	1.61	2.52

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	11.41	-11.41
Closed End Investments	0.00	6.30	-6.30
Personal Care, Drug and Grocery Stores	1.61	7.27	-5.66
Aerospace and Defence	0.00	3.87	-3.87
Beverages	0.00	2.75	-2.75

Active stock bets as at 30 June 2024:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix	3.25	0.16	3.09
DS Smith	3.25	0.24	3.01
ITV	3.13	0.13	3.00
Barclays	4.30	1.31	2.99
Standard Chartered	3.60	0.64	2.96
Aviva	3.49	0.54	2.95
NatWest	3.62	0.82	2.80
BP	5.69	3.35	2.34
Legal & General	2.78	0.57	2.21
Keller	2.22	0.04	2.18

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
GSK	2.57	5.37	-2.80
Relx	0.00	2.84	-2.84
Unilever	0.00	4.47	-4.47
Shell	1.45	7.56	-6.11
AstraZeneca	0.00	7.72	-7.72

Performance to 30 June 2024 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**-2.58**	**12.24**	**406.30**	**1,612**	**1,892**
Lipper UK Equity Income mean*	-1.22	7.13	246.26		
FTSE All-Share TR Index (12pm adjusted)	-0.35	8.13	283.55		

Discrete 12-month performance (%) to:

	30.06.24	30.06.23	30.06.22	30.06.21	30.06.20
JOHCM UK Equity Income Fund – A Acc GBP	21.74	4.68	-1.44	39.43	-21.14
FTSE All-Share TR Index (12pm adjusted)	13.89	7.75	1.64	21.04	-12.56

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

Economic data in the US continues to reflect an economy where the consumer has run out of spending ‘ammunition’. Retail sales in May grew by just 0.1% month on month (MoM) and April was revised lower to -0.2%. With the savings ratio below 4%, consumers' spending power is clearly constrained until policy is eased. Several corporates also reflected these weaker spending patterns, including Nike, Walgreens and Brown-Forman. However, the Fed has relatively little room for manoeuvre in the short term, with inflation continuing to prove somewhat sticky above 3%. This month's CPI did come in modestly softer at 0.2% MoM for the core, but the subsequent Fed meeting notes showed that the average member of the FOMC is only assuming one rate cut during the second half of 2024, despite sluggish consumer activity. Interestingly, the Fed also moved its view of the long-term neutral interest rate higher again to 2.8% (vs 2.5% two months ago), which is highly unusual. An obvious conclusion is that it may cut rates by less than some market participants have been hoping for.

The unexpected announcement of a parliamentary election in France had a significant impact on European markets, particularly bonds and politically sensitive sectors in France. The spread between French and German 10-year bonds widened by 25-30bps to around 82bps as investors grew concerned about the possible shift to the right in the political landscape. This led to a short-term fall in business confidence, with the latest PMI survey in France falling below 50. Despite the European Central Bank easing monetary policy for the first time in this cycle, the cut was accompanied by a cautious statement about the pace of subsequent reductions.

As the UK approaches the election on July 4th, the political landscape looks far more predictable. Confidence levels continue to rise across the economy, with consumer confidence hitting its highest level for almost three years and the Lloyds business barometer close to an eight-year high. Inflation hit the Bank of England's 2% target this month, and while the Monetary Policy Committee (MPC) voted to hold rates, the decision was clearly close and we may well have seen a cut if we were not in the midst of an election. Services inflation does remain somewhat elevated at 5.7%, although this month's reading was impacted by much higher airfares, which are a volatile component. It was also impacted by the lingering effect of April's 10% increase in the minimum wage, but elsewhere in the labour market, wage pressures continue to ease markedly. Unemployment hit its highest level since COVID at 4.4%, and the relationship between vacancies and unemployment returned to its pre-pandemic level of 0.6, suggesting a market in balance. Retail sales were strong in May, growing by 2.9% MoM, although this partly reflected a bounce back from the rain-affected April reading. UK Q1 GDP was upgraded to 0.7% QoQ driven by investment and consumer spending, suggesting that the consensus forecast of only 0.7% for the whole of 2024 looks far too conservative, particularly given the encouraging lead indicators across the economy.

In the world of commodities, the oil price rose close to 10% during the month, defying a consensually bearish narrative. In contrast, copper gave up some of its gains from 2024, falling around 5% as economic data from China continues to look soft.

Performance

The UK stock market's strength subsided in June (with the FTSE All Share down 0.35%). The fund was down -2.58%, underperforming the market by 2.24%.

Year-to-date, the Fund is up 12.24% compared to the market, which is up 8.13%.

Looking at the peer group, the Fund is ranked in the 1st decile within the IA UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked 1st quartile over three years, five years and 10 years and is the best Fund in the sector since inception in 2004.[1]

In many respects, June's performance trends represented a modest pullback and some profit-taking in some of the sectors that had led the market higher in the previous three months. For example, a number of our stocks in the construction sector, such as **Galliford Try**, **Keller**, and **Kier**, underperformed by 6-9% even though there was no change in company prospects. Similar observations could be made about **WPP** (-10% relative) and **Standard Chartered** (-6% relative).

The mining sector was weak as most commodity prices returned some of their 2024 gains, with copper falling around 5% during the month. Continued weakness in Chinese economic data also had an impact, and stocks, including **Glencore**, **Central Asia Metals**, and **Kenmare**, were all down 6-8% relative. Elsewhere, one of our domestically orientated small caps, **Headlam**, fell 15% relative, as a large line of stock created an overhang. This was cleared at the end of the month. **Legal & General**'s capital markets day saw the shares fall around 10% over the month. Some investors were disappointed by the new capital distribution policy (see below). Lastly, **Energean** announced the sale of its operations in Italy, Egypt and Croatia for a very respectable consideration, but the shares fell 15% over the month as, for some investors, the reduction in short-term production came as a surprise.

Significant positive performers were thinner on the ground this month, but Suzano's bid for International Paper fell away, meaning that International Paper can now proceed with the previously announced acquisition of **DS Smith**. DS Smith shares rose by around 15%. **International Personal Finance** successfully refinanced its Eurobonds, which helped the share price rise by about 10% during the month. Lastly, **Phoenix** outperformed by 5% as persistent rumours about potential corporate activity continued to circulate.

Portfolio activity

With the pullback in the market and Fund performance in June there were few stocks that were hitting sell levels (from a valuation perspective), with the majority materially away from target prices and, hence, in add territory.

Sells were mainly linked to stocks that did perform well during the month, hitting their target weights, and hence were marked back to those levels accordingly. **ITV**, **DS Smith** and **NatWest Group** at 300bps (our maximum overweight) and **Currys**, before it fell at the end of the month, (to 185bps) all fit into this category. At the start of the month before they weakened, we continued to reduce our housebuilding

[1] Source: Lipper

position – which now sits at c150bps across two holdings – **Bellway** and **Vistry**. We have material exposure through the housebuilder supply chains (with a new stock added – see below), which means when demand recovers, given the very low valuations, there will be a material performance tailwind. Most of these stocks fit into our ‘coiled spring’ thesis. Essentially, housebuilders have priced in a recovery whilst their supply chains have not. We also continued to modestly trim **Diversified Energy**, which has shown some recovery and **Paragon**, which stepped to a new high after their results announcement.

We have recently added two new stocks to the Fund: **Forterra** and **FDM**. Forterra, the second-largest brick producer in the UK (with **Ibstock** – already owned - being the number one), is well-positioned for growth. Housebuilding is at the foothills of a volume recovery. Factors that will drive this include falling interest rates (already reflected in lower two to five-year fixed rates) and the Labour Party’s housing plans (aiming for 1.5 million new homes over five years). Even if the Labour Party deliver 200k new homes per annum (compared to their stated target of 300k pa), that is c33% higher than the current level. Finally, there is the general recovery in the UK economy, with factors such as the rise in real incomes helping. Forterra is well invested, having recently commissioned a new brick plant (which we visited during the month), which is efficient and has lower carbon intensity. As demand rebounds, this will also enhance operational leverage. The stock currently trades at a price-to-earnings (PE) ratio of 5x based on recovered earnings, and if housing starts reach 200k per annum, it could potentially double.

FDM is a stock we previously owned when it was IPO’ed a decade ago, but was sold on strong performance. Recently, due to profit warnings related to the weak macro environment, the stock is now approximately 75% below its peak. FDM operates as a global tech-based consultancy, placing trained (IT) employees into large businesses, primarily in the financial sector. Given technological changes (AI, digitalisation, legacy system updates), demand for FDM’s services will likely accelerate. The company boasts a strong management team, a unique platform, and a valued client base. Additionally, FDM maintains a net cash position on its balance sheet.

Elsewhere, we added to **Easyjet**, which like **Forterra**, is trading on a PE of 5x normalised EPS, **First Group** which had another set of strong figures (here our target price, which fully accounts for the staggered nationalisation of rail assets, at 250p is c.100p higher than the current share price) and **Legal & General**, which as noted above, held a poorly received capital markets event. As we note below, the dividend growth rate was reduced from 5% to 2% - but a new buyback more than offset this. With a yield of 9% and significant excess capital, the share price is factoring in a dividend cut, not growth. We viewed the reaction as churlish. We also added selectively across the oil sector (**BP**) and the mining sector (**Anglo American** and our smaller names – **Kenmare** and **Central Asia Metal**).

Dividend Update

Our formal dividend growth forecast for 2024, established last December, anticipated flattish dividend growth in 2024 compared to 2023. This outlook considered four key factors: 1) prioritisation of share buybacks: Low valuations are encouraging companies to allocate more shareholder distributions toward share buybacks rather than dividends (this was evidenced by Legal & General during the month - see above); 2) delayed UK domestic dividend growth: some of our UK holdings are expected to experience sluggish dividend trajectories in 2024. However, an anticipated earnings recovery as the economy rebounds should drive dividend growth in 2025/26; 3) mining sector dividend impact: the recent acquisition of Teck businesses by Glencore has temporarily reduced its dividend flow (whilst it uses more of its 2024 free cashflow to de-gear); and 4) modest sterling appreciation: The higher average USDGBP exchange rate in 2024, compared to 2023, will dilute the value of dividends received in sterling terms.

At the halfway point of the year, several companies, including **Keller**, Paragon, and First Group, surprised investors with higher-than-expected dividends. Partly offsetting this, we have had several disappointments, mostly linked to point 2) above = the trajectory of UK domestic dividend flow e.g. **DFS**.

We have also seen a positive rotational effect - strong performance year to date has meant we have been selling good performers on low yields and adding higher-yielding shares. This creates dividend growth at a Fund level.

We have retained our formal guidance of a 'flattish' outturn for dividend growth in 2024, but the risk to this is now slightly to the upside. We will update this at the end of Q3, post the interim results season.

In terms of phasing, the Q1 dividend was down c.14%, with Q2 up c.24%. We expect the Q3 and the Q4 dividend to be down low to mid-single digits. This is driven by different ex-dividend dates year on year. About 40% of the annual Fund dividend comes in the Q2 heavy 'ex dividend' period.

The Fund currently yields c.5%.

In addition to the dividend profile, there continues to be material share buyback activity across the Fund. Currently, c.45% of the Fund's holdings (by weight) are buying back shares, with the banking, oil, and insurance sectors featuring prominently. A number of small caps have also recently joined the list, reflecting the (low) valuation dynamics e.g. **Severfield**/**Eurocell**.

In aggregate, our holdings are buying back c.£40bn in equity this year, with the final figure likely to be slightly more than the equivalent in 2023. This represents c.5% on average of the share count of the underlying companies across the Fund. Across two years, a total of 10% of the aggregate share count will be de-equitised. This is material and, at current valuations, is significantly accretive to earnings per share, eventually dividends per share, and potential share price upside for shareholders remaining on the register.

5% dividend + 5% buyback = 10% - a powerful dynamic.

Outlook

The UK's economic outlook continues to improve, and a decisive election result could accelerate that process. With inflation back to target, the Bank of England will modestly ease policy during the second half of the year, but the scale of the rate cuts may be less than consensus expects because the economy could pick up very rapidly. With consumer confidence close to a 3-year high, savings ratios elevated, real wage growth of around 3% and a vast unspent stock of excess savings accumulated since COVID, the trajectory of improvement is very likely to surprise positively. As such, the window of opportunity for the Bank of England is quite narrow, and they may well only ease policy by 50-75bps over the next 12 months.

With political uncertainties rising across Continental Europe, the UK will look comparatively stable (not something we have been able to say for a while), and this, combined with the improving domestic economy, should continue the nascent process of the UK stock market coming back in from the wilderness, particularly for international investors.

Valuations continue to look compelling in an international context, which is why there has been a material pick up in M&A activity. If elected, the new Labour administration is also likely to focus further on measures to increase allocations to domestic equities.

Whilst international investors remain transfixed by the performance of the mega-cap tech sector in the US, an environment of an improving domestic economy, modest monetary easing but a risk-free rate that remains above 4% should make valuation-focused strategies generating a c5% dividend yield and a total distribution yield of c.10% including buybacks, look highly attractive. We continue to orientate the portfolio towards companies that will benefit from a pick-up in consumer spending and a continuation of large-scale infrastructure projects. As we highlight above, many stocks in this area have the capacity to double or more.

We remain highly constructive about the prospects for the Fund.

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