Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: March 2018

Active sector bets for the month ending 28 February 2018

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.44	3.10	+5.34
Banks	16.49	11.58	+4.91
Construction & Materials	6.08	1.43	+4.65
Oil & Gas Producers	16.16	12.28	+3.88
Mining	10.52	6.94	+3.58

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.33	-5.33
Pharmaceuticals & Biotechnology	2.70	6.90	-4.20
Equity Investment Instruments	0.72	4.65	-3.93
Beverages	0.00	2.93	-2.93
Personal Goods	0.00	2.22	-2.22

Active stock bets for the month ending 28 February 2018

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.87	0.86	+3.01
Lloyds Banking Group	5.07	2.09	+2.98
BP	6.90	3.92	+2.98
ITV	3.12	0.27	+2.85
DS Smith	2.59	0.20	+2.39
Standard Life Aberdeen	2.72	0.43	+2.29
Rio Tinto	4.25	2.05	+2.20
National Express Group	2.25	0.06	+2.19
Barclays	3.58	1.53	+2.05
Morgan Sindall Group	1.85	0.02	+1.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.27	-4.27
GlaxoSmithKline	0.00	2.68	-2.68
Diageo	0.00	2.60	-2.60
Prudential	0.00	2.02	-2.02
Unilever	0.00	1.84	-1.84

Performance to 28 February 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-3.20**	**-3.42**	**278.50**	**£3,447mn**
Lipper UK Equity Income mean*	-2.88	-3.92	165.35	
FTSE All-Share TR Index (12pm adjusted)	-3.34	-4.21	170.97	

Discrete 12-month performance (%) to:

	28.02.18	28.02.17	29.02.16	27.02.15	28.02.14
JOHCM UK Equity Income Fund – A Acc GBP	**10.67**	**25.69**	**-8.60**	**3.76**	**22.66**
FTSE All-Share TR Index (12pm adjusted)	4.96	23.09	-7.53	5.70	13.14

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 new Chair of the Federal Reserve showed no lessening in the central bank's resolve to continue tightening monetary policy. Jay Powell, speaking at his first congressional testimony, adopted a hawkish tone, highlighting that further interest rate rises were required to avoid an overheating US economy. Most pertinently, he explicitly stated that the new stimulative fiscal policy measures introduced by the Trump administration mean that, all other things being equal, the Fed will need to tighten even faster to keep the economy in balance. Whilst inflation thus far has remained meaningfully below the 2% target, he expects it to move higher during 2018 as wage inflation accelerates.

Whilst these comments from Mr Powell came towards the end of the month, strong US economic data released earlier during February, particularly around wages, meant bond yields continued to rise and triggered a sharp sell-off in equities. This is no surprise as the complacency in markets around the impact of rising rates on equity valuations has been surprising up until now. As other central banks continue to tighten, too, in response to the strongest synchronised global growth for a decade, it feels likely that we should periodically expect further sell-offs in equity markets as market participants adjust to this new regime.

In the UK, February's labour report, which recorded the first rise in the unemployment rate for a number of years, on the face of it presented a more mixed picture. Closer examination of the data, however, showed that the only reason the unemployment rate rose was that more people declared themselves as available for work (economically active), particularly women. In contrast, the employment rate (the proportion of 16-64 year-olds in work) rose and is very close to an all-time high, while the number of vacancies rose again, hitting a record high of 823,000. Consequently, it was no surprise to see average earnings growth rising again to 2.5%. We continue to expect earnings growth to move towards 3% in the coming months.

News flow around Brexit and the transition deal has clearly been somewhat disappointing in recent weeks and increases the delicate task Mrs May faces in keeping the process moving forward. In this regard, it was not surprising to see sterling weaken modestly, following its strong run from the end of last year. However, barring a complete breakdown in negotiations with the EU, this weakness should prove temporary, as Governor Carney is also likely to continue to tighten policy ahead of market expectations as the slack in the economy erodes.

Consumer confidence throughout Europe continues to improve across the region, whilst comments from the UK-domiciled Asian-focused banks support the view that economic growth in that region is also accelerating again.

Performance

February saw a return of volatility, with a sharp fall in global stock markets in the early part of the month, albeit followed by a partial recovery in the second half. The FTSE All-Share Total Return Index (12pm adjusted) posted a decline of -3.34%. The Fund performed slightly better than the market in returning -3.20%. Year to date the Fund is down -3.42%, again slightly better than the FTSE All-Share Total Return Index (-4.21%).

Looking at the peer group, the Fund ranked fourth 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, 10 years and since launch (November 2004) and first quartile (second decile) over five years.

We would ordinarily expect the rise in bond yields seen in February to cause the Fund to outperform more materially, given its positioning. We saw the positive impact come through modestly in certain areas such as the banks, but we do not think the full effect of the bond market move has been seen yet in the equity market. This should provide a tailwind for the portfolio in the coming months.

February was a busy month for company results, and the majority of our stocks delivered well. At a sector level, there are reasons to be positive about the banks. In general, they are clearly exiting the legacy period of the financial crisis with strong capital positions. This has allowed **Lloyds Banking Group** to announce its first share buyback and **Barclays** to guide towards a much higher dividend. As we expected, **Standard Chartered** also returned to the dividend list.

The mining sector has also seen accelerating free cash flow turn into strong dividend growth. **Rio Tinto** and **Anglo American** both exceeded our dividend forecasts while it is likely that **Glencore** will do so later this year. In our view, both the bank and mining sectors remain very cheap and under-owned. Both sectors outperformed during the month.

Elsewhere, UK domestics continued to show some life. Our building / construction shares were mostly up in relative terms, with both of our brick stocks being notably strong, while our retail names also performed well.

Turning to the negative contributors, our two big oil names, **BP** and **Royal Dutch Shell**, produced good results amid clear evidence that free cash flows have recovered strongly. Nevertheless, both underperformed modestly as the market remains solely focused on changes in oil prices.

A trading update from **Northgate** had a negative impact (the share price was down c. 15% relative). The update showed good momentum in key KPIs like vans on hire, particularly in the Spanish business, as well as highlighting an optimisation in the approach to monetising its van fleet – vans are being kept for longer and sold later. This change hit near-term profit forecasts but is a positive over the longer term as it enhances cash flow and net present value; the market, wrongly in our view, chose only to focus on the P&L impact. **Standard Life Aberdeen** also underperformed – we discuss this position in more detail in the next section.

Portfolio activity

We added one new position to the Fund during February, **Diversified Gas & Oil (DGOC)**, and sold one position, **Thomas Cook Group**.

DGOC operates small-scale ‘nodding donkey’ oil and gas wells in the north-eastern corner of the US. Larger operators are disposing of these assets at low prices (c.4x EBITDA), and DGOC is acting as a consolidator within its current geographic footprint. The two value drivers are the low price paid for these assets and the network benefits of adding these acquisitions into an already established operational footprint.

We entered the stock via a placing, which raised money to fund the company's latest two acquisitions. With a market capitalisation of close to £300m, the placing has materially changed the size of the company. This is now reflected in its cost of debt, refinanced from a high rate of 8.5% to 2.5% following the equity fund raise. The stock is on a free cash flow yield of >15% and has a dividend yield of > 5%.

Elsewhere, we sold Thomas Cook following strong share price performance (up 50% over the last 12 months) after management executed on its restructuring and profit improvement programme despite difficult market conditions. The share price performance left the stock on a more reasonable valuation, which, coupled with the low dividend yield, led to our decision to sell. The stock added 20bp to Fund performance during our period of ownership.

We also took profits in a number of stocks that had performed well, namely **Vitec**, **Forterra** and **Hollywood Bowl.** All three of these stocks still have good upside and positive momentum in their businesses.

We continued to add to two of our more recent additions, **Standard Chartered** and **Hammerson**. The latter remained weak after the announcement of its acquisition of Intu, which will consummate later in 2018. The stock trades on a 45% discount to its book value. As noted above, Standard Chartered, which is now c. 1% of the Fund, returned to the dividend list, with its full-year results showing a strong acceleration in revenue growth. We also added to **DFS**, **Rank** and **Northgate**.

Two other stocks that we added to during February were **Standard Life Aberdeen** and **Vodafone**. The former weakened following the announcement of the potential loss of the Lloyds asset management contract. In addition, the market took an initially negative view of the sale of its life and pensions business to **Phoenix Group**. This negativity revolved around the headline price and the lack of clarity over how the proceeds would be used. We believe the latter will be made clear when the deal documentation is published. The board's track record on capital allocation decisions gives us confidence that an appropriate amount will be handed back to shareholders and not horded. Standard Life is also keeping the fastest-growing part of the life / pensions business, the UK retail wrap platforms, which generate c. £200m of annual revenue. We believe this to be a valuable franchise that needs to be adjusted for when considering the headline price achieved. In terms of the wider valuation of the business, stripping out the value of Standard Life Aberdeen's two Indian businesses and the excess capital (which will be returned) leaves the residual pure asset management business on a P/E multiple of just 6x. The stock also yields over 6%.

Vodafone's valuation (with a dividend yield of 6.5% and a free cash flow yield of 8%) also looks anomalous given the momentum in the business and the direct and indirect benefits which would flow if it were to consummate the Liberty transaction, which it has confirmed is under discussion.

Outlook

It is becoming clearer by the month that the path to policy normalisation has categorically begun in the US, the UK and Europe. The continuation of the rise in global bond yields during February was very encouraging evidence that this transition to a more normal interest rate environment is underway. Higher wages and higher inflation – the main drivers of this – also saw more evidence of upward movement during the month, as discussed above.

The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, it has undoubtedly pushed valuations of many assets and individual instruments to elevated levels that will be hard to justify if the cost of capital rises. We indicated at the end of last year that we would not be surprised if markets, after a strong run over a number of years, found life tougher at a headline level, as this adjustment in bond yields feeds through. The stock market volatility / downward market adjustment during February is evidence of this, and we expect, as indicated above, it will remain a theme during the rest of 2018.

Within the equity market, we strongly believe that the overvaluation is most apparent in consumer staples and other perceived defensive sectors, such as utilities and pharmaceuticals. Conversely, we believe that many of the areas to which the Fund is exposed will respond well to a change of stock market leadership if monetary policy normalises, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also selective opportunities in the UK domestic arena, too.

Although the Fund is close to an all-time relative and absolute high, it is very encouraging that valuations within the Fund remain very low. Looking at our top 10 active positions (shown on the front page of this document), eight of them are either on a P/E ratio of less than 10x or a free cash flow yield of >10%. The other two, **DS Smith** and **National Express**, whilst slightly higher rated

(12-13x P/E) are not expensive in an absolute sense and are very cheap in comparison to other defensive stocks.

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 is an important driver of the unit price. As we noted in December's bulletin, when we guided to mid-single-digit growth in the Fund dividend for 2018, the Fund's prospective yield for 2018 is c. 4.50%. We will update our guidance on the Fund dividend formally in next months' update when the full-year results season has ended, but we remain very comfortable with the current guidance. This is despite the pressure the rise in sterling has had on UK plc dividend flow, which we had budgeted for in the guidance we provided. This yield, strong dividend growth and low valuations embedded across the portfolio, coupled with the shift in monetary policy, leave us cautiously optimistic in our outlook for the Fund's relative 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

Investments fluctuate in value and may fall as well as rise. Investors may not get back the value of their original investment. Past performance is not necessarily a guide to future performance. Dividend yield quoted is prospective and is not guaranteed.
Investors should note that there may be no recognised market for investments selected by the Investment Manager and it may, therefore, be difficult to deal in the investments or to obtain reliable information about their value or the extent of the risks to which they are exposed.

The Investment Manager may undertake investments on behalf of the Fund in countries other than the investors' own domicile. Investors should also note that changes in rates of exchange may cause the value of investments to go up or down.