JOHCM UK Equity Income Fund

Monthly Bulletin: March 2020

Active sector bets for the month ending 29 February 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.81	3.51	+6.30
Mining	10.02	5.98	+4.04
Financial Services	8.65	4.65	+4.00
Media	7.39	3.80	+3.59
Food & Drug Retailers	4.92	1.69	+3.23

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.53	-8.53
Equity Investment Instruments	0.00	5.62	-5.62
Tobacco	0.00	4.10	-4.10
Beverages	0.00	3.47	-3.47
Travel & Leisure	1.22	4.39	-3.17

Active stock bets for the month ending 29 February 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
ITV	3.25	0.21	+3.04
BP	6.85	3.85	+3.00
Barclays	4.23	1.24	+2.99
Phoenix Group	3.14	0.18	+2.96
DS Smith	3.06	0.20	+2.86
Standard Life Aberdeen	3.16	0.31	+2.85
Lloyds Banking Group	4.45	1.64	+2.81
Aviva	3.46	0.67	+2.79
Glencore	3.76	1.01	+2.75
Legal & General Group	3.20	0.74	+2.46

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.38	-4.38
GlaxoSmithKline	0.00	3.73	-3.73
British American Tobacco	0.00	3.37	-3.37
HSBC	1.71	5.01	-3.30
Diageo	0.00	3.04	-3.04

Performance to 29 February 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	**-11.07**	**-15.01**	**247.00**	**£2,287mn**	**£2,784mn**
Lipper UK Equity Income mean*	-9.58	-11.96	159.74		
FTSE All-Share TR Index (12pm adjusted)	-9.37	-11.95	170.20		

Discrete 12-month performance (%) to:

	29.02.20	28.02.19	28.02.18	28.02.17	29.02.16
JOHCM UK Equity Income Fund – A Acc GBP	**-4.77**	**-3.73**	**10.67**	**25.69**	**-8.60**
FTSE All-Share TR Index (12pm adjusted)	-1.20	0.93	4.96	23.09	-7.53

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.

Fund size change - reminder

A quick reminder that the drop in the Fund's size in January followed the long-planned move by our largest client (which was c. 20% of the Fund) to transition out of the Fund into two segregated accounts, a shift that happened in early January. The strategy size remains similar with modest inflows in February.

Economic developments

Towards the end of the month, investors became increasingly concerned about the global spread of the coronavirus and its potentially damaging impact on economic activity. As has been widely discussed, it is the disruption from preventative actions that will have the biggest impact on economies rather than the illness itself. However, markets have moved quickly to price in a significant slowdown in activity, with the US 10-year Treasury yield hitting a new low of 1.15%. This looks like a severe reaction at this stage, but whilst the relatively recent experiences of SARS and swine flu can provide a useful road map, the scale and footprint of this outbreak is likely to be more severe and could cause a short-term period of economic contraction. In the shorter term, global supply chains, particularly those relying upon manufacturing in Asia, will be tested, although at the time of writing, Chinese factories are beginning to re-open. Obviously the sharp fall in the latest Chinese manufacturing PMI to 35.7 (from 50.0) reflects the impact of the containment measures implemented in February.

Most central banks (apart from the Fed) have limited capacity to provide conventional stimulus via monetary easing, although we are still likely to see some form of globally co-ordinated response which will include a combination of monetary easing, liquidity provision and fiscal stimulus. With global interest rates already low in absolute terms, we continue to believe that policy makers will increasingly focus on fiscal stimulus, with the UK in the vanguard. Indeed the changing of the Chancellor indicates that the Johnson administration will not prioritise a path to a balanced budget in the short term, preferring to take advantage of the very low government bond yields to substantially increase infrastructure spending.

The budget this month should provide clarity on this front and will be intended to offset the business investment caution that could still prevail during the UK-EU trade negotiations. However, it should not be forgotten that around 65% of UK GDP is driven by consumer expenditure. In that regard, the pick up in activity since the general election is welcome. Residential housing markets are seeing increased prices and levels of transactions, with the latest RICS survey reporting new buyer enquiries up 23%. More broadly, a number of data points from restaurant and leisure

companies (such as The Restaurant Group reporting YTD sales +5%) point towards a stronger start to 2020. Even data from the challenged retail sector has begun to tentatively improve, with the CBI's distributive trades survey hitting a 10-month high and retail sales posting a healthy 0.9% increase in January. Clearly this momentum will be challenged by the spread of the virus, but the underlying state of households' cash flow is very strong and can withstand a short-term setback.

In the US, economic activity has continued to progress reasonably smoothly, with a number of the regional manufacturing surveys such as the Philadelphia Fed's index showing the strongest reading for three years following the greater clarity over the trade dispute with China. However, any virus-driven slowdown could have wider impacts on the political landscape, as it may test President Trump's strongest credential, particularly when contrasted against the highly socialist policies of Democrat presidential candidate Bernie Sanders. If markets begin to worry that Sanders could win in November, it may have a meaningful effect on stock market leadership, particularly the big technology names. In Europe, economic growth was minimal towards the end of 2019. Growing signs that Germany may loosen its stance on fiscal policy and its adherence to a budget surplus are a move in the right direction. This will need to continue if the virus has a sustained impact.

Performance

The market, represented by our benchmark, the FTSE All-Share Total Return index (12pm adjusted), fell sharply during February, driven by newsflow surrounding the coronavirus. The Fund was weaker than the market over the month in returning -11.07% versus -9.37%. The indiscriminate selling in the last week of the month led to many dislocations in share prices, particularly in the small- and mid-cap space, which will take time to smooth out.

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

As indicated above, the downward move in bond yields highlights an extreme 'risk off' sentiment which was also very evident in equity markets. Defensives performed strongly and cyclicals, banks and the commodity sectors fell materially. This provided a significant headwind to the Fund's performance. The polarisation between growth and value is now wider than it was during the TMT bubble and last August (when the performance differential last hit a wide point before value rallied). The gap is now unprecedented.

As well as this general shift to perceived (but very expensive) safety, we had two stocks specifically affected by the virus. Firstly, small-cap **Norcros** warned of supply chain issues from its China supplier base. The downgrade was c. 5% while the shares fell c. 30%. **Easyjet** also predictably fell by a similar amount. We added to both (see portfolio activity section for further detail).

On the positive side, our UK construction names performed well which led to a number of portfolio changes (see portfolio activity section). In contrast, other UK domestics like **ITV** performed poorly.

The majority of our results during the month were positive; names like **Vistry** and **Countryside** posted good results and the majority of our meetings with management teams have been positive. We did, however, have two disappointing sets of results during the month. **WPP** fell following its full-year figures that showed revenue c. 1% lower than expected with margins similarly lower. The end goal articulated by the then new management team a year ago has not changed but it has pushed the timetable out. The shares trade on a P/E yield cross over of 8x and 8% respectively. The other disappointment was **Hammerson** cutting its dividend more materially than it needed to (and more than we expected) to give it more flexibility. Part of the reason for the dividend cut was assets sales, which improved the quality of the portfolio and reduced debt, which should eliminate questions over its balance sheet. The shares trade at 200p vs a NAV of 600p just released and a trough NAV (JOHCM estimate) of c. 500p. A third of the NAV is premium outlets, the biggest of which is Bicester Village. Another third is France / Ireland, which looks reasonably well placed, whilst the final third is UK shopping centres. Here a large part of the value is in larger centres such as the Birmingham Bullring. The discount to NAV looks astonishing to us.

Portfolio activity

We sold **Morgan Sindall** from the Fund as its yield fell below the market average and therefore no longer met our process criteria. Its share price has trebled since the Brexit vote as a result of good management, positive margin progress in a number of its business units, notably construction and urban development, and excellent balance sheet management, with net cash consistently beating expectations (in contrast to Kier and Carillion). It has been one of the biggest contributors to the performance of the Fund since its inception, generating over 250 bps of relative performance. This is another example of why having sensible exposure to small caps in the Fund is important to maximise the performance potential. Our small cap weight is c. 19%, down from 22% in the middle of last year. Our target medium term range is 18-20%.

The majority of our other construction holdings (c. 10% of the Fund) were also strong. We reduced the weightings of **Forterra**, **Vistry** and **Countryside**. These stocks still have upside but the strong recent price action has meant upside to our target prices are less and weightings have been adjusted accordingly. The outlook for construction sector looks promising given housing-related policy, the improved consumer confidence in the UK, HS2 contracts and the likely additional fiscal investment in the upcoming budget. We added to **Mccarthy & Stone** and **Norcros** (following the warning noted above).

In contrast to the strong construction sector, other areas within UK domestics underperformed. We added to some of our holdings on this weakness. Notable examples include **Tesco**, which is now one of our top 15 active positions, and the newly merged **Redde Northgate**, where the rationale for the merger still has not been submitted to a proper full analyst meeting. In recent days both the CEO and the Chairman acquired shares in the stock, which was encouraging.

The market panic and fall associated with the coronavirus led to a number of sharp moves, as noted above. In broad terms, we added to financials, mining and oil, which all fared poorly. Turning to the banks, we added to **Lloyds Banking Group**, **Barclays** and **Standard Chartered**, whilst we continued to trim **HSBC,** which had a disappointing set of results and still has not provided clarity over who will lead the bank as permanent CEO. In mining, we added to **Anglo American**. It had good results that demonstrate the rewards of a more diversified product suite (compared to its peers) while also benefiting from demand for its platinum group metals (PGM) from automakers requiring more emission-friendly solutions. Elsewhere, we added modestly to our oil names, mainly **BP**, which is our highest conviction name in this sector.

As mentioned above, there were also some specific hits to Fund performance due to the coronavirus. We added materially to Easyjet, which fell c. 30% in the last week of the month. It is now, again, trading just above replacement cost. Prior to the virus outbreak the company was making positive moves on numerous fronts, such as the new holidays business, yield management and costs. A stock’s long-term positives, along with its valuation, have to be remembered during periods of market turbulence, such as the one we face now. Furthermore, if there is a prolonged period of weakness for the travel sector, Easyjet will benefit from the difficulties faced by its financially weaker competitors (as it did with Thomas Cook last year). We have seen similar scenarios play out in the past, SARS for example. The lesson is not to forget the long-term drivers.

We initiated a position in **Investec** and, depending on the valuation, will be interested in Ninety One, the asset management business scheduled to be spun out of Investec in March. Ninety One is one of the best asset management businesses in the UK, in our view. It has a global presence that has largely been built organically since it was formed in 1991. Ninety One earns a relatively low margin of 32%, but that has ensured it is well invested compared to competitors who run higher margins. This has resulted in a strong and consistent record of new asset flows. Removing Ninety One from Investec leaves a bank which will have a higher tier 1 capital position (courtesy of the split mechanics – the low capital ratio had hitherto been one of our concerns), which is in the process of refocusing itself after the two co-founders and former CEOs left the business. It is one of the cheapest banks in the world at a 0.55x book value, once the asset manager and its wealth management operations are stripped out of the valuation metrics.

Finally, we reduced our position in **Brewin Dolphin**, which, at 15x earnings, is one of our most expensive holdings in the Fund, and also added to **Hammerson** and **Legal & General**.

Outlook

Markets sold off sharply at the end of February. Whilst the scale of the sell-off has surprised us, markets have looked extended for a while, especially in the US and within growth / momentum stocks. This, in addition to the role of machines, AI and ETFs, has meant we have witnessed a very sharp fall with no natural stabilisers to halt it. In the very short term, value stocks have fallen more than growth/momentum stocks because of a perceived higher economic cyclicality. However, with the market more distorted than it was at the height of the TMT bubble, this looks like the wrong reaction to us.

Central banks have limited scope for stimulus from a monetary policy point of view, but governments will probably step up on the fiscal side. The coronavirus will cause a soft patch economically - but it should be finite. If the virus is not contained or slowed down by the onset of warmer weather, or a workable medical treatment, then perhaps we will see no earnings growth this year rather than the +7-8% that was previously assumed. Nevertheless, our portfolio of stocks yields c. 6.5% this year even with no growth. Our current live dividend growth forecast remains higher than our existing guidance of low single-digit growth with stocks like BP beating our forecast in recent weeks. We will provide a full update on the Fund dividend at the end of Q1 as usual.

Whilst we still think the growth and momentum bubble looks dangerous (and would tread carefully there), in our world of value, stocks look extremely cheap to us.

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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