JOHCM UK Equity Income Fund

Monthly Bulletin: March 2021

Active sector bets for the month ending 28 February 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.46	3.29	+7.17
Mining	15.43	9.14	+6.29
Media	8.10	3.20	+4.90
Food & Drug Retailers	5.28	1.70	+3.58
Banks	11.20	7.69	+3.51

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.40	-7.40
Equity Investment Instruments	0.00	6.81	-6.81
Personal Goods	0.00	4.77	-4.77
Travel & Leisure	1.05	4.93	-3.88
Beverages	0.00	3.35	-3.35

Active stock bets for the month ending 28 February 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.49	1.25	+3.24
BP	5.74	2.70	+3.04
Phoenix Group	3.19	0.18	+3.01
Glencore	4.47	1.47	+3.00
Aviva	3.64	0.65	+2.99
Anglo American	4.60	1.62	+2.98
ITV	3.13	0.19	+2.94
Legal & General	3.63	0.71	+2.92
WPP	3.38	0.46	+2.92
DS Smith	3.09	0.23	+2.86

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Unilever	0.00	4.34	-4.34
AstraZeneca	0.00	4.11	-4.11
HSBC	0.00	3.96	-3.96
Diageo	0.00	2.97	-2.97
Royal Dutch Shell	2.12	5.09	-2.97

Performance to 28 February 2021 (%):

	1 month	Year to date	Since inception	Fund size (m)	Strategy size (m)
Fund – A Acc GBP	**7.28**	**6.57**	**266.70**	**£2,006mn**	**£2,379mn**
Lipper UK Equity Income mean*	2.70	1.90	163.89		
FTSE All-Share TR Index (12pm adjusted)	2.06	1.61	182.12		

Discrete 12-month performance (%) to:

	28.02.21	29.02.20	28.02.19	28.02.18	28.01.17
JOHCM UK Equity Income Fund – A Acc GBP	**5.68**	**-4.77**	**-3.73**	**10.67**	**25.69**
FTSE All-Share TR Index (12pm adjusted)	4.41	-1.20	0.93	4.96	23.09

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 stand out feature of February was the very sharp rise seen in government bond yields across most Western economies. In both the US and the UK the 10-year yield rose by around 50bps to 1.40% and 0.83% respectively. Whilst most of the movement was at the longer end of the curve, in the UK, for example, the 2-year bond yield moved back into positive territory at 0.1% for the first time since April 2020. Whilst we have anticipated such a move for some time, markets clearly became increasingly confident about progress with the virus, both in terms of a steady and consistent decline in new infections combined with an accelerating rollout of the vaccination programme; this is particularly the case in the UK and the US. Furthermore, whilst evidence of building inflationary pressures has been present for some time, markets began to take more notice of rising commodity prices, increasing consumer confidence and further fiscal stimulus packages, all of which will see a meaningful step-up in inflation as economies progressively unlock and as we annualise against the sharp contraction in activity from March last year. Markets are also beginning to price in a more medium-term step-up in inflationary pressures as we point out in the outlook section.

The UK closed 2020 with a stronger-than-expected December, resulting in a GDP contraction of 9.9%, which is probably over-stated by around 200bps by the UK's unique way of measuring public sector output. However, the economy has managed to find ways to progressively deal with each lockdown in a more contained way; whilst GDP will fall in Q1 2021, it is likely to only be by around 2% with many of the real-time economic indicators such as mobility traffic and job vacancies very resilient. Indeed 81,000 more people were in payrolled employment in January 2021 compared to December 2020, despite the restrictions, marking the second monthly gain in a row. Wage growth has also been accelerating, with regular pay up more than 4% in the last three months, whilst vacancies have increased by 64,000 over the same period.

The resilient employment market and the elevated level of forced saving (the 2020 savings ratio was 18%, equivalent to an additional £100-150bn), leaves the economy poised to rebound very sharply as restrictions are relaxed. We are already seeing both business and consumer confidence rising to reflect this likely recovery; the February 2021 composite PMI survey was +8.6pp to 49.8, whilst the GKF consumer confidence index rose to its highest level since February 2020. Housing markets also continue to show strong demand with mortgage approvals in January 2021 up over 40% compared to the previous year.

The US's economic profile is very similar to that of the UK at the moment where activity is picking up quite quickly as case numbers fall. No doubt policy makers will attempt to stall the rise in bond

yields by making various pronouncements about current moderate inflationary pressures and their desire to keep loose policy in place for a considerable length of time. However, with pent up demand from consumers coinciding with the largest stimulus package in history and mobility restrictions being loosened, they will struggle to convince.

Performance

Market dynamics were once again volatile in February. Although the index ended the month only modestly higher, within that there was a material shift in the market mix caused by some of the factors discussed above – namely higher bond yields and higher commodity prices.

The Fund performed very well across the month, with a return of 7.28% compared to an index return of 2.06%. Looking at the peer group, the Fund ranked first decile within the IA UK Equity Income sector for February and is similarly placed 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).

The commodity sectors performed well in February. The oil sector, including **BP**, our largest holding, was up 5-7% relative to the Fund's benchmark, the FTSE All-Share Total Return index (12pm adjusted), with our small cap stocks in this area performing very well (e.g. **Savannah** up 45%), whilst mining, which has been strong for much of the last six months, remained robust. **Glencore** and **Anglo American** were up c. 15% relative. The mining sector produced very robust results during the month with some dividends materially exceeding our forecasts. The sector remains very cheap, in our view, and, as highlighted in previous months, is at the centre of two positive trends: the global economic recovery, led by China, which will spread as the vaccine is rolled out in 2021; and decarbonisation and the acceleration of the green agenda, which is metal intensive.

We have very little in sectors directly affected by Covid-19, which have been volatile and in many instances will not recover their former profit levels due to structural challenges e.g. retail property owners. The two stocks we do own in this area, **Easyjet** (up 30% relative) and **National Express** (up 20% relative), performed well. We have now largely sold the latter (discussed below). Easyjet should, in our view, be a 'winner' over the next decade with a materially lower cost base than before the pandemic and it is now operating in a market with much lower capacity due to competitor exits.

Bank results were also strong with most, particularly the domestic names, beating forecasts. The rise in bond yields also helped this sector. Shareholder payouts, including both buybacks and dividends, were slightly better than expected. **Barclays,** for example, announced a payout of 5p per share versus our 3p estimate, but a significant proportion of the payout (4p) will come from buybacks, with management signalling that its stock remains too cheap. This mix means in aggregate the flow of dividends from our banks is slightly lower than our estimates (with buybacks higher). At a Fund level this is more than offset by the dividend beats in the mining sector, so our view on strong Fund dividend growth, which we will provide an update on next month, remain intact.

UK domestic names performed well, helped by the rise in sterling and general optimism around the roadmap to re-opening the economy. Within this, small caps were particularly buoyant. **Norcros**, **Galliford** and **Costain** were all up more than 10% relative. **ITV** also performed well.

Other notable moves include **DS Smith,** which rose following rumours of a bid from Mondi, and recent IPO and addition **Conduit,** which is benefiting from rising insurance prices.

There were not many laggards across the month, although more defensive type stocks were weak. Both our food retail names were down 7% relative, with **Hipgnosis** and **Vodafone** also down in relative terms.

Portfolio activity

With market dynamics shifting in February we made a number of adjustments to the Fund. We sold **SSE** and added **National Grid**.

Developments in global ‘green’ policy, ESG, pressure on oil companies to pivot away from carbon and ESG asset flows have collectively created an interesting cross-sector situation. Stocks such as Orsted (the largest wind farm operator quoted in Europe) have done very well as they have grown quickly over the last five years following policy changes but have also enjoyed significant investment interest.

SSE has partially benefited from these trends. As we have alluded to in our recent updates, we have, as a result of this, struggled with SSE’s valuation for much of the last nine months and have consequently been reducing our position. In the last few months all major oil companies have announced, to varying degrees, a shift away from oil (via a material reduction in oil-related capex) towards renewables, with large increases in capex focused on wind, solar and carbon capture. This weight of capital has started to place downward pressure on returns across certain parts of the renewables complex, notably offshore wind. The additional competition and lower forward returns could be a major headwind for the historic operators in these areas that, until now, have done very well in terms of profit, returns and share price performance.

Whilst the oil sector is paying higher prices in an element of catch up, its current valuation dynamics more than discount this. We have noted before that BP is trading on a 15%+ free cashflow yield.

The change in mix of electricity supply will require significant investment in networks to connect offshore wind farms to the grid. National Grid is well placed for this trend given its strong position in the UK as well as in the US. In contrast to the pure renewable companies, its shares have lagged due to short-term concerns over what returns will be permitted in its regulated asset bases, with reviews in both the UK and the US being concluded. Despite being a defensive stock, the shares are c. 20% lower (on an absolute basis) than their pre-Covid-19 levels and are on a one-year relative low. We will gradually build the position up. If the investment requirement is as large as current government policy suggests, the company may need to raise additional capital. This would likely create some potential short-term weakness.

We also largely sold out of National Express, which we had re-acquired in the post-Covid placing in Q2 last year. After a weak period following the placing (halving at one point), the shares have rallied strongly and are now 33% above the placing price and nearly 70% above our average entry price. The stock is now fully valued and we sold it on valuation grounds. The fundamental recovery should be very strong and it will move back onto our monitor list.

As noted above the mining sector was very strong. Stocks like Anglo American and Glencore breached our 300bp maximum active position levels, so we pared them back. The sector remains a key pillar of the Fund at c. 15% of the overall exposure. **Tesco** paid a special dividend associated with the sale of its Asian assets equal to c. 80bp of the Fund (c. 20-25% of the position). This will be treated as a capital distribution and not income given its nature. Across the month both Tesco and **Morrison** were weak (as noted above) and we continued to add to them.

On the addition side the main change was our participation in the **TP ICAP** rights issue to fund the purchase of Liquidnet. TP ICAP had been very weak for months, compounded by the technical depressant of the rights issue. The stock recovered well in the second half of the month.

We have noted in recent reports that we are reducing **Lloyds Bank** as its share price recovers and using the proceeds to fund better ideas with more fundamental support and upside. We continued this process in February, with the proceeds used to finance some of the additions noted above. We also continued a previously mentioned switch from **Countryside** to recent new addition **Bellway**. These positions are now a similar size.

We continued to do a rolling review of large stocks we do not own. We do not see material upside in any of these names (except National Grid – see above). High valuations and high debt levels coupled with foreign exchange downgrade risk are common features of these pharmaceutical, consumer staples and utilities stocks.

Outlook

We now have greater certainty around a number of issues that have affected markets in recent times. There is a clear roadmap to post-Covid normalisation as vaccinations are rolled out; there is greater clarity over Brexit; and a less volatile global backdrop with Biden in the White House. At

the same time fiscal and monetary stimulus is likely to remain very high, as evidenced by the commentary from politicians and central bankers in both the US and the UK. Consumers also have significant incremental savings (more than £100-150bn in the UK) funded effectively by government furlough schemes, which will create a significant wall of (excess) demand as economies are unlocked.

These factors are collectively why bond yields are rising and why the mix within the equity market is shifting decisively. We think this will be an enduring trend. Why? Partly due to the extended nature of valuations pre-Covid and then subsequently accentuated by the pandemic, but also due to a number of tangible changes. Globalisation (which created deflation) is reversing (or at the very least pausing); there is pressure globally to close inequality gaps, which will lead to rising wages; commodity prices are at six-to-seven-year highs, which will feed into inflation; and it is quite clear governments and central banks want inflation to move to 2%+ to help erode real debt burdens.

The increasing signs of building inflationary pressures will, as it has started to, begin to affect bond yields, discount rates and consequently stock market leadership in favour of cyclicals and financials.

The Fund has shown a strong recovery since October 2020 and we are now within 5-6% of the prior high watermark (in relative terms). The economic and market context above should be a major tailwind to Fund performance.

There are also two other dynamics at play. First, almost all our holdings are on the front foot i.e. coming out of Covid strongly with a company-specific growth tailwind (e.g. green spend driving metals demand, market share gains due to competitor failures, STEM recruitment, increased spend on homes etc). Most market forecasts for stocks across the Fund are also too low, in our opinion, due to both caution by management post Covid and trends being better than expected, so there is upgrade momentum. Indeed, upgrades in the 'value' side of the market are in aggregate better than on the 'growth/defensive' side, with foreign exchange headwinds also hurting the latter.

Second, the valuation dynamic still remains clear across the Fund (apart from SSE and National Express, which have been sold and largely sold respectively). There are no stocks flashing amber/red in valuation terms within the portfolio, with all of holdings on modest valuations, in our view.

It is this confluence – strong GDP recovery / rising long-term interest rates, our stocks largely on the front foot with forecasts that are too low and cheap valuations – which makes us believe we can continue the Fund's strong recovery that we have seen since October 2020.

On a wider basis, we believe investors should consider whether they have enough exposure to the UK market, which has a healthy bias towards the value factor and where most stocks trade on a very low valuation compared to their international peer group.

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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