JOHCM UK Equity Income Fund

Monthly Bulletin: March 2022

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.
- The Fund promotes environmental and social characteristics throughout the investment decision making process, please see the following link for further details: https://www.johcm.com/uk/our-funds/fund-details-JOH-UK-EI/johcm-uk-equity-income-fund#sustainability
- Benchmark: FTSE All-Share Total Return Index.

Active sector bets for the month ending 28 February 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Industrial Metals and Mining	15.87	7.19	+8.68
Life Insurance	10.43	2.92	+7.51
Household Goods & Home Construction	5.45	1.32	+4.13
Construction and Materials	5.20	1.47	+3.73
Media	6.75	3.20	+3.55

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.40	-9.40
Closed End Investments	0.00	6.37	-6.37
Personal Care, Drug and Grocery Stores	2.46	7.06	-4.60
Beverages	0.00	3.83	-3.83
Tobacco	0.00	3.79	-3.79

Active stock bets for the month ending 28 February 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Legal & General	3.73	0.68	+3.05
Standard Chartered	3.53	0.58	+2.95
Glencore	5.33	2.39	+2.94
Phoenix Group Holdings	3.12	0.19	+2.93
Aviva	3.58	0.66	+2.92
ITV	3.07	0.17	+2.90
Barclays	4.19	1.30	+2.89
Vistry Group	2.97	0.09	+2.88
Anglo American	4.74	1.87	+2.87
BP	5.67	3.03	+2.64

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.73	-5.73
HSBC	0.00	4.52	-4.52
Shell	2.01	6.36	-4.35
Unilever	0.00	3.93	-3.93
Diageo	0.00	3.52	-3.52

Performance to 28 February 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**-3.05**	**-0.77**	**326.00**	**£2,147m**	**£2,499m**
Lipper UK Equity Income mean*	-2.20	-2.63	196.96		
FTSE All-Share TR Index (12pm adjusted)	-1.29	-1.53	221.98		

Discrete 12-month performance (%) to:

	28.02.22	28.02.21	29.02.20	28.02.19	28.02.18
JOHCM UK Equity Income Fund – A Acc GBP	16.17	5.68	-4.77	-3.73	10.67
FTSE All-Share TR Index (12pm adjusted)	16.03	4.41	-1.20	0.93	4.96

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 Russian invasion of Ukraine dominated the latter part of the month, causing sharp moves in a number of currencies, commodities and other asset classes. The oil price rose a further $10 during February, leaving it around 30% higher than at the start of the year. Other commodities where a high proportion of production comes from Russia and Ukraine also rose significantly, such as thermal coal and wheat (both +20%). The bellwether commodity, copper, was more restrained at +5% and, despite its safe haven status, the gold price only rose 6%. Bond yields were particularly interesting during the month; for the first part of February, they rose sharply as central bankers' rhetoric turned increasingly hawkish, with the US 10-year hitting 2.04% and the UK 1.61%. Whilst both fell back to 1.87% and 1.44% respectively at the end of the month, this was still c.10 bps higher than at the start of February despite the economic uncertainty of Ukraine. Clearly whilst economic growth may be more challenging in the short term, inflationary pressures could be more acute, particularly in the energy space.

Indeed, inflationary prints for January continued to set new records, with the 7.5% annual increase in the USA a 40-year high and the UK's 5.5% close to a 30-year high. The UK number is likely to move above 7% during April when domestic energy prices are re-set. The rise in inflationary pressures is not just being driven by commodity prices or supply side shortages. Labour markets remain extremely tight, with UK vacancies up again in January to a new high of 1.3 million and average weekly earnings running at +4.25% in Q4 2021. The Bank of England has been behind the curve on this dynamic for some time but they have finally upgraded their 2022 forecast for wage growth from 1.25% to 3.75%.

However, most domestically orientated companies that we speak to seem to be settling annual increases at above these levels given the difficulty of finding and retaining staff. We expect the full-year out-turn to be closer to 5%. In the short term, this will still see real wages contract, but in a modest way and as we have written about before, the £200bn of accumulated consumer savings will more than offset any real income squeeze at the aggregate level, although the impact will be uneven across different cohorts of society. In the short term, the media coverage of the energy price squeeze has dented UK consumer confidence, with the February GFK reading falling to -26 from -19 in January. In contrast, the similar index in the US was flat this month.

Despite this, retail sales in both the UK and US surprised positively in January and the UK's services PMI for February saw a reading of 60.8 (vs 54.2 in Jan) - well above expectations, driven by the relaxation of Covid restrictions and the re-opening of travel and hospitality. Given that services represent 80% of UK GDP, this reading is particularly noteworthy. In Europe the rebound in PMIs was less marked but noticeable all the same, rising from 51.1 to 55.8.

Performance

Stock markets fell in February as the Russia / Ukraine situation worsened. This accelerated in the final few days of the month as Russia invaded Ukraine. The FTSE All-Share Total Return index (12pm adjusted) finished down -0.47%. The Fund underperformed its benchmark with a return of -3.05%. Year-to-date the Fund is down -0.77%, slightly better than the market, which is down -0.80%. Looking at the peer group, the Fund is ranked second quartile within the IA UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked second quartile over three years and first quartile over five years, ten years and since launch (Nov 2004)[1].

[1] Source: Lipper

The majority of the Fund's underperformance came during the last three trading days of the month as the Ukrainian situation worsened. The main negative was not direct impacts on certain stocks exposed to Russia (**BP** / **Raven Group**), but the immediate 'risk off' mentality which pushed the market mix towards growth / defensives and away from value. The two specific areas where this manifested itself were the broader financials sectors and small caps. For reasons mentioned elsewhere in this report (e.g. valuations, positive operational momentum etc) as things become clearer this should reverse. The mining and oil sectors where the Fund is well represented performed well. In the oil sector our exposure to BP cost the Fund c.10-15bp on a relative basis, with the stock underperforming by 5% across the month. We cover our view on BP post the Rosneft decision in the next section.

As noted, financials were very weak – this included the large banks (despite extremely strong results, followed by very confident meetings with our management teams), the insurance stocks (particularly **Phoenix)** and other financials such as **TP ICAP**. Our largest positions remain on very low valuations e.g. **Barclays** and **Standard Chartered** are on 0.5x tangible book value and Phoenix is on a dividend of 8%+.

We had two specific issues in our smallest, small cap stocks, which together cost c. 40bp of relative performance – **Morses Club** and Raven Group. The larger issue was with Raven Group, which is the market leader in logistics property in Russia (similar to what Segro does in the UK). The issues in Russia led to a 50% fall in the share price. We are awaiting commentary from the Board, with the final valuation assessment likely to be heavily influenced by where the Russia / Ukraine situation evolves to. The stock at the end of the month was c. 25-30bp of the Fund.

Our wider universe of small caps was also weak – **DFS, Keller, Norcros** etc – more a result of the wider market dynamic, noted above than any stock specific reasons.

Portfolio activity

We sold National Grid on valuation grounds. Whilst well positioned for the energy transition, after rising 30% during our ownership (which at 1 year was unusually short), with a spike in the second half of the month as the Ukrainian situation developed, the stock is fully valued on all metrics. In the utility sector we continue to hold c. 2% of the Fund in Drax, which is still, despite nearly doubling over the last year, on a PE of less than 10x and very well positioned in the near term (producer of c. 7% of UK electricity, including a close to 50% share of all swing capacity e.g. hydro) and over the longer term (carbon capture).

We continued to build our positions in the four new ideas – three of which we discussed in the last couple of updates – **Ashmore**, **Lancashire** and **Ibstock**. These collectively now account for c. 150bp of the Fund. We will continue to build the sizes of these positions and discuss the other name as prices allow, at target entry prices. All of these new holdings are in stocks with market-leading positions on multi-year relative and, in many cases, absolute lows.

The oil price rose strongly as noted above. This benefited a number of stocks in the oil sector e.g. **Diversified Energy** rose 10% relative. However, BP underperformed ahead of the announcement at the end of the month that it would divest its stake in Rosneft. Whilst this at first glance is a negative given the likely valuation of the sale of the stake (which was reflected in the shares on the day of the announcement) we think when the dust settles it will be viewed as positive. Why? 1) the loss of the Rosneft dividend is equal to the free cashflow of an additional $5 on the oil price, 2) BP confirmed that the exit will not change its financial framework i.e. dividend, where the yield is 5%+ and ongoing share buybacks, 3) BP had underperformed in the months running up to this (e.g. by 10% vs Shell over the last quarter), 4) the stake in Rosneft (who are laggards on ESG / energy transition) had muddied the very powerful energy transition story at BP – a discussion we had raised in our last meeting with BP management during the month, 5) the valuation of BP is very low – a FCF yield of 15% at

$70 oil and 20% at current oil prices. We consequently added to BP, and it, now shorn of its Russian exposure, remains one of the largest positions in the Fund. Pre the Ukraine situation developing it was comfortably on a one-year relative high as its sector-leading energy transition roadmap was increasingly being acknowledged. We continued to modestly reduce our holding in **Shell**. Our large miners outperformed the market following good results, stronger-than-expected dividends for **Anglo American** and **Glencore** and the impact on commodity prices of supply disruption from the Ukraine situation. Glencore, Anglo American and **Rio Tinto** were all up 10-15%. Around 28% of the Fund is in the oil / mining sector. Valuations are cheap as noted above for BP. In mining, by way of example, Glencore trades on a free cashflow yield, on a mark-to-market basis, of c. 30%. We marked our position in **Endeavour Mining** to 75bp. It performed very strongly as the gold price rose.

Elsewhere we added to **DS Smith**, which is now on a PE of 10x. It is a European market leader in corrugated packaging – which is benefitting from the boom in ecommerce and the switch from plastics to cardboard. We also added to **Lookers** at c. 90p – which is 12p below where the owner of webuyanycar.com acquired 20% of the company in January. On a PE of c. 6x our normalised earnings, any takeover of the whole company would need to be at a material premium to the initial stake purchase. Given the momentum in the business, even without a bid, we believe there is 60% upside to a reasonable valuation. We also added to certain banks on weakness – Barclays and **Paragon**.

To fund the purchases, as well as the National Grid sale, we continued to trim our holding in **Tesco**, which, despite having upside, is closer to our fair valuation (within c. 20%).

Outlook

Clearly the Russian and Ukrainian conflict has added a new degree of uncertainty to the shorter-term economic outlook. In itself, the impact could be predominantly limited to the rise in oil and gas prices, particularly in Europe. However, the risk of further escalation and a wider economic impact across Europe cannot be ruled out at this stage given the unpredictability of Russian policy.

Whilst the conflict is a human tragedy for those in the region, at this stage, we do not believe it will prove to be the key issue that investors will have to grapple with during 2022; this is still likely to be the necessity for a series of rate rises across much of the developed world, particularly the USA and UK, in response to strong economic growth (as Covid gradually falls away), very limited spare capacity and building wage inflation.

This regime change is likely to see a very different set of stocks taking up the baton of stock market leadership, with financials and modestly valued companies likely to be in the vanguard at the expense of highly rated stocks and sectors that require a very low discount rate to justify their valuation. Whilst the Ukrainian conflict may create a setback in this process in the short term, it does in many respects provide another opportunity for investors to re-orientate their portfolios in this direction.

Valuations amongst our cohort of stocks are extremely accommodative and balance sheets are in rude health, resulting in over 50% of our holdings currently engaged in a share buyback, which can only enhance value further at these levels. Despite a weaker February driven by the Ukrainian uncertainty, we continue to see the potential for a strong year of relative outperformance.

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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This is a marketing communication.

Please refer to the fund prospectus and to the KIID before making any final investment decisions. These documents are available in English at www.johcm.com, and available from JOHCML at the address set out above.

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The investment promoted concerns the acquisition of shares in a fund and not the underlying assets.

Investments include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.

The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

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Sources for all data: JOHCM/Bloomberg (unless otherwise stated).