JOHCM UK Equity Income Fund

Monthly Bulletin: May 2018

Active sector bets for the month ending 30 April 2018

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.57	3.08	+5.49
Banks	15.58	11.00	+4.58
Construction & Materials	5.37	1.73	+3.64
Oil & Gas Producers	16.96	13.41	+3.55
Mining	10.05	6.51	+3.54

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	2.64	7.58	-4.94
Tobacco	0.00	4.85	-4.85
Equity Investment Instruments	0.54	4.52	-3.98
Beverages	0.00	2.89	-2.89
Personal Goods	0.00	2.33	-2.33

Active stock bets for the month ending 30 April 2018

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
ITV	3.28	0.23	+3.05
Aviva	3.85	0.87	+2.98
BP	7.10	4.29	+2.81
Lloyds Banking Group	4.66	1.91	+2.75
Standard Life Aberdeen	2.86	0.41	+2.45
DS Smith	2.63	0.22	+2.41
Glencore	3.69	1.78	+1.91
Hammerson	2.08	0.18	+1.90
Rio Tinto	3.80	1.92	+1.88
National Express Group	1.90	0.07	+1.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	3.82	-3.82
GlaxoSmithKline	0.00	2.93	-2.93
Diageo	0.00	2.57	-2.57
Prudential	0.00	2.00	-2.00
Unilever	0.00	1.94	-1.94

Performance to 30 April 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**7.60**	**1.89**	**299.30**	**£3,753mn**
Lipper UK Equity Income mean*	6.18	-0.38	175.91	
FTSE All-Share TR Index (12pm adjusted)	6.78	0.06	183.03	

Discrete 12-month performance (%) to:

	30.04.18	28.04.17	29.04.16	30.04.15	30.04.14
JOHCM UK Equity Income Fund – A Acc GBP	**14.41**	**22.37**	**-7.58**	**8.97**	**16.98**
FTSE All-Share TR Index (12pm adjusted)	8.40	19.78	-4.99	7.35	10.10

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

US 10-year Treasury yields briefly breached the psychological 3% level towards the end of April. The move to this level was driven by a number of factors which are inter-related. Firstly, there has been a steady rise in inflationary expectations as wage inflation progressively moves higher and as fears that widespread commodity inflation will manifest itself in rising prices (particularly in the oil-related supply chain). Secondly, broad economic momentum in the US remains robust, with business investment (+6.1% in Q1 2018) in particular responding to the fiscal stimulus. Thirdly, despite ridicule from the liberal press, President Trump's foreign policy agenda, with Korea over nuclear weapons and with China on trade, appears to have had some success. Only time will tell whether this is by luck or judgement, but his hard line approach appears to have triggered concessions on both fronts. Lastly, it is clear from his early public statements that Federal Reserve Governor Powell is determined to continue to tighten policy during this phase of strong economic performance. This is to be welcomed as it will give the Fed ammunition for future policy easing as and when it needs it (other central banks should take note).

Closer to home, the UK's Q1 GDP growth of only 0.1% is unquestionably disappointing; however, the difficulty lies in working out how disruptive the bitterly cold weather of March was as well as the impact of an unusually early Easter. Anecdotal evidence suggests that parts of the UK economy ground to a halt in March, with shopping centres and high streets in particular severely hit and many sites closed for a number of days. Finding reliable data points that cut through this impact is difficult, but the weekly sales numbers published by the John Lewis partnership show that sales for the 12 weeks to 21 April (thereby stripping out the base effects of the timing of Easter in 2017) were up around 1.5%. Certainly not exciting but equally not a disastrous outcome either. Nevertheless, it is likely that apparent slowdown will give the Bank of England reason to pause for thought. As such, the Bank is likely to delay the next base rate rise for a while until the underlying trajectory of growth is clearer. We still strongly believe, though, that UK monetary policy should continue to be progressively tightened, as the labour market continues to run out of slack. The increase in regular average earnings by 2.8% year-on-year reflects this situation, as does yet another record employment rate of 75.4% and a near record high level of vacancies of 815,000. Furthermore, the return to real wage growth should, in time, lead to improving consumer confidence.

European lead economic indicators have clearly exhibited a weakening trend since the start of the year, with many Purchasing Managers Indices readings falling back from their consistently high levels of 2017. It feels likely that the 20% rise in the euro relative to the dollar during 2017 is the major factor at work here. Europe's industrial economy has found itself significantly less competitive at the same time as fears around a trade war are weighing on business confidence.

Given this backdrop, it is no surprise to see ECB President Draghi's rhetoric turn more dovish in reiterating an accommodative monetary stance, as the European Central Bank would like to see a somewhat weaker euro.

Commodity prices continued to generally move higher over the month, particularly oil. Most of these markets are characterised by strong global demand (including from China) and limited new supply growth. This situation looks likely to continue in the months ahead, although a further spike in the oil price could start to cause some real economy pain in places.

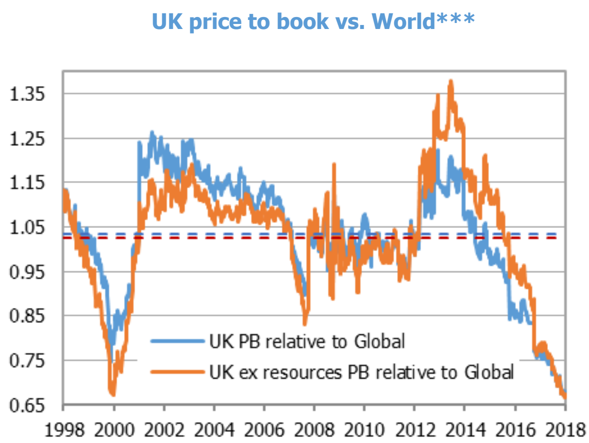
Performance

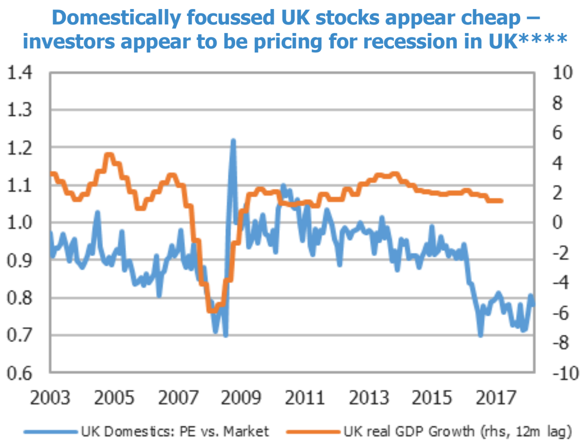
The FTSE All-Share Total Return Index (12pm adjusted) posted an increase of 6.78% during April. The Fund performed strongly in returning 7.60%. Year to date the Fund is up 1.89%, ahead of the FTSE All-Share Total Return Index which returned 0.06%.

Looking at the peer group, the Fund is ranked second 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, five years, 10 years and since launch (November 2004).

The market bounced strongly during the month. This was partly driven by the greater value attraction that had been created by the market weakness in Q1, partly by positive developments such as the Korea denuclearisation talks, partly by the rise in the oil price and partly by a recovery in UK domestics.

The Fund was well placed for most of those developments. Our domestic-related stocks, particularly our retail names – **DFS** (up 19% relative), **Halfords** (up 11% relative) and our food retail names (**Sainsbury** / **Morrison**) – performed well as the market started to focus on the clear valuation attractions we have been noting for the past year. The two charts below (the first showing the price-to-book ratio of the UK versus the world and the second showing domestics versus overseas earners P/E valuation relative vs GDP trends) both highlight the tremendous valuation opportunity that currently exists. We have continued to add exposure gently to this area.





***Credit Suisse as at 30 March 2018. ****Barclays as at 15 March 2018.

One of the drivers of this appeared to be the resumption of real income growth, which we touch on above. Sainsbury, already up strongly during April, added 15-20% on the last day of the month following the announcement of its proposed merger with Asda. We see this as a good transaction for all stakeholders. A much better placed group with a stronger competitive position, less leverage and more growth options should emerge. Whilst most UK domestics picked up, there were still some standouts hovering around their lows – **ITV** and **Rank** (which had a poor trading statement) were two of the notable ones.

As mentioned above, the oil price rose strongly, which led to a good contribution from our oil holdings **BP** and **Royal Dutch Shell**, both up 5-7% relative. Conversely, our mining names lagged, particularly **Central Asia Mining** despite good results.

British American Tobacco, one of our largest portfolio voids, underperformed following a warning (on profit mix) from rival Philip Morris. All of the UK-quoted consumer staples are also seeing fx-based downgrades driven by the year-on-year appreciation of sterling versus the US dollar.

Financials were mixed during the month and in aggregate slightly down in relative terms.

Portfolio activity

We added one new stock to the Fund during April: **Galliford Try**. Galliford has been hurt by one construction contract, the Aberdeen road bypass, which was written historically by a different leadership team. The negative impact of this heavily loss-making contract was compounded by Carillion (who were part of the joint venture on the contract) entering administration, leaving Galliford to pick up Carillion's share of the losses. This put pressure on Galliford's balance sheet, which led to the group undergoing a rights issue to raise £150m. The rights issue created technical weakness, which allowed us to build our position at an average price of c. 850p. This, on our calendar 2019 forecasts, represents a P/E of 5.3x and a yield of 9.5%. Beyond the valuation, we have an attractive set of underlying businesses: a small (now de-risked) construction business, an urban regeneration / partnership homes business, and housebuilder Linden Homes, the group's largest division. The balance sheet after the rights issue is strong, in our view, while management have targeted growing EBIT by more than 60% over the five years to June 2021 (which is not in our or consensus forecasts). To fund this addition, we continued to reduce other stocks in the construction sector that have done well, namely **Forterra**, **Costain**, **Countryside** and **Bovis**.

In the commodity sectors, we trimmed **Royal Dutch Shell** and added to **Diversified Gas & Oil**, **Central Asia Mining** and **Glencore**. On the latter, we part-funded this by a reduction in **Rio Tinto**. These changes continue to increase the base metal end use exposure of the Fund at the expense of bulk commodities, where the supply / demand balance is less positive.

In the food retail sector, we continued to add to recent addition **Morrison**. When the **Sainsbury** transaction was announced at the end of the month the Fund had c. 120bp in Sainsbury and 75bp in Morrison (both ahead of the price moves associated with the announcement).

Elsewhere, we reduced **National Express** following a strong performance since its results. We added to **Keller**, which had fallen year to date (undeservedly so in our opinion), and to **Standard Life Aberdeen** and **ITV**, both of which remained sluggish.

The takeover of **Laird** by Advent was approved by shareholders during April. This significantly (but not totally) reduces the potential for another party to make a competing offer. The Advent transaction remains conditional on a number of regulatory approvals and no adverse changes to the business. Due to the shift of risk vs. reward following the shareholder vote, we sold c. 40% of our holding to fund other ideas.

We materially added to **Hammerson** (now c. 210bp of the Fund) after Klepierre withdrew its bid for Hammerson but ahead of the deal with Intu being called off. In the announcement highlighting the latter, the board laid out a clear strategy to close the gap between the share price (c. 500p at that point) and the net asset value (close to 800p). We do not believe that the full gap can be closed given the underlying valuation dynamics on the UK retail side of its portfolio. However, the more positive side of Hammerson's portfolio (value retail e.g. Bicester Village, Ireland and France), coupled with the board being under pressure having rejected the Klepierre approach, in our view, means the gap between the current share price and the NAV should continue to close.

Outlook

The move in the US 10-year Treasury yield to around 3% feels like a significant moment in time. Ten years on from the global financial crisis, some semblance of a cost of debt and capital is beginning to appear in the US. To some extent, this very event has caused some market commentators to question whether these tighter monetary conditions will start to slow economic momentum. The fact that this has coincided with a period in time where some economic indicators in Europe and the UK have slowed means that markets are on high alert for further signs of softness.

This high level of alert is likely to mean that we will continue to see somewhat higher volatility in markets and individual stocks as investors react to forthcoming data. However, we strongly believe that Western central banks should continue to progressively withdraw stimulus when possible, so as to progress the process of policy normalisation and to provide ammunition for future policy easing as and when it may be needed.

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 (a current expectation of 5-7% growth) is an important driver of the unit price, which would mean the Fund's prospective yield for 2018 is c. 4.3%. This yield, strong dividend growth and low valuations embedded across the portfolio, allied with the shift in monetary policy, leave us optimistic in our outlook for the Fund’s relative and absolute 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