Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: May 2019

Active sector bets for the month ending 30 April 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.72	3.27	+6.45
Banks	15.07	10.42	+4.65
Construction & Materials	5.35	1.68	+3.67
Oil & Gas Producers	17.31	13.69	+3.61
Life Insurance	6.54	3.84	+2.70

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.05	-7.05
Equity Investment Instruments	0.26	5.10	-4.84
Tobacco	0.00	3.94	-3.94
Beverages	0.00	3.68	-3.68
Personal Goods	0.00	2.57	-2.57

Active stock bets for the month ending 30 April 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.18	1.19	+2.99
ITV	3.21	0.22	+2.99
Aviva	3.70	0.72	+2.98
Standard Life Aberdeen	3.24	0.30	+2.94
BP	7.66	4.76	+2.90
DS Smith	3.05	0.20	+2.85
Lloyds Banking Group	4.67	1.93	+2.74
Glencore	4.23	1.51	+2.72
Phoenix Group	2.84	0.16	+2.68
Paragon Banking Group	2.08	0.05	+2.03

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.30	-3.30
GlaxoSmithKline	0.00	3.28	-3.28
AstraZeneca	0.00	3.28	-3.28
British American Tobacco	0.00	2.95	-2.95
Unilever	0.00	2.16	-2.16

Performance to 30 April 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**3.83**	**12.23**	**281.80**	**£3,472mn**
Lipper UK Equity Income mean*	3.25	12.14	178.07	
FTSE All-Share TR Index (12pm adjusted)	3.16	12.60	189.64	

Discrete 12-month performance (%) to:

	30.04.19	30.04.18	28.04.17	29.04.16	30.04.15
JOHCM UK Equity Income Fund – A Acc GBP	**-4.38**	**14.41**	**22.37**	**-7.58**	**8.97**
FTSE All-Share TR Index (12pm adjusted)	2.34	8.40	19.78	-4.99	7.35

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

Markets fears of a major economic slowdown during the fourth quarter of 2018 continued to fade into the background in April. Further evidence that the economic stimulus in China is having a sustained impact was a major factor in this reappraisal, with strong credit growth data supplementing the upward trajectory in most of the key lead indicators, including most of the PMI surveys. This increased confidence in economic activity in China is encapsulated by the sharp rise seen in one-month HIBOR over the last two months; having fallen as low as 0.9% at the end of February, it has recoupled with USD LIBOR in recent weeks and stands at above 2.1% at the end of the month. Critically, this greater market confidence in a Chinese economic upswing, despite many unresolved trade issues, has also led to an expectation that European lead indicators will begin to improve over the next few months. In the past there has been a 3-6 month lag between economic improvements in China and an improvement in business confidence on the continent, particularly amongst the export-orientated industrials sectors. In many respects, such a pick up is necessary as economic growth across Europe has stalled in recent months, with some of the long-term structural issues such as demographics and regulation beginning to loom large again in investors' minds, particularly because the ECB policy toolbox for further stimulus is pretty empty.

In the US, the siren wailing from Q4 2018 about inverted government bond curves has quietened down, but there remains a slight unease about the Fed's future policy direction. Economic data has been mixed, but remains positive – for example, the manufacturing ISM survey has fallen from around 60 to 55 in recent months, leaving it still firmly in expansionary territory but at a rate more commensurate with 2% GDP growth rather than 3%+. Other more consumer facing indicators are also quite volatile, including housing and retail sales, which reflects the rise in the cost of money offset by a firm employment market and the confidence boost from a sharply rebounding stock market. For now, inflationary expectations feel reasonably well anchored but with rising commodity prices and the nascent recovery in China, they are vulnerable to an increase. For now, however, any input cost pressures have been largely offset by the strong US dollar.

In the UK, the Brexit saga rolls on with the extension to the end of October giving all participants the opportunity for some reflection. The chances of a general election at some stage this year have risen considerably during the last few months as it may be the only way to resolve the political impasse. However, the October extension may not give enough time for a full domestic political reset – Mrs May stepping down, a new Conservative leadership contest and subsequent general election fought along a more clearly articulated Brexit stance by both parties – all before meaningfully engaging with Europe over a further renegotiation. In the meantime, UK economic momentum remains positive, albeit less pronounced versus 2018. The employment and wage growth data continues to be strong, with wages rising at their fastest rate for ten years in nominal

terms. However, the political malaise has definitely led to consumers taking a more cautious view in the short term over big ticket discretionary items such as overseas holidays, cars or furniture. It will be fascinating to see if this caution eases a bit over the summer during this extension period – the early signs from the overseas holiday market suggest that started to happen in the last two weeks of April.

Performance

Equity markets were up strongly in April, with the FTSE All-Share Total Return Index (12pm adjusted) returning 3.16% during the month. The Fund, up 3.83%, outperformed the market. Year to date the Fund is up 12.23%, versus the FTSE All-Share Total Return Index, which is up 12.60%.

Looking at the peer group, the Fund ranked third quartile / sixth 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 second quartile over five years.

The drivers of the aggregate positive absolute and relative performance in April were twofold. First, financials performed well, driven by higher equity markets (**Polar Capital**, **Standard Life Aberdeen** and **Liontrust**) and higher bond yields (banks, in particular **Standard Chartered** and **HSBC**). Second, our domestic stocks staged a recovery – names like **ITV** (up 10% relative*) and **Forterra** and **Ibstock** (up 5% relative*). Some of our smaller stocks such as **Sthree** and **Severfield** also contributed positively.

The main detractors to performance were weakness in the commodity sectors which gave back some of the strong run from the first quarter. In addition, the Fund was hurt by two stock-specific issues. First, **Galliford Try** warned that it would take an incremental one-off loss in its construction division. This was disappointing but the share price performance (-20%) was disproportionate given the fact this is a one-off charge. It also likely reflected the change in chief executive. The second stock-specific issue related to **Petrofac**. Its shares fell following reports that Iraq had removed the company from a short list for a new contract due to the ongoing SFO investigation into historic allegations. Elsewhere, **Hammerson** was also weak.

Portfolio activity

In the financials sector, we continued to cut **HSBC**. It is trading between 1.2-1.3 times its tangible book value, which looks expensive versus the sector (Barclays trades on half this multiple) and compared to its return on capital (c.10 - 11%). Our main bank positions are **Barclays**, **Lloyds** and **Paragon**. **Hammerson** continued its sluggish performance as the market's focus remained on the negativity surrounding UK shopping property assets. Our focus remains on the c. 60% of the portfolio that is not in this asset class. There are other material positives: the pressure from an activist investor to sell assets / prove out the the net asset value; the large discount the share price (330p) is at compared to the last reported NAV (+700p); our view of a likely trough NAV (c. 600p); and the indicative bid received from Klépierre last year (635p).

The commodity sector has generally been strong year to date, although it softened in the second half of April as mentioned above. Here we continued to slowly reduce **Rio Tinto** and **Anglo American**. Our main position is **Glencore**, which remains the cheapest stock in the sector. We also continued to reduce **Royal Dutch Shell** gradually. As mentioned last month, we added to our position in **Diversified Gas & Oil** via a placing to fund a further acquisition. This was announced in March, but funded in April.

Part of the reason our dividend has grown strongly since inception (>10% CAGR) is down to our process of selling stocks when the yield falls below the market average and recycling into higher yielding stocks. We estimate this adds 2-3% p.a. to the Fund's dividend growth. We continued to trim stocks that are towards this cut-off point – examples being **National Express**, **Countryside** and **Ibstock**. We also further reduced **Kingfisher,** which has been surprisingly strong despite the poor newsflow.

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* Relative to the Fund's benchmark, the FTSE All-Share TR index (12pm adjusted).

We added to last month's new name, **WPP**. It is now c. 100bp of the Fund. We also added to **Hipgnosis.** It is the only UK-listed vehicle that is acquiring song rights. This market, which is growing strongly as iTunes and Spotify grow, is still priced as though this growth won't feed through, with the average catalogue being acquired on a P/E of c. 12.5x. The quality of the portfolio being acquired is in our view high, assisted by the contacts of the people involved with this Fund. We were able to increase our position via a placing to fund further catalogue purchases.

We also added to **Galliford Try** and **Petrofac**, which were weak for reasons mentioned above.

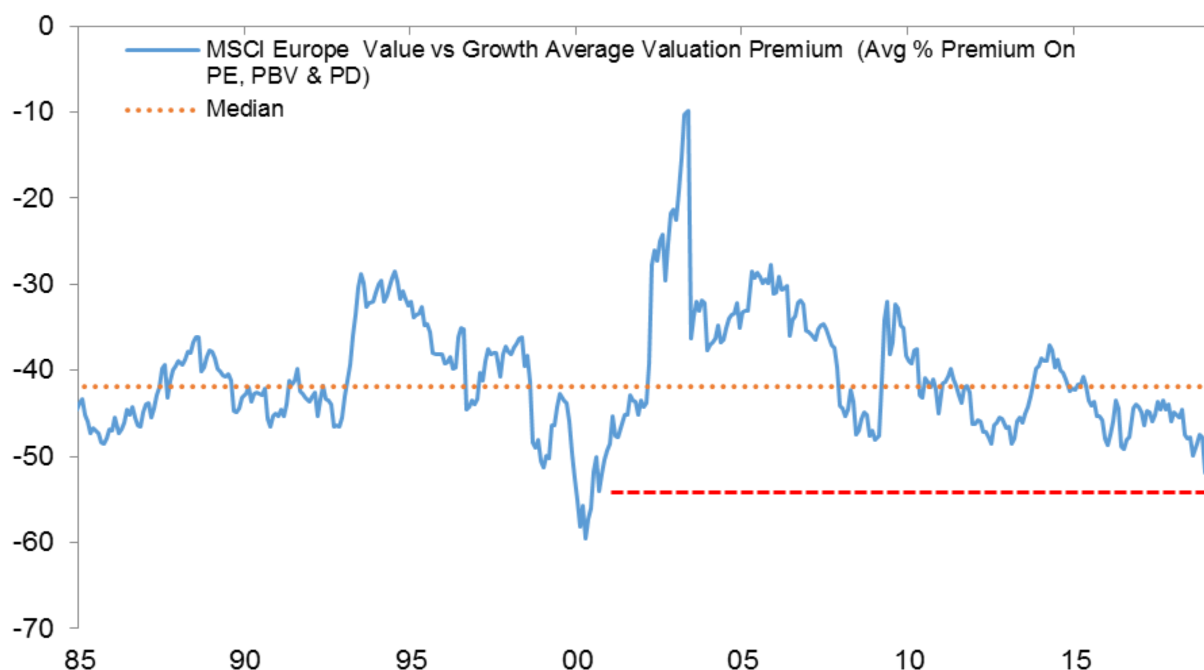
One new name we have not yet commented on but have been adding to the Fund over the last few months is **Headlam**, the leading distributer of carpets in the UK to the independent sector. This stock has been owned twice by the Fund before, with the last sale three years ago at >500p. We started re-entering it at <400p, another example of the malaise that has surrounded domestic assets over the last few years. With management action on costs, the beneficial restructure of its distribution and warehouse and a gentle market recovery over the next few years, Headlam should be able to increase margins towards 7.5-8% (they are currently around 6%). It has net cash, strong asset / property backing and even before any rebound in profitability, is on a low P/E of c. 10-11x.

Outlook

As noted above, the economic tone is showing tentative signs of improvement, reflected in a strong rebound in markets year to date. Bond yields are also edging higher and there are signs that a value bias is starting to perform better.

The valuation gap between quality / growth and value stocks is stark. The chart below highlights that, on various measures, the valuation gap / spread is back near levels last seen at the peak of the technology boom in 2000. There is significant valuation risk around large parts of the market (growth stocks, defensives, bond proxies, consumer staples, healthcare to which the Fund is not exposed to), which we believe many market participants are complacent about.

Back to the time of the TMT bubble: The stark valuation gap between growth and value stocks



Source: Morgan Stanley

In the UK, it is disappointing that a resolution on Brexit has been delayed. This will stop the release of pent up demand for certain categories of discretionary spending and business investment. Despite this, the UK economy remains in better condition than most commentators expected due to the strong employment and fiscal position.

We reconfirmed last month that, despite a number of headwinds (e.g. FX and political uncertainty), our Fund dividend forecast of low-to-mid single-digit percentage growth for 2019 (after c.18% growth in 2018) remains well underpinned. After a further month of newsflow and company results, we remain very confident in this forecast. This would mean the Fund would yield 5.2% for 2019.

As ever, we remain focused upon valuations. In this regard, we remain very optimistic about our portfolio. There are a few examples where valuations are getting fuller and where we are reducing exposure e.g. HSBC. But these examples are limited to much less than 10% of the Fund, despite the strong performance of the market / Fund in an absolute sense year to date. The vast majority of the Fund therefore remains very cheap in our opinion. This value trajectory and continuing Fund dividend growth should underpin good relative performance over time.

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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