Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: May 2021

Active sector bets for the month ending 30 April 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.17	3.27	+6.90
Industrial Metals and Mining	14.96	8.43	+6.53
Media	8.11	2.87	+5.24
Household Goods and Home Construction	6.01	1.82	+4.19
Banks	11.43	7.95	+3.48

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	7.52	-7.52
Closed End Investments	0.00	6.82	-6.82
Beverages	0.00	3.57	-3.57
Travel & Leisure	0.72	3.90	-3.18
Tobacco	0.00	3.13	-3.13

Active stock bets for the month ending 30 April 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	5.63	2.54	+3.09
ITV	3.13	0.19	+2.94
Vistry Group	3.05	0.12	+2.93
WPP	3.42	0.49	+2.93
Anglo American	4.57	1.64	+2.93
Aviva	3.59	0.66	+2.93
Legal & General	3.59	0.68	+2.91
Standard Chartered	3.44	0.57	+2.87
Glencore	4.24	1.37	+2.87
Phoenix Group	2.99	0.16	+2.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Unilever	0.00	4.55	-4.55
AstraZeneca	0.00	4.12	-4.12
HSBC	0.00	3.93	-3.93
Diageo	0.00	3.19	-3.19
GlaxoSmithKline	0.00	2.78	-2.78

Performance to 30 April 2021 (%):

	1 month	Year to date	Since inception	Fund size (m)	Strategy size (m)
Fund – A Acc GBP	**2.91**	**16.19**	**299.80**	**2,160**	**2,552**
Lipper UK Equity Income mean*	3.38	10.30	184.83		
FTSE All-Share TR Index (12pm adjusted)	3.43	9.02	202.68		

Discrete 12-month performance (%) to:

	30.04.21	30.04.20	30.04.19	30.04.18	30.04.17
JOHCM UK Equity Income Fund – A Acc GBP	**41.22**	**-25.85**	**-4.38**	**14.41**	**22.37**
FTSE All-Share TR Index (12pm adjusted)	22.59	-14.76	2.34	8.40	19.78

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

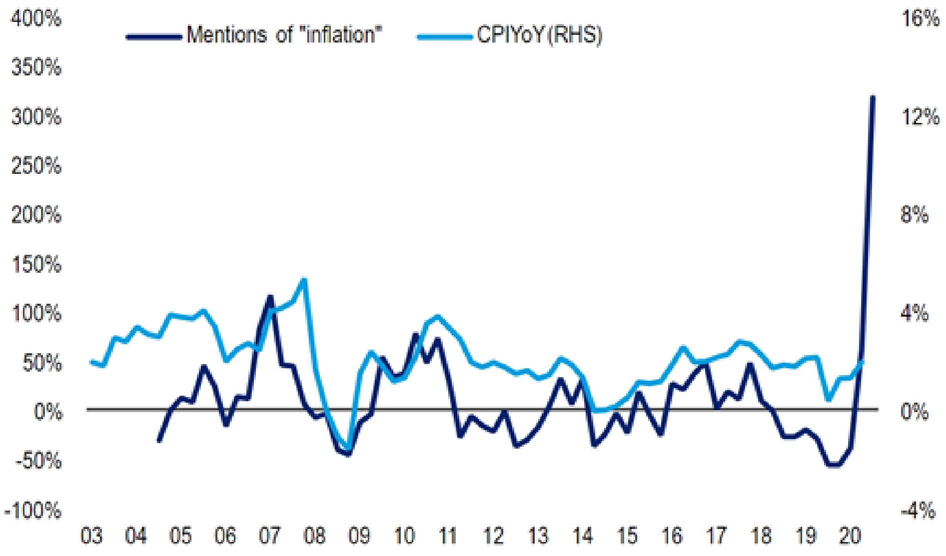
Signs of an accelerating economic recovery were widely evident this month, particularly in countries where vaccination programmes are more advanced, such as the US and UK. In the US, the Philadelphia Federal Reserve Business Outlook Survey recorded its highest reading since 1973; the Empire State Manufacturing index hit the highest level for four years; the Conference Board's Consumer Confidence index is higher than pre-pandemic levels; and retail sales grew in March by 28% year-on-year and 10% sequentially from February.

In the UK, the recovery trajectory is similarly steep - the Markit composite PMI index, at 60.0 versus 41.2 in January, shows how broad the improvement in business confidence has been, with services now in a strongly expansionary phase too, whilst March retail sales were +5.4% year-on-year, despite the country still being in lockdown. ONS high frequency data shows that credit card spending in the week to April 22nd was only 2% below normal, despite ongoing limitations on travel and hospitality, and that online job adverts were running 3% higher than the level prior to the pandemic's start in February 2020.

Most commodity prices continued to rise sharply during the month in anticipation of accelerating economic activity, with copper up 13%, oil up 8% and the Bloomberg Agriculture index up 12%. So far in 2021, the copper price has risen 27% and the oil price has gained 31%, which has clearly injected strong upward price pressure on input costs. In March, UK input prices rose 5.9% year-on-year, the fastest rate since October 2018, but output prices were only up 1.9%, suggesting some lag in the passing-through of these increases. This is reflected in a series of business surveys showing that many businesses expect to increase prices in the coming months. The chart overleaf shows this very vividly. In the US, the Consumer Price Index rose 0.6% month-on-month, the largest increase for nine years, partly driven by higher gasoline prices.

Exhibit 10: Mentions of "inflation" on calls more than tripled so far, pointing to higher inflation

YoY change in S&P 500 companies' mentions of "inflation" on earnings calls vs. CPI YoY (2003-present)



Source: BofA Global Research, Bloomberg

Given this backdrop, it is unsurprising that inflation expectations continued to rise in April, with the US 10-year breakeven inflation rate rising 6bps to 2.43%. However, this was not matched by a rise in bond yields in April. During the month, the US 10-year treasury yield actually fell by around 10bps to 1.64%, which looks somewhat odd given the accelerating growth profile highlighted above. Clearly central banks are keen to ensure bond yields remain under some form of control, either directly or implicitly, and the Fed's dovish tone is an attempt to prevent bond yields rising so quickly that it prematurely slows the recovery. Nonetheless, given the looseness of monetary policy, in conjunction with very large fiscal stimulus packages, it seems highly likely that the upward trajectory of bond yields will resume soon, particularly given that the US (and UK) are likely to see +7-8% annualised GDP growth in the coming quarters. It is also worth noting that a large family office investment portfolio (Archegos) was wound up during the month and that the sheer scale of this move may have had some short-term impact on asset prices, which might explain the somewhat counterintuitive moves that have been seen.

The inflation debate has firmly moved onto whether the current increase is transitory, as we annualise against last year's Covid-19 shutdown, or the start of something more permanent. Much of this will depend upon whether the sharp increases in input costs translate, in time, into higher wages. We have covered this topic in previous months, but we continue to believe that many market participants have underappreciated the change in stance of the Fed towards a more inclusive agenda targeting full employment for minority groups and an implicit focus upon income and wealth inequality. In combination with a Democratic administration and a rise in populism globally, this is likely to see the labour force rediscover some of its bargaining power as the recovery takes hold.

Performance

Market dynamics remained positive in April and the Fund continued to move up across the month, with a return of 2.91% being slightly below the index return of 3.43%. Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector 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).

As noted above, bond yields were under pressure for much of the month, which meant there was a pause in the rotation towards areas of the market where the Fund has higher exposure. This was evident in the insurance sector, which underperformed by around 3-5%. Banks were mixed, helped by strong results towards the end of the month (particularly **Standard Chartered**), with provisions being materially below expectations (linked to the clear signs of better-than-expected economic activity) and the first signs that net interest margins are stabilising and inflecting. Elsewhere some of the more defensive sectors which the Fund does not own performed well.

This overall drag on performance was offset by a series of strong updates from numerous companies across the Fund. In our opinion, it is very clear that forecasts are materially too low – a combination of the better-than-expected economic recovery and very prudent expectation setting by management teams at the end of last year. These results have occurred whilst much of the global economy was still locked down, which bodes well as restrictions are eased. The other theme is the scale of the 'beat' or increase in forecasts, with numerous results 25-50% ahead of expectations. Examples across the month included: **Norcros** (up 14% relative), which had three unscheduled trading upside warnings in the space of six weeks that guided profits higher and signalled a net cash balance sheet (versus forecasts of net debt); **Page Group** (up 15% relative) which, in an unscheduled update, indicated profits would be c.40% above consensus expectations; and **Lookers** (up 25% relative), which indicated again in an unscheduled update that results were materially better than forecast. Other highlights included **BP**, **WPP** and **DFS**.

We also had a number of laggards. However, these were not driven by any negative fundamental newsflow. **Drax**, **Galliford Try**, **ITV** and **Diversified Gas & Oil** fit into this category. We expect their shares to recover in due course.

The mining sector, after a couple of months of profit taking, moved back into positive territory as metal prices such as copper rallied to new highs. **Central Asia Metals** and **Anglo American** were the best performers.

Portfolio activity

As markets continue to move higher it is important to remain disciplined regarding valuation. This is particularly important now as a number of our holdings are seeing material upgrades, which means momentum can take over and drive share prices higher than a long-term valuation framework would support. We sold two stocks in April: **Tyman** and **Forterra**, which followed the sales of SSE and National Express since start of the year. We believe this removes valuation risk from the Fund, with most stocks still in the 'green' zone.

Tyman has more than tripled from its Covid-19 lows in March last year, and its share price is up 55% from where it was before Covid-19 took hold. We value all our stocks on normalised earnings and currently look to sell / reduce when the multiple on those earnings (which may be reached in 2-3 years' time) hits a P/E of 12.5x. This may seem like a low multiple to many readers, but it is reflective of the value elsewhere in the Fund and the low valuation of our new ideas. Our current low exit multiple is also a good sign that valuation in our part of the market remains very low overall. Tyman also fell out of our yield criterion. The stock contributed c. 70bp of relative performance in the period we owned it. Forterra was sold on similar metrics. It added 10-20bp of relative performance across our ownership.

Our new idea pipeline remains strong. We have around four stocks that are fundamental 'buys', where we are waiting to see if they hit strict entry prices. One of these stocks where we have established a position is **International Personal Finance**. This is a market leader in niche lending markets in parts of eastern Europe and Mexico. The shares are close to half where they traded in 2019 and down a third from their pre-Covid-19 level. The balance sheet is very strong, in our view, and the company has started to recover from the impacts of Covid-19. The pandemic has hidden some encouraging trends in markets like Mexico, trends that were in place before Covid-19 hit driven by change in local management. Covid has also led to a structural change in the cost base and competition, with a number of competitors exiting. The company also has a digital business which could be very valuable. The stock trades on a normalised P/E of 5x, which, if achieved, would mean the stock yields 10%. It also trades at a material discount to its book value. We will comment on the other new ideas as they become material parts of the Fund.

Elsewhere we increased a number of stocks that were laggards, namely **Galliford Try**, **Paragon**, **Randall & Quilter**, **Diversified Gas & Oil**, **Tesco** and **Drax.** All of these stocks, which collectively account for 10% of the Fund, remain very attractively priced in our view. For example, Galliford Try trades below the level of its average net cash position; Tesco trades on a free cashflow yield of 9%; Randall & Quilter is valued at 170p per share versus our target price of 363p; and Diversified Gas & Oil yields 9%. This is further evidence of the 'green' valuation signals noted above.

We also continued to add to recent addition **Bellway**. We reduced our position in fellow housebuilder **Vistry**, which performed well, to keep the holding around our maximum 300bp active position. We also reduced **Countryside** and **Lloyds**, where we have been gradually reducing into strength for reasons articulated in our previous reports.

Outlook

As we mentioned last month, recent conversations with unit holders and other interested parties have centred around the key debate: have we now seen the value rally, driven by vaccinations, or is there more to come?

As markets and the Fund continued to move higher in April, there was more evidence that the foundations of the moves are strengthening and also evidence that, in our view, there remains material upside in the Fund.

The macroeconomic backdrop remains positive. As we indicated above, recent data has been unambiguously positive, which will both propel earnings forecasts but also lift bond yields, both of which will be positive for performance given the Fund's positioning. At the same time, it is very clear that inflation will rise both in the short and medium term.

The most frequently noted issue in the 20 meetings we have had with management teams over the last month is that there are cost headwinds building and that prices of end products are being increased accordingly. These trends will also, in our view, push US treasury yields towards 2%, which will again help market performance continue to shift towards value and away from the still very expensive growth stocks.

Central to the inflation debate, as we note earlier, the Fed has radically changed its policy priorities, driven by a strong desire to reduce income and wealth inequality. Such a change is a huge regime shift from the last 30-40 years and will also be supported by the Biden administration's levelling up agenda. Similar principles are at play elsewhere in the world, including the UK, where higher minimum wages and more generous pay settlements for key workers or employees in the gig economy are evident for all to see.

The table below shows the performance of value factors versus growth factors over different time periods. It reminds us of the extent of growth's outperformance over time and the modest recovery in value stocks in 2021 versus the 2020 underperformance. It also shows (on the right-hand side) the valuation of the different factors versus their history. Growth remains very expensive and value remains very cheap. Broadly speaking, value has only been cheaper 10% of the time over the last 20-25 years while growth has only been more expensive 10% of the time.

	Returns Top vs. Bottom Quartile by Factor										
Europe Factor Performance Q4 vs. Q1	Q1 21	Q4 20	Q3 20	Q2 20	Q1 20	2020	2019	5Y	10Y	Since 1995	PE Valuation Percentile vs. History
Value	11.4	11.0	-10.1	-1.7	-24.8	-26.3	-10.3	-8.7	-6.5	0.9	10
...PE	13.5	8.1	-7.6	-0.8	-25.6	-26.2	-8.4	-9.2	-5.4	1.2	13
...PB	11.5	18.7	-9.8	-0.8	-21.4	-16.5	-8.1	-4.8	-6.1	-0.6	6
...DY	5.0	-0.4	-7.9	-3.5	-19.6	-28.9	-7.6	-7.4	-4.0	1.7	18
...FCF	7.3	-0.6	-3.9	2.1	-10.2	-12.4	-7.5	-5.7	1.0	5.9	1
Quality	-4.2	-8.0	6.2	0.6	15.1	13.0	11.7	4.4	7.2	5.2	95
...ROE	-1.9	-7.5	6.7	0.3	11.7	10.6	6.5	2.7	5.6	3.9	93
...Leverage	-3.3	2.1	5.8	7.0	1.3	17.1	5.4	6.2	4.4	2.7	28
...Ern Stability	-2.1	-10.0	0.5	-1.0	11.9	0.3	9.0	1.5	2.9	2.2	96
Growth (eps)	-5.2	-13.0	5.8	5.5	7.7	4.5	6.7	0.1	3.5	2.2	86
Growth (sales)	-6.3	-12.3	9.3	7.9	14.4	18.4	11.7	3.7	4.1	-1.6	86
Earnings Mmt	2.6	-14.4	7.0	-0.6	16.4	5.9	-0.5	2.0	7.5	7.7	1
Price Mmt	-7.0	-20.4	10.3	2.4	16.6	4.9	7.1	2.7	6.3	8.7	69
Low Vol	-6.9	-16.8	-0.9	-8.3	19.9	-9.4	2.6	-0.4	3.5	4.4	93
Nifty 50 vs Mkt	-5.2	-8.5	2.3	0.0	15.4	8.1	13.3	10.8	10.5	9.6	96
Shifty 50 vs Mkt	5.3	3.9	-6.6	1.2	-7.1	-8.7	-1.5	-1.8	1.6	4.1	7

Source: Exane, as at 31 March 2021

We can see this low valuation dynamic vividly in the Fund. The aggregate price-to-book of the Fund has rarely been lower in its 17+ year history (excluding the Covid-19 period), and it is currently at its widest absolute gap versus the index. This rhymes with the commentary above that the majority of the Fund is in the 'green' zone on valuation metrics.

The final aspect to note is where earnings momentum lies. This is not normally something we focus on, but we note it as it is very clear that, as indicated above, the combination of the robust economic outlook and forecasts, which are prudently set, means forecasts are materially too low across the Fund. This upgrade cycle will also help Fund performance. Linked to this, it is also very interesting that in the table above the earnings momentum factor, at '1', has never been cheaper versus its history. This is reflective of the fact that earnings momentum, which has historically always been on the 'growth' side of the market, is now very firmly on the 'value' side.

The confluence of a very strong economic recovery, low valuations and forecasts that are materially too low should bode well for the Fund's absolute and relative performance. Whilst we have recovered the majority of the falls associated with Covid-19, we remain c. 4% below both our absolute and relative high watermarks. The above observations make us confident we can reach new ground in due course.

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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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.

Investments fluctuate in value and may fall as well as rise. Investors may not get back the value of their original investment.

Past performance is not necessarily a guide to future performance. Dividend yield quoted is prospective and is not guaranteed.

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