



JOHCM UK Equity Income Fund

Monthly Bulletin: May 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 30 April 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.45	2.64	7.81
Industrial Metals and Mining	14.81	7.21	7.60
Construction and Materials	5.55	1.39	4.16
Household Goods & Home Construction	5.35	1.20	4.15
Media	6.70	3.19	3.51

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.89	-10.89
Closed End Investments	0.00	6.33	-6.33
Personal Care, Drug and Grocery Stores	1.72	6.79	-5.07
Beverages	0.00	4.05	-4.05
Tobacco	0.00	3.77	-3.77

Active stock bets for the month ending 30 April 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Standard Chartered	3.66	0.57	3.09
Glencore	5.69	2.61	3.08
Aviva	3.72	0.66	3.06
BP	6.12	3.06	3.06
Phoenix	3.20	0.18	3.02
Barclays	3.97	1.01	2.96
Legal & General	3.53	0.61	2.92
Vistry	2.91	0.08	2.83
DS Smith	3.00	0.17	2.83
ITV	2.80	0.11	2.69

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	6.73	-6.73
Shell	2.35	6.87	-4.52
HSBC	0.00	4.16	-4.16
Unilever	0.00	3.86	-3.86
Diageo	0.00	3.77	-3.77

Performance to 30 April 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	-1.44	-0.82	325.80	£2,029m	£2,370m
Lipper UK Equity Income mean*	-0.43	-0.59	204.51		
FTSE All-Share TR Index (12pm adjusted)	-0.56	0.59	228.91		

Discrete 12-month performance (%) to:

	31.04.22	31.04.21	31.04.20	31.04.19	31.04.18
JOHCM UK Equity Income Fund – A Acc GBP	6.50	41.22	--25.85	-4.38	14.41
FTSE All-Share TR Index (12pm adjusted)	8.67	22.59	-14.76	2.34	8.40

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

With the Ukrainian conflict developing into a potentially drawn-out affair, there has been a lot of focus on elevated levels of inflation around the world, with numerous striking examples such as the Eurozone's 31% year-on-year increase in producer prices, driven in large part by an 87% increase in energy costs. With the prospect of elevated energy prices for some time, central bankers' rhetoric became more hawkish, with Jerome Powell, for example, stating that a 50 basis points (bps) hike at the May meeting was "on the table". Consequently, bond yields rose significantly during the month, with the US 10-year up 49 bps to 2.93%, UK +39 bps to 1.90% and the German 10-year threatening to break above 1%, having spent much of the last few years in negative territory.

Business and consumer confidence readings were notably weaker around the globe, particularly in Europe and China, with the latter severely impacted by the continued commitment to the "zero tolerance" covid policy. Retail sales in China were down 3.5% in March year-on-year and this is likely to have weakened further in April given the lockdowns. However, monetary policy continues to be loosened with a further reduction in the Chinese reserve requirement ratio during the month.

In the UK, consumer confidence surveys hit another 2-year low, driven by the focus on rising energy prices. The media have focused on a second month of falling retail sales as evidence that the "cost of living crisis" is already impacting behaviour. However, the fall in retail sales has been entirely driven by reductions in online sales (down 8% in March year-on-year) and food, as consumers spend a greater proportion of their disposable income on travel and hospitality as COVID restrictions have been lifted. It is striking that Barclaycard's UK March spending was 17% higher than the same month 3 years ago (pre-pandemic). This continued strength should not be a surprise given that the UK unemployment rate fell to 3.8% in February and annual wage growth rose to 5.4%. Whilst this is still below the rate of inflation, it is the highest nominal rate for over a decade and combined with the gradual run-down of the UK Consumers' excess savings, is likely to keep activity relatively elevated, despite the rise in energy prices. Whilst UK GDP only grew by 0.1% in February vs the previous month, this was mainly because January had seen a surprisingly rapid rate of growth at 0.8%, resulting in the quarterly growth rate still running at around 1%, which remains higher than most economists' forecasts. Clearly a slowing of growth is likely over the summer.

In the USA, the direct impact of the Ukrainian conflict on consumer confidence has been relatively modest, but the impact of rising interest rates is beginning to influence activity in the housing market. Existing home sales fell to a 2 year low in March, driven by higher mortgage rates, whilst new housing starts were also lower due to materials shortages.

Performance

Stock markets remained volatile in April as the Ukrainian situation continued and the narrative on economic growth / inflation remained in focus. Despite this adverse backdrop the market only fell slightly (-0.56%). Uniquely, the UK market remains up year to date vs large falls elsewhere. This is largely due to the UK market being underpinned by its high exposure to commodities and defensives (such as pharmaceuticals, which is now c. 11% of the market). Mid and small caps are down c. 8-10% year to date. The Fund underperformed during the month recording a return of -1.44%. Year to date the Fund is down 0.82%, compared to the index, which is up 0.59%, and the peer group, which is down 0.59%. Looking at that peer group, the Fund is ranked 3rd quartile within the IA UK Equity Income sector so far in 2022. On a longer-term basis, the Fund is ranked third quartile over three years, second quartile over five and first quartile over ten years and since launch (Nov 2004).

The main positive in the Fund continued to be the oil sector – with all stocks up over the month but two of our smaller cap names, **Savannah Energy** and **Petrofac** up by 15% and 30% respectively. Both of these stocks remain very cheap. The mining sector, which has been strong, saw some profit taking (particularly **Anglo American**) albeit our small caps (e.g. **Central Asia Metal**) in this sector performed well, which meant the aggregate contribution was neutralised. **Drax** rose a further 5% following a good trading update and continued strong power prices.

The main negative contribution was domestics and in particular small caps. **Kier**, **Norcros**, **Redde**, **DFS**, **Lookers** and **Vistry** all struggled. We comment on the valuations of some of these in detail below.

In financials, banks were slightly up in aggregate after some reasonable results, with all banks showing better net interest income trends (resulting from rising rates), no negative provision trends and good cost control. The real stand out was **Standard Chartered**, which is most geared to rising interest rates. This stock probably had its best results (vs expectations which were low) in 30 years, and at a time when the stock was close to a 30-year low in terms of valuation metrics. Management guided that it could reach its target of 10% return on book value a year earlier than 2024, which was its previous guidance. The stock was on 0.4x book on the day of the figures, before seeing the stock up c. 12%. It remains under 0.5x book and should be >1x book if it meets its 10% target. Elsewhere in financials insurance was slightly lacklustre albeit most of the stocks went ex-dividend whilst other financials (e.g. **TP ICAP**) were weak.

Portfolio activity

No new stocks were added to the Fund during April, reflecting the ultra-low valuation we have embedded in the Fund and the by and large continued strong operational performance across our current holdings. Now is the time to put a 'foot on the ball' and be patient to let some of this value feed through.

Below are some examples of stocks we have added to during the month, which we hope will give a feel for this, and there are some aggregated valuation metrics noted in the Outlook section that also show this.

Finding stocks to sell or positions to reduce to make these additions is harder given the valuation dynamic within the Fund. It is often a case of reducing stocks that have less upside. **Drax** has been a very strong performer – up close to 100% relative over 12 months. It continues to be exceptionally well positioned, benefiting from higher power prices, its position in flexible electricity (which we saw during the month on a trip to see some of these assets in Scotland) and its investment plans in carbon capture. Whilst not expensive (a PE of < 10x 2023) we reduced our position to c. 150bp on the basis of its performance and the lower dividend yield. We also continued to reduce **Rio Tinto** where we have articulated some longer-term concerns in previous monthly reports and also to more acutely focus our exposure toward transition metals (and away from iron ore). We are now underweight Rio Tinto and will continue to wind it down at the right price / valuation. We also continue to reduce **Tesco** (now c. 100bp overweight) to reflect both less potential upside and rising pressure on costs. We also reduced **Vodafone**.

Four stocks we have materially added to during the month, which give a feel for the undervaluation mentioned above, are:

Vistry (housebuilder & partnership homes) trading on a PE of 6x, a yield of 8%+ and in line with tangible book value, with no debt, private equity interest in this sector is likely. Our prudent price target (based on 1.5x price to book for the house building side and 15x PE for partnership homes) is more than twice the current share price. Vistry is c. 3% of the Fund;

Barclays, which in common with all banks, materially beat Q1 profit forecasts, with net interest income margins rising (as interest rates rise), costs under control and excess credit provisions / capital trades on a PE of 6x and less than half its tangible book value. It yields 5-6%. Barclays is c. 4% of the Fund;

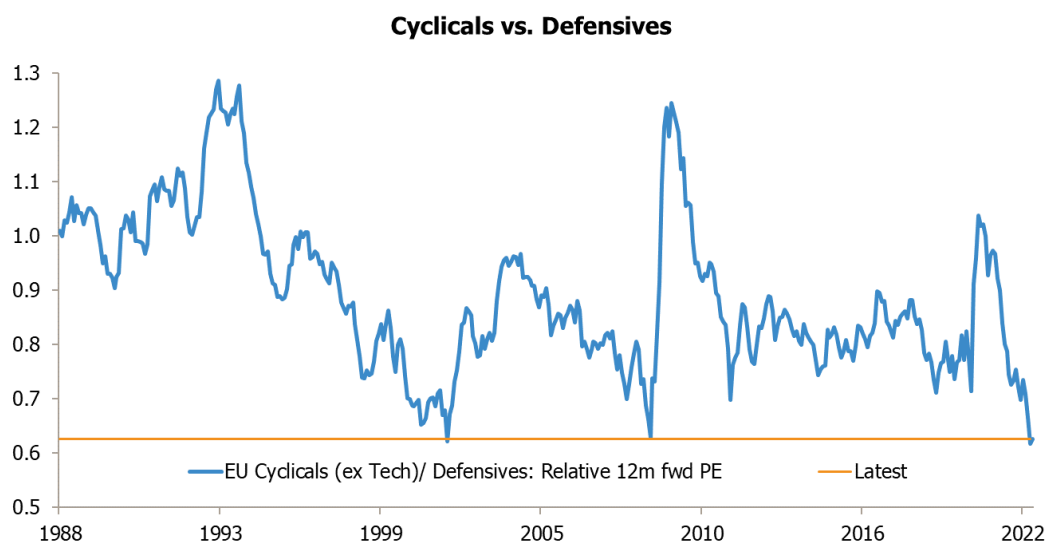
DFS now has a market share of over 35% and is expanding as others leave the market. It is moving into tangential areas (e.g. beds) and has just paid a special dividend alongside a share buyback. It is trading on a PE of < 6x. DFS is c. 1.5% of the Fund;

ITV, following a record year for advertising in 2021 the company announced an investment to accelerate growth. The stock trades on a PE of c. 6x and yields more than 6%. If we value its studios (i.e. content business) at 10x EBITDA (lower than peers) the large broadcast business would be valued at less than zero. ITV is c. 3% of the Fund.

The common theme in the above examples are a PE of 6x or less, a yield of 6% or more, safe balance sheets, managements that are executing and forecasts that are prudently set to reflect the wider risks. As we have recently discussed in the new JOHCM blog ([see here](#)) these valuations seem absurd.

Outlook

Behind a flattish market year to date – at least in a UK context – there has been one of the most material mix changes in recent history. As noted above, oil and mining have been strong for obvious reasons. Beyond that there has been a material rotation towards defensives and away from financials and cyclicals. This can be seen in the chart below – it shows the valuation between defensives and cyclicals is now at the same extremity as it was after 9/11 and during the Lehman collapse in the financial crisis, i.e. there is extreme risk aversion in the market. This degree of valuation differential normally lays the framework for very strong performance of cyclicals / financials as risk tolerances normalise.



Source: Datastream, BNPP Exane estimates

The degree of valuation distortion can also be seen by looking at some index constituent data. The largest seven defensive stocks – AstraZeneca, Glaxosmithkline, Unilever, Diageo, Reckitt Benckiser, BAT and Imperial Tobacco (none owned by the Fund) now make up nearly a quarter of the UK market. AstraZeneca is also close to returning to a market

capitalisation equal to the entire UK quoted banking sector. On a stand-back, common sense perspective, these observations should set off alarm bells.

The other side of this is obviously why the majority of the stocks in the Fund are on very distressed valuations. We show examples of this at a single stock level in the section above, the potential upsides to prudent target prices we have across the Fund.

This can also be seen in the Fund dividend yield. We upgraded our guidance for this year's expected growth to 25-30% last month, which would bring the dividend per unit above the pre-Covid level. On this basis the Fund yields > 5% for the current calendar year. This yield, coupled with the capital upside, are together a potentially powerful combination.

The terrible conflict in Ukraine, coupled with associated macro-economic implications, has created a fog that has somewhat obscured these attractive characteristics from investors' line of sight, but as and when the fog clears (as it will, as it did after 9/11 and after Lehman), we are confident that they will positively re-assess strategies such as ours, as they were beginning to do earlier this year.

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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Information on the rights of investors can be found [here](#).

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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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