Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: June 2023

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.
- Benchmark: FTSE All-Share Total Return Index.

Active sector positions as at 31 May 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.29	2.66	6.63
Construction and Materials	7.84	1.62	6.22
Household Goods & Home Construction	6.06	1.07	4.99
Banks	14.04	9.26	4.78
Industrial Metals and Mining	10.48	6.03	4.45

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.95	-10.95
Personal Care, Drug and Grocery Stores	0.00	7.62	-7.62
Closed End Investments	0.00	6.15	-6.15
Beverages	0.00	3.62	-3.62
Tobacco	0.00	3.21	-3.21

Active stock bets as at 31 May 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
NatWest	3.64	0.62	3.02
Standard Chartered	3.67	0.66	3.01
Phoenix	3.18	0.18	3.00
Barclays	4.07	1.07	3.00
DS Smith	3.16	0.17	2.99
Aviva	3.48	0.49	2.99
Glencore	5.06	2.28	2.78
Bellway	2.85	0.12	2.73
Paragon	2.77	0.05	2.72
BP	6.29	3.58	2.71

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.28	-3.28
HSBC	1.86	5.24	-3.38
Unilever	0.00	4.40	-4.40
Shell	2.30	6.89	-4.59
AstraZeneca	0.00	7.37	-7.37

Performance to 31 May 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**-4.38**	**-2.44**	**315.20**	**1,552**	**1,840**
Lipper UK Equity Income mean*	-3.21	0.81	206.10		
FTSE All-Share TR Index (12pm adjusted)	-3.12	2.12	236.40		

Discrete 12-month performance (%) to:

	31.05.23	31.05.22	31.05.21	31.05.20	31.05.19
JOHCM UK Equity Income Fund – A Acc GBP	-5.36	6.84	44.88	-20.99	-12.21
FTSE All-Share TR Index (12pm adjusted)	1.01	8.15	22.07	-10.02	-3.52

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

UK economic performance has continued to defy the sceptics with both the Bank of England and the IMF upgrading their forecasts during the month. The IMF move is particularly noteworthy given how high profile their negative view published in January was; since then they have moved from forecasting -0.4% GDP growth in 2023 to 0.4%. The services sector has driven this resilience, particularly consumer spending in areas such as travel and hospitality, with the latest UK Services PMI reading at 55.1 reflecting this strength. Whilst the UK Consumer confidence survey hit another 1 year high, the index score of -27 still suggests that consumers are more positive in their actions and behaviours than in answering surveys, where the ever-present media doom tends to permeate into their thinking.

Employment markets are showing signs of cooling somewhat, with unemployment rising modestly this month, although it should be noted that so far, this is because of an overdue increase in labour supply rather than a reduction in the number of people in employment; total employment grew by 180,000 in Q1 2023, but the total supply of labour grew by 240,000 over the same period with over 55s and students meaningfully re-entering the labour force for the first time since the pandemic. However, the flash April data (which can be unreliable as it's based upon a small survey) suggested a further weakening in April, which needs to be watched. Despite this brighter picture, which is also reflected in the Citigroup UK economic surprise index remaining at a 1 year high, it was the higher-than-expected inflation print which drew the most attention during the month. Whilst the annual inflation rate fell back from 10.1% to 8.7%, driven by a 1.8pp fall in electricity and gas prices, forecasters had anticipated a slightly steeper reduction, with core inflation actually rising from 6.2% to 6.8%, driven by food prices (up 19%) and broader service sector inflation. However, it should be noted that goods inflation fell from 12.8% to 10% and UK PPI inflation hit a 2 year low at 3.9%. Furthermore, with many hard and soft commodities / agricultural products well below their highs of earlier in the year (and continued to struggle in May), it is very likely that inflation will continue to fall throughout the remainder of 2023, helped by the 18% reduction in OFGEM's price cap for July which will reduce the annual rate by 0.75% on its own. Whilst we believe inflation will probably fall to around 5% by the end of the year, markets took the view that the Bank of England will have to tighten further this year to steepen the inflation reduction trajectory, with 2 year bond yields rising around 50bps to 4.3%.

The stickiness of inflation has also been witnessed in some European countries, such as Italy, which experienced a similar outcome to the UK. However, the situation is more mixed, with France and Spain seeing steeper reductions. The German economy continues to exhibit the weakest trends, with the Q1 0.3% fall in GDP pushing the economy into a technical recession. The relatively weak performance of global manufacturing sectors (compared to services) is largely to blame. The European Central Bank has publicly stated that they will continue with monetary tightening for now, although the quantum of further rate rises may depend upon how the manufacturing sectors develop during the second half of 2023. This may be partly driven by the path of China's economy, which thus far has continued to see a strong rebound in consumer spending after the covid unlock (latest Services PMI at 54.5) but a much weaker manufacturing performance (PMI 48.8), which has pressured commodity prices.

The US economy continues to be difficult to read accurately; whilst a number of forward-looking surveys reflect a slowing of activity, the pace of decline is quite

inconsistent. Consumers continue to show a healthy degree of resilience, with the latest Conference Board's Consumer Confidence reading still above 100. Furthermore, the Federal Open Market Committee minutes were pretty clear that the Fed will pause its cycle of monetary tightening to assess the impact of the previous rate rises. Inflationary pressures continue to decline in the region, with the latest PPI print at 2.3%, its lowest reading for 2 years.

Performance

Markets were sluggish in May, with some of the issues noted above dominating like rising bond yields, the US Government debt ceiling and pressured commodity markets. The UK FTSE All Share was down 3.12%, the Fund underperformed the benchmark, down 4.38%. Year-to-date, the Fund is down 2.44%, whilst the FTSE All Share is up 2.12%. Following a strong start to the year, the Fund has struggled since the Silicon Valley Bank (SVB) news in February, which led to a powerful risk-off mentality across markets. This latest move has left the valuation elastic as stretched as it has ever been, between value and growth, defensives vs cyclicals, large vs small, which is discussed in the outlook section below. Looking at the peer group, the fund is ranked 4th quartile within the UK Equity Income sector year-to-date. On a longer-term basis, the fund is ranked 1st quartile over three years, 3rd quartile over five years, 2nd quartile over 10 years and is 2nd best Fund in the sector since inception in 2004.[1]

Banks continued to recover from March's events (SVB / Credit Suisse), with **NatWest Group** and **Standard Chartered** up 6 and 7% relative respectively. Many small caps, including those we touch on in the next section, were also notable contributors. As well as those discussed below, **Severfield** (up 10% relative), **Polar Capital** (up 10% relative), **Palace Capital** (up 10% relative) and **Conduit** (up 6% relative) were also strong. This is the first month since the end of last year that this has been the case and is encouraging.

First Group, despite the loss of one of its rail contracts, continued to be a strong performer (up 7% relative).

Results (with a few pockets of weakness – as discussed below) continue to be robust, with solid results in the month from recent addition **Marks & Spencer,** as well as, **EasyJet**, **Keller** and **Conduit**.

It is worth contrasting current operational performance with the 2008 / 09 period. At that time, nearly every statement was problematic and initiated a downgrade, and the stock market was full of stocks with balance sheet issues. The majority of the stocks the Fund owns continue to publish strong statements with strong momentum, which we believe should continue. Part of this is tangible, for example, market share gains at Marks & Spencer and EasyJet and part is driven by companies beating cautious expectations set by management. Obviously, balance sheets are much stronger now than in 2008 / 09. Only one stock in our Fund is over-levered, **National Express**, which we discussed in a recent update. This is a small position and we have publicly called for the board to sell one of their three divisions to remove their 'debt jacket' (read here).

[1] Source: Lipper

As mentioned above, there are pockets of weakness, c.10-15% of the Fund. **Headlam** issued a weak statement which led to downgrades of c.9% for 2023, **Eurocell** similarly issued a weak statement and **ITV's** update was sluggish. All three stocks are at or very close to all-time relative lows (ie. lower than the financial crisis, lower than Covid). Headlam trades 20% below the value of its cash, stock and properties (ie. tangible net assets); all are market leaders, two have little to no debt and all trade on c.7x depressed earnings. **Currys** continued to weaken, despite a better-than-expected update. **Vodafone** was weak as the new CEO rebased expectations, which now look credible. We had cut our position by more than 50% over the last few years, but started to add post the fall after this set of results.

The commodity sectors were also weak, particularly the oil sector as the oil price fell.

Portfolio activity

Given the market's valuation dynamics discussed elsewhere in this bulletin, sell ideas remain challenging, and most of the month's reductions remained 'housekeeping' in nature.

Several of our small caps started to perform better, and we accordingly marked positions to target weights. **Kier** and **International Personal Finance (IPF)** reached 12 month relative highs, while **Tyman** reached a 6 month relative high. At the start of June, Tyman was promoted to the FTSE 250, which will reduce our aggregate small cap weighting to c.17%. Despite some positive performance trends from these three holdings, the current valuation of these stocks reveals how lowly valued they remain, with Kier trading on a PE of 4x, IPF on a PE of 5.5x (and a yield of 9%) and Tyman on a slightly higher PE (9x) but on depressed earnings. During the month, Tyman had an inline trading update (which is positive given its main end-use market – US Housing – which has been weak but now looks to be starting to recover). IPF held an upbeat mini-Capital Markets Day, focused on its digital businesses after a strong trading statement at the end of April which upgraded forecasts and Kier had an encouraging visit to HS2. UK small caps remain one of the most undervalued asset classes globally.

Elsewhere a number of our larger positions started to regain poise and were marked to 300bp; this was true for the banks (NatWest Group, **Barclays** and Standard Chartered) and in the middle of the month, both housebuilders (**Vistry / Bellway**), albeit they weakened towards the end of the month.

We also reduced our position in **First Group**, following a strong rise in its share price.

We added one new stock to the Fund during the month – **Inchcape**. We have been monitoring Inchcape for a decade, but it has always been too expensive to add to the Fund. It is the global leader in car distribution, operating in markets too small for vehicle original equipment manufacturers (OEMs) eg. BMW, Mercedes, where it acts as their agent in these countries. This is a growth market because vehicle penetration in these markets is low and despite being the largest operator in this segment, Inchcape only has a market share of 1%. It is fragmented, with OEMs wanting to move relationships towards Inchcape, which has a superior digital presence, money laundering controls and cyber security. The footprint is skewed to emerging markets, particularly Asia and Latin America, where growth dynamics are picking up. The stock has a strong balance sheet (less than 1x Net Debt to EBITDA), yields c.4.5% and trades on a PE of 9x.

In the first part of the month, we added to **Marks & Spencer** before the share price increased after its results. Some of the reasons we discussed in last month's bulletin (read here) for the purchase were clear in those results (eg. a return to the dividend list, outperforming forecasts).

We increased the weight of **Drax** after their recent investor day, following announcements of internally funded plans to become one of the leading players in carbon capture globally.

We also added to **Easyjet,** which had solid results and saw forecast upgrades. As well as the recovery in the airline business, it is becoming clear that the recently established and separate holiday business has and should continue to be a profitable and valuable franchise. From a standing start around three years ago, we believe it will make £80m this year and we expect it to generate £200 to £300m of profit on a 5 year view; when combined with the recovery in airline earnings, we forecast the company to make c.100p of EPS, which compares to a share price of less than 500p. The board confirmed they would return to the dividend list in a meaningful way in the next 12 months.

Outlook

Much of the debate in markets at present centres upon whether the Fed can engineer an economic soft landing; most market participants feel quite sceptical about the prospects of success, but the performance of equity indices suggests a moderately growing sense of optimism is building in that regard. The Fed's monetary tightening phase looks to be over, but we anticipate a lengthy pause rather than a hasty reversion to rate cuts. Inflationary pressures continue to dissipate, particularly input costs, whilst consumers have proven resilient thus far, helped by strong employment markets and comparatively low levels of leverage. Elsewhere in the world, China's emergence from its COVID restrictions has been a little softer than anticipated but will still help global growth, whilst many parts of the emerging world will begin to ease monetary policy as inflationary pressures subside. Europe and the UK will likely see modest economic growth during the rest of 2023 and a stronger 2024.

Given this backdrop, we continue to find value on offer across many parts of the UK equity market. Recent weeks have seen a number of policy proposals emerge, which might help reignite institutional interest in UK equities as an asset class and it will be intriguing to see how these thoughts develop, but the valuation case for UK equities relative to the rest of the world could not be clearer. Furthermore, within the market, we continue to see much better value in sectors that have a degree of economic sensitivity rather than those focused upon more classically defensive sectors. You do not need to have an overly optimistic view of the global economy to make use of this opportunity as the gap is so wide and, in many cases, balance sheets are stronger in the more cyclical sectors.

As further evidence emerges that inflationary pressures are abating, it is likely that investors will shift their focus to some of these areas, including financials. Whilst publicly, central banks are sticking to their stated ambition of returning inflation to 2%, in practice, we question whether they have the desire to do so given the benefits of a 2% inflation rate compared to 3%, which do not justify the additional economic

damage, in terms of unemployment, that would be required. So progressively, we expect a distancing of central banks away from the 2% target, at any price, rhetoric.

Whilst there are some pockets of weakness, many companies in the Fund continue to report robust trading and valuations remain compelling across the portfolio. With the dividend yield close to its all-time high despite the strongest balance sheets we have experienced, at some stage investors should return to our cohort of stocks and in the meantime, we are being paid a healthy dividend yield as compensation for the desired patience. If structural reform of the UK institutional pension system stimulates a mindset change around how asset allocators and trustees view UK equities, there could be a step change in interest. As a strategy, we have delivered a strong dividend yield for over 20 years and grown that distribution by c.9% per annum since inception. Whilst that outcome has come with some volatility, it ranks very favourably with the bond asset classes institutions have herded towards. Furthermore, the inflation protection that equities can offer, as their earnings are linked to nominal prices, should not be ignored either. Lastly, a dividend yield of around 5.75% for 2023 is a useful starting point from which to grow distributions.

Further information

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