Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: June 2024

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 2024:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction and Materials	10.29	0.44	9.85
Life Insurance	9.26	2.19	7.07
Banks	15.49	9.96	5.53
Industrial Metals and Mining	9.61	6.48	3.13
Retailers	4.24	1.54	2.70

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	11.31	-11.31
Closed End Investments	0.00	6.19	-6.19
Personal Care, Drug and Grocery Stores	1.63	7.16	-5.53
Aerospace and Defence	0.00	3.87	-3.87
Beverages	0.00	2.71	-2.71

Active stock bets as at 31 May 2024:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.32	1.34	2.98
Standard Chartered	3.65	0.70	2.95
ITV	3.06	0.12	2.94
NatWest	3.60	0.70	2.90
Phoenix	3.02	0.15	2.87
Aviva	3.36	0.53	2.83
DS Smith	2.90	0.20	2.70
Keller	2.32	0.04	2.28
Legal & General	2.87	0.61	2.26
WPP	2.56	0.35	2.21

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
GSK	0.00	2.84	-2.84
HSBC	2.52	5.41	-2.89
Unilever	0.00	4.32	-4.32
Shell	1.60	7.42	-5.82
AstraZeneca	0.00	7.26	-7.26

Performance to 31 May 2024 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**4.23**	**15.21**	**419.70**	**1,668**	**1,957**
Lipper UK Equity Income mean*	2.99	8.43	250.13		
FTSE All-Share TR Index (12pm adjusted)	1.67	8.51	284.89		

Discrete 12-month performance (%) to:

	31.05.24	31.05.23	31.05.22	31.05.21	31.05.20
JOHCM UK Equity Income Fund – A Acc GBP	25.17	-5.36	6.84	44.88	-20.99
FTSE All-Share TR Index (12pm adjusted)	14.42	1.01	8.15	22.07	-10.02

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

In the UK, the setting of the date for a General Election in early July surprised most market commentators but did not materially impact Sterling or bond yields. Labour's consistent lead in polls over the last few months suggests that markets are expecting a clear and decisive result, which in many respects may act as a further clearing event in the eyes of the international investment community. Indeed the release of various economic data points over the month was more significant in shaping market movements.

UK Q1 GDP comfortably exceeded expectations, coming in at 0.6%, driven by a very strong March at 0.5%. Notably, this was not driven by consumer expenditure or an early Easter but by investment spending. UK inflation fell significantly this month to 2.3% compared to 3.2% in the prior month, but this out-turn was a little higher than expected predominantly because services inflation only fell 0.1% to 5.9%, with prices still rising strongly in areas such as hospitality, possibly driven by the April hike in the minimum wage. In contrast, goods inflation weakened further, with food up less than 3%, whilst the anticipated energy price falls had a major impact, with gas prices 37% lower than a year ago and electricity prices 20% down. Clearly, inflation is now close to the 2.0% mandated target, but the energy base effects are now behind us; OFGEM's July price cap will be 7.5% lower than April, but last year, it fell 15% in July and, as such, will not help drive the annual rate of inflation lower. Furthermore, wage inflation has continued to prove somewhat sticky in the last few months. The latest labour report showed unemployment higher at 4.3% at 1.49 million, well ahead of vacancies at 913,000, but average earnings have held broadly flat over the last four months at around 5.7-5.8%.

With UK consumer confidence rising again this month by another 2 points to a fresh two-year high, and with consumers sitting on substantial excess savings, the Monetary Policy Committee (MPC) has many factors to weigh up at present in setting monetary policy. The slightly higher-than-expected inflation print had already made a June rate cut less likely than before, and the timing of the election in early July means any move might look politicised. However, with the European Central Bank (ECB) still likely to cut rates next month and several non-Euro bloc countries such as Sweden and the Czech Republic easing policy this month, the window of opportunity is there for the MPC. As we have stated before, the UK probably only needs 50-75bps of monetary easing to stimulate a substantial pick up in consumer activity due to the very high savings ratio at present and strong real wage growth. A change of government may also help drive a more confident consumer and could stimulate further business investment.

In contrast, economic indicators in the US continue to look relatively weak. Retail sales in April were only up 0.2%, and importantly, the prior two months were substantially revised down. With the latest savings ratio for US consumers at 3.2% compared to a figure of 5-7% pre-pandemic, in many respects, a sense of exhaustion is evident amongst US consumers. In some respects, this would suggest the Fed may ease policy relatively soon, but their room for manoeuvre is somewhat restricted by a rate of inflation, which continues to be sticky and is stubbornly printing above 3%. While some factors, such as shelter, may naturally ease in the coming months, it still means Jerome Powell may have to sit on his hands for a few months. This has been reflected in US 2-year bond yields approaching 5% as the number of short-term rate cuts implied by markets has been substantially reduced.

Performance

The UK stock market's strength continued in May (with the FTSE All Share up a further 1.67%). Within this overall positive trend, the change in market leadership that has been evident since November continued, benefiting the Fund. The latter was up 4.23%, outperforming the market by 2.52%.

Year-to-date, the Fund is up 15.21% compared to the market, which is up 8.51%.

Looking at the peer group, the Fund is ranked in the 1st decile within the UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked 1st quartile over three years, five years and 10 years and is the best Fund in the sector since inception in 2004.[1]

The leadership change has been driven by a confluence of positive factors, including lower inflation, a modest uptick in UK economic activity, an acceleration in M&A activity and strong company results. This shift has led to a performance reversal of the previously strong defensive sectors, which we believe are still overpriced and where earnings blips are starting to occur. Conversely, cyclical sectors, such as the financial and commodity sectors (where the Fund is invested), are now outperforming.

The valuation gap was so large that the moves since November should still be seen as the foothills of the potential that could feed through over time.

As indicated above, the early election has been perceived as generally positive, should bring stability and allow certain sectors that were previously in policy 'limbo' to emerge. For instance, housing and housing-related activities should be underpinned by housing policies we expect in the manifestos, and there will be more clarity on clean energy policy.

There were a number of very positive results/trading updates that moved share prices materially higher. **Keller** raised guidance after its Q1 update, **Marks & Spencer** results beat expectations and **Curry's** upgraded their full-year guidance for the third time since the start of the year. Each of these stocks were up between 15-20% relative. Take Keller as an example: Although its shares have already doubled over the past 18 months, our medium-term target price suggests a similar upside from here. This target price is based on 10x normalized earnings, which we forecast to be 210p per share, along with balance sheet capacity assessed at 600p per share - a total of 2700p.

The banks sector continued to move higher - **Barclays** was up 5% relative whilst **Standard Chartered** was up 11% relative. These two banks remain the two cheapest banks in the UK on a price-to-book basis. Additionally, the mining sector (excluding **Anglo American** - discussed in the next section) performed strongly. Other notable risers included **ITV**, which reported a positive trading update, signalling an upward trend in TV advertising. **Ibstock** and **Norcros** also saw notable rises.

The Fund benefited from the fall in the share price of National Grid (which we do not own). The announced rights issue (due to high leverage/higher investment plans)

[1] Source: Lipper

and the resulting dilution were materially higher than expected. This contributed c.25bps to relative performance.

There were few offsetting negatives. Unlike the mining sector, the oil sector faced challenges. **BP** was down 8% relative, and **Petrofac** was also down materially following a further delay in its refinancing efforts. **EasyJet** (see below) also fell following some weak pricing comments from competitors.

Portfolio activity

As the Fund's absolute and relative performance moved forward, May was another active month for portfolio activity.

M&A continued to be a notable feature during the month, as we highlighted above.

We commented on **Hipgnosis** last month, where competition between two bidders moved the share price above the original IPO price. We sold 60% of our position in April, and the remaining 40% was sold in May. Most of our position was sold above the current final offer price, as the market speculated that the eventual final bid would be higher. Across the ownership of this stock, 10bps was added to the Fund's relative performance. Last month, we mentioned that this example provides some valuable lessons (e.g. a focus on board strength) but also highlights how active engagement and focus can help recover lost value.

We made additional sales to maintain our portfolio weights as share prices moved sharply. Specifically, we adjusted positions in **Costain**, **Central Asia Metal**, and certain banks, either returning them to their target weight or to our maximum overweight level (300bps). Despite these adjustments, all of these stocks remain materially undervalued. We also continued to reduce our housebuilder exposure (**Vistry** and **Bellway**) during pockets of further strength across the month. After a substantial increase, they are beginning to discount a material recovery.

We added one new stock to the Fund, which we will discuss/disclose in a future report when we have finished establishing the position. We continued adding to recent additions **Morgan Advanced Materials** (now 75bps) and **Centrica** (now 110bps). **Drax** was weak (c.10% plus down) after Sunak announced the election would be called early. While this development may delay the ongoing consultation regarding the bridge mechanism for Drax power station - from the end of the current subsidy regime in 2027 to the start of power carbon capture in 2030 - we believe there will be clarity later this year, post-election. Drax plays a critical role in the overall electricity supply in the UK (approximately 5%), and the mood from the Labour Party regarding further investment in this area is positive. This situation serves as yet another example of market short-termism.

Several other stocks were weak and were added to. **EasyJet** seemed to discount around five times the same news – that pricing across summer months would likely be 1-2% lower-than-expected, based on information from different operators. Currently, EasyJet is trading at less than book value and on less than 5x its aspired medium-term earnings.

In our view, we are clearly passing through the final part of the bottom of the 'v' in operational trading/sales of products in the housing market chain, e.g. doors, windows, bathrooms, etc. Certain stocks in this area are still around lows (which contrasts with house builders, which have already moved materially higher, as noted above). We added to **Wickes**, which had a good Capital Markets Day focused on its Tradepro business, and **Headlam** (which had a weak statement). We also added to **Phoenix Group**, **First Group** and **TI Fluid Systems**, all of which experienced weakness during the period.

We also added to two of our stocks that were involved in M&A during the month. BHP submitted a third offer for **Anglo American -** that valued the latter at c.3000p. The valuation of this bid was in our fair value range, and seemingly in Anglo American Board's fair value range. It also looked strong compared to sell side 'sum of the parts' analysis. The bid timetable was extended for a week, but after that, the bid was rejected due to concerns from the Anglo Board regarding its structure. We were disappointed that the Board did not extend the timetable a second time to facilitate a transaction given (a) the deadline for the bid was also the same day as elections in South Africa, an important stakeholder who needed to be engaged, and (b) it was clear BHP was trying to mitigate the perceived risks. We increased our position as these events unfolded. Looking ahead, there are two likely scenarios: Either another bidder (such as **Glencore**) emerges now that an acceptable value and structure are clearer, or Anglo will proceed independently and face pressure to execute the strategy outlined in its defence strategy.

DS Smith was also volatile due to speculation surrounding its bidder, International Paper, potentially being acquired by a Brazilian company. However, no concrete bid (has yet) materialised, and the details seemed to lack credibility as the debt needed to fund the suggested acquisition would have left the company unsustainably geared. We increased our holdings in DS Smith during this period of weakness.

We commented on **Tyman** last month, which received an approach from the US-listed Quanex. Our assessment indicated that the offer was c.50-75p too low. In our view, an optimal exit price would be 450-475p per share, which equates to c.12x normalised EPS, which we believe is fair valuation for a market leader. We also noted that a large part of the offer comes in the form of paper in Quanex, where flow back is likely to erode some of the headline value. Throughout May, Tyman's shares gradually declined in line with the fall in Quanex's share price. Given the value dynamics and the nature of the situation, we find it surprising that no other potential suitors have emerged.

Outlook

Last month, we outlined the growing list of short-term catalysts for UK equities: potential divergence of UK central bank policy with the Fed, a divergence of economic growth with the US, accelerating M&A in the modestly valued sectors, accelerating self-help to unlock undervaluation, and gathering price momentum. All of these have strengthened during the last month, except for the potential divergence of central bank policy as the latest inflation print and wage data have probably deferred the first UK rate cut by a couple of months.

However, we can now add to the list a likely clarification of the UK political environment with a new government due to be in power in just over four weeks' time. International investors, in particular, will see a clean election result as a meaningful new catalyst, given the erratic political manoeuvres of the last decade. Furthermore, UK equity's strong recent performance has definitely caught the attention of the more momentum-driven investors, of which there are many globally.

Domestic economic momentum is also gathering momentum, not just in the official data but also in company commentary. A prime example is ITV, which has seen advertising growth accelerate from 3% in Q1 2024 to 12% in Q2. This has partly been driven by the broadcasting of Football's EURO 2024 in June but clearly shows the improvement in business confidence more broadly. The Lloyds business confidence survey gained 8 points in May to 50%, reaching its highest level since the 2016 Brexit referendum. The situation in the UK is somewhat nuanced as the recovery has been partly driven by an expectation that interest rates will be cut, and yet if the recovery happens more quickly, it will negate the need for those cuts, which, in turn, may cool the recovery. However, with the ECB likely to ease policy, too, the window for UK rate cuts is open and should be embraced by the MPC.

Whilst the unit price of our Fund has had a welcome move higher in the last three months, we would encourage all investors (both existing and potential) to look at the bigger picture. The UK has seen a steady de-rating vs other international markets since the Brexit referendum in the summer of 2016, and two or three months of better performance is merely a rounding error in the context of that longer term context. UK valuations, both for domestically orientated stocks and international ones, remain at heavy discounts compared to their own history or their international peer group. We believe we are in the mere foothills of a UK equity market recovery, which may take many years to fully play out.

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