Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: November 2017

Active sector bets for the month ending 31 October 2017

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	8.94	2.93	+6.01
Construction & Materials	6.18	1.53	+4.65
Banks	15.43	11.08	+4.35
Oil & Gas Producers	16.45	12.28	+4.17
Mining	9.50	6.25	+3.25

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.89	-5.89
Pharmaceuticals & Biotechnology	3.06	7.21	-4.15
Equity Investment Instruments	0.38	4.45	-4.07
Beverages	0.00	2.97	-2.97
Personal Goods	0.00	2.50	-2.50

Active stock bets for the month ending 31 October 2017

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.88	0.85	+3.03
BP	7.07	4.06	+3.01
Lloyds Banking Group	4.85	2.01	+2.84
Standard Life Aberdeen	3.13	0.48	+2.65
Rio Tinto	4.39	1.75	+2.64
DS Smith	2.79	0.20	+2.59
Barclays	3.85	1.29	+2.56
National Express Group	2.60	0.06	+2.54
ITV	2.75	0.26	+2.49
Morgan Sindall Group	1.87	0.02	+1.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.65	-4.65
GlaxoSmithKline	0.00	2.74	-2.74
Diageo	0.00	2.64	-2.64
Unilever	0.00	2.05	-2.05
Prudential	0.00	1.97	-1.97

Performance to 31 October 2017

	1 month (%)	Year to date (%)	Since inception (%)	Fund size
JOHCM UK Equity Income Fund	**2.67**	**14.68**	**280.50**	**£3,479m**
Lipper UK Equity Income Mean*	1.44	9.28	169.92	
FTSE All-Share TR Index (adjusted)	1.88	10.37	176.04	

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

Economic momentum continued to be very strong across most of the developed world economies during the month, with many of the forward-looking indicators hitting multi-year highs. Examples included the German IFO Survey of business confidence hitting an all-time peak in October; the US Conference Board Consumer Confidence Index registering its highest level for 17 years; and the US ISM Manufacturing Index reaching a 13-year high and showing a particularly strong rate of acceleration in the last quarter. Furthermore, the rather more historic indicators of economic performance also showed consistently strong growth, with Q3 GDP growth in both the UK and the US exceeding expectations. It is this backdrop which is driving the somewhat co-ordinated withdrawal of stimulus by central banks across these regions.

This withdrawal of stimulus is occurring in different ways and at different speeds, but the direction of travel is clear. The Fed looks to be clear in its resolve to further raise interest rates, even with the uncertainty of the new Governor's appointment looming. In the UK, the reversal of the post-Brexit vote "temporary" monetary stimulus looks very likely to be confirmed at the November meeting, whilst in Europe the ECB has begun to taper its quantitative easing programme. On the latter, the debate about whether the decision to reduce the QE purchases to €30bn per month was more dovish than consensus or not rather misses the bigger picture, namely that the process of tapering has finally begun.

In the UK, the most closely-watched release of the month (both by us and by Mr Carney) firmed slightly, with UK average weekly earnings rising 2.1% year-on-year. We strongly believe that with the reduced inward migration from Europe, labour shortages will intensify in the private sector. Coupled with the delicate political situation leading to less austerity and rising public sector awards, we expect to see growth in average earnings progressively move towards 3% over the next year. It is important to note that this measure tends to move glacially, not least because it is a rolling three-month average, so the publication of one extra month's data has a limited immediate impact. However, the policy-makers at the Bank of England know that once the labour force rediscovers its collective bargaining power, the impact can be material and long-lasting, hence their focus upon this key indicator. At the same time, we would anticipate that the headline inflation data, which hit 3% this month, will progressively fall back from here as the base effects of the currency devaluation drop out. Consequently, the real wage squeeze will fade over the coming months.

In Europe, whilst economic momentum has continued to build across the Continent, inevitably issues of political stability and collective unity still threaten to disrupt the recovery, not least in Catalonia. The election of the youngest ever leader in Austria is a reminder that extremist parties and anti-establishment platforms are likely to continue to grow in popularity across the region. Concern in Brussels that similar movements will grow more powerful across Europe explains their desire to drive a relatively hard bargain with UK over its exit.

The Brent oil price rose above US$60/bbl for the first time in two years and has now more than doubled from its low in January 2016. However, it still remains around 50% below the levels seen during 2014, and with the oil majors showing strong capital discipline, OPEC holding firm on its commitment to restrict output, and the weakening economics of shale operators in the US, we expect the commodity to continue to surprise many commentators. The deteriorating economics of the shale operators, with declining production and rising operating costs, is beginning to manifest itself in a slightly declining rig count in North America, despite the higher oil price.

In Asia, China's GDP growth continues to show resilience, with 6.8% printed in the third quarter. Demand for most industrial commodities remains firm, assisted by strong growth elsewhere in the world, with the 25% rise in the copper price so far in 2017 evidence of an improving supply/demand dynamic.

Performance

The market was strong during October, with the FTSE All-Share Total Return Index (12pm adjusted) posting an increase of 1.88%. The Fund continued to perform strongly compared to the benchmark, returning 2.67%.

Year-to-date the Fund is up 14.68% versus the benchmark return of 10.37%. Looking at the peer group, the Fund is ranked first decile within the IA UK Equity Income sector over one year to 31 October 2017. On a longer-term basis, the Fund is ranked first decile over three years, 10 years and since launch (November 2004) and first quartile (second decile) over five years.

October is normally a 'risk' month for both the market and the Fund because there are usually a larger than normal number of profit warnings - any company that is not going to hit full-year forecasts, having seen its September results and October trends, has to announce to the market. And indeed there were a large number of warnings in October: Interserve, IWG, Pendragon, Dialight, Merlin, Carpetright, GKN and WPP all had sluggish statements.

The Fund had two poor statements. **Barclays** (down 7% relative over the month) delivered a poor quarter, particularly in its investment bank, and whilst it produced useful timelines for its ROCE recovery and cost targets, the former rely on a big revenue recovery in the investment bank. **Low & Bonar** (down 13% relative over the month) also warned profits in one of its five divisions would be worse than expected. But the Fund also had a number of strong statements: **BP**, **National Express**, **DS Smith** (all three of which are in our top 10 active positions), **Hollywood Bowl** and **Laird** were all very positive. A large part of the Fund's outperformance was linked to these trends.

Elsewhere, both the wider oil and mining sectors performed well (up 2-5% relative), underpinned by rising commodity prices and a growing realisation of the strong cash flow characteristics in the mining sector. **Keller** and **Northgate** made ground following capital markets events in the latter part of September and early October respectively that both gave a strong message on future performance aspiration. Offsetting these positives was the generally sluggish performance of financials, **ITV's** continued underperformance (see below) and weakness in our retail names.

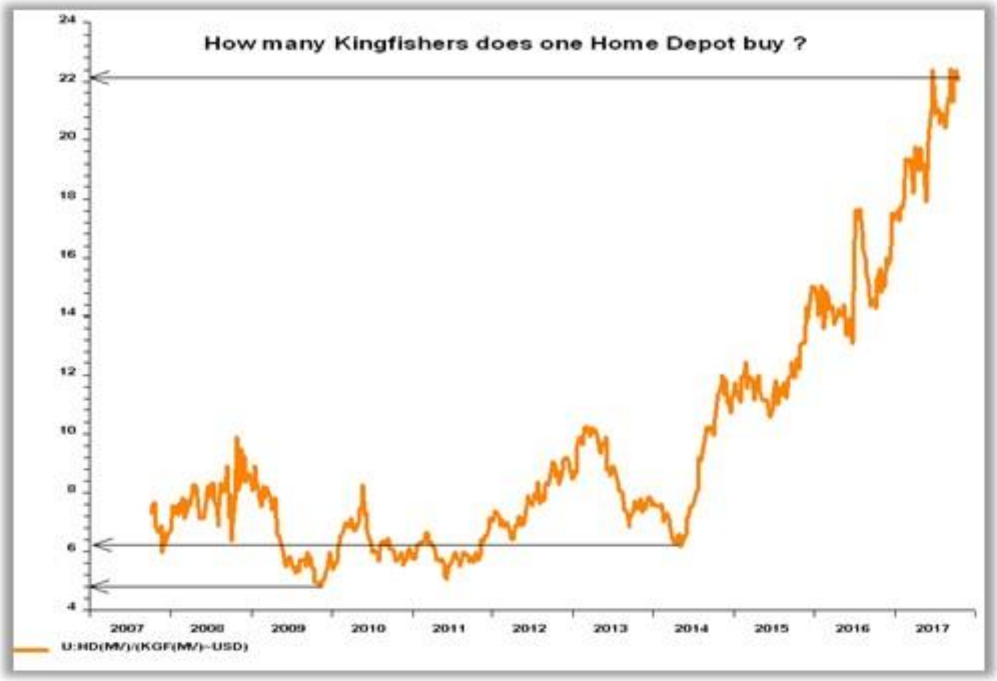
Another notable feature of the market in October was poor statements by a number of the 'defensives'. GlaxoSmithKline, Reckitt Benckiser and Imperial Brands all had disappointing results, with many of their US-quoted peers also showing similar softness. The basic issue is a lack of revenue growth. This is caused by a multitude of issues, many of which we believe are structural (deflationary pricing, "infinite shelf", lower barriers to entry, online competition, etc). The stumbling of the micro performance, coupled with high valuations (c. 20x P/E being the common ground) and the impact of rising bond yields, which we have discussed before, create a difficult combination. We remain very underweight in these areas.

Portfolio activity

We added one new stock to the Fund in October in the form of international home improvement retail group **Kingfisher**, owner of brands such as B&Q and Screwfix in the UK and Brico Depot and Castorama in France. Its shares are trading around a 7-8 year relative low, on a P/E of c. 12.5x and currently yield nearly 4% while the company has c. £600m net cash on its balance sheet.

The recently appointed management team has articulated a strategy that if executed would add £500m to annual profits by the year ending January 2021 (using 2016 as the base year when the group made c. £700m). This is a potential material step change in profitability about which the stock market is highly sceptical despite early evidence of traction. The £500m is to be generated by optimising operational efficiency (which should be relatively low risk), improving digital capability (which was needed) and creating a unified and unique offer that is sold across the group. The latter is the most material part of the total estimated gains (70%) but will be the most difficult to execute. On the current valuation, the share price is assuming no success with this new strategy, which creates a useful risk/reward dynamic.

Kingfisher's low valuation is put into context by the graph below. This shows how many Kingfishers Home Depot's market cap could buy over time: three years ago the market cap of Home Depot was worth six Kingfishers; today you could buy 22 Kingfishers with Home Depot's market cap. Home Depot has executed well, using some of the strategies Kingfisher is now adopting, trades on 20x EPS and makes a margin that Kingfisher would deliver were its new strategy to prove successful.



Source: Redburn (Oct 2017)

The new strategy is not the only attraction of Kingfisher. Firstly, it also offers exposure to the recovering French economy (something that is hard to find via UK-listed stocks), with c. 40% of EBIT sourced from France via its ownership of Castorama and Brico Depot. Secondly, Screwfix (c. 20% of group EBIT) has one of the best organic growth records in the whole market, if considered separately. Thirdly, Kingfisher owns c. £3.5bn of freehold property. Fourthly and finally, it has a strong position in the vibrant Polish market.

The weakest part of the group, in our view, is B&Q, which accounts for c. 25% of EBIT. However, this business will also benefit from the new strategy and investment in digital and could be boosted by a retrenchment by Bunnings, the Australian retailer that acquired Homebase a few years ago. Recent results from this business suggest the Bunnings UK axis is struggling.

In other activity, we continued to add to recent new additions **Hammerson** and **Central Asia Metals.** We also continued to reduce our positions in both **AstraZeneca** and **Laird** into strength. We have outlined the rationale for these changes in recent monthly reports. In the former, we are now down to a c. 50bp overweight, with the stock being 3% of the Fund. AstraZeneca is our only holding in the pharmaceuticals sector; we do not own any GlaxoSmithKline, which, as noted above, had weak results; it also presented a confused picture on its dividend outlook. We continue to think Glaxo has a number of challenges, including its level of debt, potential liabilities from various put options, competitive challenges in a number of its large businesses (e.g. its HIV franchise) and that its P&L (and hence EPS and P/E-based valuations) does not include a number of material cash items (e.g. certain royalties). AstraZeneca has some of these traits, which is why we are comfortable reducing the weighting given how the share price has recovered, and in running a large underweight in the sector.

We also reduced **DS Smith** slightly, which has been a good performer recently, and **Sainsbury**, where near term trends, based on industry data, appear sluggish. We added to **ITV**, which continues to underperform despite evidence that TV advertising is recovering. We also topped up our **Vodafone** position, which has continued to perform poorly (down c. 10% relative the past year).

Outlook

The path to policy normalisation has categorically begun in the US, the UK and Europe. The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, without doubt it has pushed valuations of many assets and individual instruments to elevated levels that will be hard to justify if the cost of capital rises. There are also a number of geopolitical risks that also make for a more cautious tone – namely Korea, Trump's progress (or lack of) on policy, Trump / Russia, the tensions in the Middle East, Brexit, etc.

Within the equity markets, we strongly believe that the overvaluation is most apparent in consumer staples and other perceived defensive sectors such as utilities and pharmaceuticals. It is pleasing that we are starting to see chinks in the armour in the operational performances of these businesses. Conversely, we believe that many of the areas that we are exposed to will respond well to a change of stock market leadership if monetary policy were to normalise, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also selective opportunities in the UK domestic arena, too.

The long-term performance of the Fund is heavily correlated to the Fund's dividend growth and the resulting absolute level of the dividend. As we discussed two months ago, the dividend growth of the Fund remains robust – our current guidance is between 9-11% in 2017. We will provide a final update on the 2017 dividend growth in early December, with the risk remaining to the upside. The Fund yields c. 4.15% based on this 2017 dividend stream. This starting yield, strong dividend growth (which we expect to continue in 2018), the low valuations embedded across the portfolio, coupled with the shift in monetary policy, leave us cautiously optimistic in our outlook for the Fund.

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

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.

Investors should note that there may be no recognised market for investments selected by the Investment Manager and it may, therefore, be difficult to deal in the investments or to obtain reliable information about their value or the extent of the risks to which they are exposed.

The Investment Manager may undertake investments on behalf of the Fund in countries other than the investors' own domicile. Investors should also note that changes in rates of exchange may cause the value of investments to go up or down.