JOHCM UK Equity Income Fund

Monthly Bulletin: November 2018

Active sector bets for the month ending 31 October 2018:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Banks	16.47	10.26	+6.20
Financial Services	9.22	3.10	+6.12
Mining	10.76	6.28	+4.48
Oil & Gas Producers	17.87	14.13	+3.75
General Retailers	5.12	1.69	+3.43

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.97	-8.97
Tobacco	0.00	4.62	-4.62
Equity Investment Instruments	0.61	4.77	-4.16
Beverages	0.00	3.22	-3.22
Personal Goods	0.00	2.45	-2.45

Active stock bets for the month ending 31 October 2018:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.68	0.73	+2.95
BP	7.65	4.73	+2.92
ITV	3.10	0.24	+2.85
Lloyds Banking Group	4.64	1.81	+2.83
Barclays	4.08	1.29	+2.80
DS Smith	2.92	0.22	+2.71
Glencore	4.25	1.58	+2.68
Standard Life Aberdeen	2.62	0.30	+2.32
National Express Group	2.26	0.07	+2.18
Hammerson	2.05	0.16	+1.89

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	3.49	-3.49
AstraZeneca	0.00	3.34	-3.34
GlaxoSmithKline	0.00	3.32	-3.32
Diageo	0.00	2.88	-2.88
Unilever	0.00	2.07	-2.07

Performance to 31 October 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-5.85**	**-5.95**	**268.60**	**£3,472mn**
Lipper UK Equity Income mean*	-5.52	-5.41	161.35	
FTSE All-Share TR Index (12pm adjusted)	-5.03	-3.72	172.34	

Discrete 12-month performance (%) to:

	31.10.18	31.10.17	31.10.16	31.10.15	31.10.14
JOHCM UK Equity Income Fund – A Acc GBP	**-3.13**	**21.92**	**7.88**	**3.69**	**1.82**
FTSE All-Share TR Index (12pm adjusted)	-1.34	13.29	12.19	3.09	0.85

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

Is this month's correction an economic event or just a stock market one? It is worth pointing out that it is not unusual to see stock market setbacks at this time of year. This is principally because October typically marks the point in the calendar when companies have to "own up" if they are not going to meet their full-year projections. In this respect, 2018 has been fairly typical, with a number of global companies issuing disappointing updates, particularly those in the autos and broader engineering sectors. Furthermore, a wider group of companies have begun to warn about rising inflationary pressures, both from raw materials and labour, fuelling fear about peak margins. This slightly more cautious tone from the corporate sector has combined with the growing sense of stimulus withdrawal from central banks to create a not entirely surprising bout of profit taking by equity investors.

Stock market falls are rarely orderly in nature. We have been warning about the narrow leadership of markets, particularly in the US, for some time. As such, we are not surprised by the 25% fall in the likes of Amazon in October (still leaving the stock up 40% for the last 12 months). However, what has been a little surprising has been the impact that these falls in the FAANGS have had on unrelated sectors and markets across the world, which are valued on a very different basis. Typically, it takes a few weeks for the situation to even itself out.

However, in general, this has been a (somewhat overdue) stock market event rather than a reflection of a major change in economic prospects. Clearly there has been some slowing of economic momentum, most clearly in Europe where both the latest PMIs and the initial Q3 GDP prints reflect the slowest rate of growth for four years. The impact of a slowing and structurally changing autos market has had a significant impact here, particularly in Germany, as have political uncertainties in Italy. Europe's exports to China have also shown signs of slowing, as the impact of trade tariffs and a slightly softer Chinese economy also have an impact.

In the US, economic momentum remains strong for now, as robust employment markets manifest themselves in the highest consumer confidence readings for 18 years. However, in places the impact of monetary tightening is beginning to appear as more expensive mortgages have contributed to new home sales falling for four months in a row. Nevertheless, Federal Reserve Governor Powell is still likely to focus upon the building inflationary pressures in the short term and continue to progressively tighten, despite the protestations of Mr Trump and the stock market setback.

In the UK, despite the latest Brexit impasse, the economy has remained on its resilient path. Wage inflation is accelerating, with the latest three-month average pay number (to August) rising to

3.1%, its highest level for almost ten years. It is striking that the most significant contributor to this acceleration has been an increase in public sector wages over the summer. This reflects the loosening of pay caps in areas such as the NHS and looks set to accelerate further following the "end of austerity" budget. With real wage growth set to rise further, it seems likely that consumer activity will continue to surprise positively. However, business confidence continues to drift lower and requires a decisive breakthrough in the European negotiations to pick up. This contrast between the different elements of the economy makes for a tricky set of meetings for the Bank of England. Nonetheless, their bias is likely to favour further interest rate increases, mainly due to the very tight labour market. Any kind of resolution on the Northern Ireland issue and a commensurate removal of the Brexit uncertainty will almost certainly be met with monetary tightening.

Performance

As discussed above, the FTSE All-Share Total Return Index (12pm adjusted) fell significantly in October, returning -5.03%. The Fund modestly underperformed in returning -5.85%. Year to date the Fund has returned -5.95% versus an index return of -3.72%.

Looking at the peer group, the Fund is ranked third quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked first quartile over three years, five years, 10 years and since launch (November 2004).

Performance trends in October were distinctly defensive. This was partly driven by a sudden decline in global markets, creating a rush to perceived safe areas, and partly, in a UK context, by sterling weakness caused by the noise around Brexit negotiations. This also helps the relative performance of the defensives given they are largely overseas-earners. The tobacco, pharmaceuticals, beverages, utilities and related areas all performed strongly, which hindered the Fund's relative performance.

The other feature of October was the lack of market focus on valuation. Stock price moves were more driven by liquidity, general market movements and the rush to perceived safety at any price. These conditions do not favour the Fund's style but will iron out over time as the market returns to focus on valuation, as it always does. Indeed, this started to happen in the last few days of the month. As we describe elsewhere in this report, there is now, in our view, material value in the Fund.

Beyond these two trends were a number of interesting performance observations. Our UK banks performed well. Both **Lloyds Banking Group** and **Barclays** were good relative performers after strong results. In fact, all four of our bank positions (the two mentioned above, along with **HSBC** and **Standard Chartered**) responded well to their results and were up on the release day. This is the first time we can remember this happening since the end of the financial crisis – maybe a seminal moment. In contrast to the banks, the insurance sector performed poorly, with both of our largest stocks (**Aviva** and **Phoenix**) down 5%+ relative.

Our two largest positions that we classify in our defensive bucket, **National Express** and **DS Smith**, performed very differently. National Express moved to a new relative high following a very strong trading update, whilst DS Smith fell 10% relative on very little new information and shortly after a very positive capital markets day. Both of these stocks normally correlate with the wider defensive parts of the market.

The domestic part of the portfolio in general underperformed. This was particularly the case for stocks linked to the house building sector. **Countryside**, **Bovis** and **Forterra** were particularly weak.

On a stock specific basis, our two best performers were **TP ICAP**, up 10% relative, recovering further from a profit warning during the summer, and **Raven Property**, up 25% relative, following a strong set of figures in September.

Portfolio activity

Driven by the downward move in the market and the volatility within it across the month, we made a number of changes to the Fund during October.

We have noted in the last few monthly reports that we had been reducing our position in **Sainsbury's**. This was partly a function of its performance (after the step change up in the share price following the announcement of its proposed merger with Asda) and partly a function of lacklustre operational performance. We sold the residual position during October.

Separately, we have been monitoring the recovery of **Tesco** (which we view positively and believe is sustainable) for the last 12 months. We had not previously added the stock to the Fund as we viewed the valuation as being too high. The shares fell c. 20% in the run up to Tesco's recent results and immediately after as one of its main overseas markets, Thailand, disappointed. This created the opportunity to enter the stock on a valuation more in line with other parts of the Fund (a P/E ratio of 10x and a free cash flow yield of c. 8-9%). As well as the UK turnaround, the opportunity in the wholesale segment (after the acquisition of Booker), the joint purchasing arrangements with Carrefour and the strength of the balance sheet, which will likely lead to strong ordinary dividend growth and special dividends, are the key attractions. Our aggregate position in food retail is c. 70bp lower (compared to June 2018) following these adjustments, reflecting the fact that the sector has performed well. We will continue to add to Tesco over the next few months. The other position is **Morrisons**, which remained unchanged.

As we mentioned earlier, two of our defensive stocks performed very differently. We added to **DS Smith** (its P/E ratio is less than 10x for 2019) whilst **National Express** was marked back to its target weight.

As noted above, parts of the domestic sectors were very weak during the month. We added to **Galliford Try**, **Forterra** (where another fund management group sold c. 8% of the company, which cleared a long running overhang) and **Countryside,** amongst others.

In the oil sector, we added a small position in **Savannah Petroleum**. Similar to the other small cap stock we own in the oil sector (**Diversified Gas & Oil**), it has a high free cash flow yield and a high dividend yield. The majority of the small cap oil / gas sector have neither as they are mainly focused on exploration. Savannah spans both production and exploration, with a geographic focus in Nigeria and Niger. The production assets in Nigeria provide a strong free cash flow profile that funds the exploration in Niger and the dividend. The group has strong assets / rights in each country and has, to date, delivered positive results and executed well on strategic initiatives. Assuming both sides of the business perform as we anticipate, the free cash flow yield is well over 20%, similar to Diversified Gas and Oil. Our position is currently small (c. 30bp) as we monitor progress versus the outlined strategy.

We funded our position in Savannah by reducing our holding in **Royal Dutch Shell**. This move meant we are now underweight this stock for the first time in c. 3-4 years. Our main position in the oil sector is **BP**, which is one of the largest active positions in the Fund.

Finally, in the financial sector, we reduced **Lloyds** slightly and added to **Barclays** to equalise the weightings. Both banks posted positive results in October but Barclays, courtesy of its valuation (0.6x book value), has more upside. Both remain in our top ten active positions. We also added to **Standard Life Aberdeen** to partially rebuild its weighting after the capital return that crystallised during the month.

Outlook

As we have been commenting for some time, the progressive withdrawal of monetary stimulus across the major developed economies was likely to introduce more volatility in markets and generally make it harder for indices to make meaningful progress. However, the impact of this tightening should predominantly be on the highly rated parts of the market (FAANGS, consumer staples, compounders). These areas have dined out on an effective zero cost of capital for years. Regular readers will know that we have been cautiously positioned here for a very long time. The valuation agenda in the parts of the market where we are invested is very different, as evidenced by the following data as at the end of October:

- 63% of the Fund (by value) has a dividend yield of >6% to December 2019
- 65% of the Fund (by value) has a free cash flow yield of >10% to December 2019
- Only 10% of the Fund has net debt/EBITDA OF >2x (excluding financials)
- Almost 50% of the Fund (by value) has committed to buy back equity over the next 12 months

- The aggregate price-to-book multiple of the Fund sits just above 1x.

We believe this combination of valuation characteristics for a diversified portfolio of ~60 stocks invested across the market cap spectrum is extremely attractive, particularly when combined with the strong dividend growth that the Fund is currently displaying (our current guidance is 12 / 13% growth for 2018 with risk to the upside).

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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