J O Hambro Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: November 2020

Active sector bets for the month ending 31 October 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.31	3.02	+7.29
Mining	13.63	7.36	+6.27
Media	9.01	3.54	+5.47
Food & Drug Retailers	6.33	2.18	+4.15
Banks	10.84	6.80	+4.04

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.01	-10.01
Equity Investment Instruments	0.00	7.35	-7.35
Tobacco	0.00	3.77	-3.77
Beverages	0.00	3.52	-3.52
Personal Goods	0.00	3.06	-3.06

Active stock bets for the month ending 31 October 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.12	1.00	+3.12
Legal & General Group	3.70	0.60	+3.10
Phoenix Group	3.23	0.20	+3.03
Vistry Group	3.09	0.07	+3.02
WPP	3.41	0.39	+3.02
Tesco	4.07	1.09	+2.98
ITV	3.12	0.15	+2.97
Countryside Properties	2.95	0.09	+2.86
BP	4.97	2.13	+2.84
Anglo American	4.06	1.23	+2.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.73	-5.73
HSBC	0.00	3.66	-3.66
GlaxoSmithKline	0.00	3.56	-3.56
Diageo	0.00	3.18	-3.18
British American Tobacco	0.00	3.12	-3.12

Performance to 31 October 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	**-1.40**	**-36.15**	**160.70**	**£1,432mn**	**£1,765mn**
Lipper UK Equity Income mean*	-3.69	-25.96	118.03		
FTSE All-Share TR Index (12pm adjusted)	-4.04	-23.09	135.99		

Discrete 12-month performance (%) to:

	31.10.20	31.10.19	31.10.18	31.10.17	31.10.16
JOHCM UK Equity Income Fund – A Acc GBP	**-30.92**	**2.39**	**-3.13**	**21.92**	**7.88**
FTSE All-Share TR Index (12pm adjusted)	-18.85	6.78	-1.34	13.29	12.19

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

Economic data released during October generally reflected the continued recovery from the sharp reduction in activity in Q2 2020. However, a number of indicators began to show slowing momentum during the month. This is highly likely to continue in Q4 as restrictions on mobility are increased, particularly in Europe including within the UK after Saturday's announcement of a one-month lockdown.

In the UK, the August GDP growth estimate of 2.1% month-on-month was much lower than expected, with industrial production in particular showing only modest growth. Whilst acknowledging that growth has progressively slowed over the late summer, we would still expect this number to be revised higher at some stage and for September to show a healthy rate of growth, too. This is based upon a number of strong economic indicators and company commentaries in a variety of sectors. The UK labour market has shown surprising stability and resilience thus far: the number of people in paid employment actually grew by 20,000 in September (although the figure is still 630,000 lower than in March) and vacancies grew by 144,000 in Q3 (332,000 lower than at the end of March). The housing market is particularly strong, as the quality of one's home environment has never been more important to individuals – UK mortgage approvals in September were 91,400, which is the highest monthly figure for 13 years and 30% above the pre-Covid-19 monthly levels. Banks have reported extraordinary levels of mortgage applications in the last few months, which has resulted in quite sharp increases in mortgage pricing as demand outstrips supply. Retail sales have also recovered very strongly, with September showing 4.7% growth year-on-year but, in keeping with the general tone, the CBI distributive trades survey reflected the likely future slowdown in activity with the first negative reading since June. Furthermore, clearly the extra restrictions for November will come at a difficult seasonal moment for a number of retailers. However, we would expect housing/mortgage demand to remain relatively robust, even if physical viewings are somewhat restricted, due to individuals' desire to upgrade their own physical environment.

In the US, whilst most of the focus has been upon the upcoming election, the economic data has again shown strong resilience. Housing was a standout as single-family homebuilding hit a 13-year high. There is also evidence of restocking in the industrial supply chain, which is best reflected by the Philly Fed New Orders index jumping to its second highest level on record. Notably, despite the resurgence of the virus and a failure to sign a further stimulus deal, 10-year Treasury yields actually rose by 15bps during the month.

Chinese economic activity has continued its strong recovery, particularly in industrial production with the Caixin October manufacturing Purchasing Managers Index hitting its highest level since January 2011. The slowdown in growth in Continental Europe will be accelerated by the mobility restrictions announced in the last few days. The mid-month PMI surveys were already reflecting this, with the European composite reading just below 50.

Performance

After initially rising, the market fell sharply in the last week of October, leaving the FTSE All-Share Total Return index (12pm adjusted) down 4.04%. The Fund outperformed the market by 264bp, falling by 1.40%. It remains significantly behind year to date (-36.15% versus a -23.09% return for the index), with most of the underperformance arising after the pandemic first broke, in March/April.

Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector for October. On a longer-term basis, the Fund is ranked fourth quartile over three years, third quartile over five years, second quartile over ten years and first quartile since launch (Nov 2004).

The positive relative performance over the month was largely down to better mood music around Brexit (which led to a small uptick in sterling) and increasing expectations of a Biden victory in the US election. Both factors led to a rise in bond yields in the first part of the month, albeit some of the ground made was lost in the latter part of the month. We will know the outcome of both within days, which will set the tone for markets over the next six months.

These developments led to banks outperforming strongly (c. 10-12%). This was helped by a strong results season for the banks, with good trends across all of the main drivers and in particular lower provisioning and better capital profiles. The insurance sector was more muted, with **Aviva** particularly under pressure. Elsewhere in the financial sector, **TP ICAP** underperformed. It announced a very good strategic deal but fumbled the methodology of financing it, which created pressure on the stock.

Small caps also performed well on the back of strong results. This fits in with the theme we have discussed in previous reports: the majority of the Fund is noticeably back on the front foot following Covid-19-related setbacks and most are on the right side of the spending shift, as consumers move away from travel, leisure and commuting spending towards spending around the home. Stocks of note include **Norcros**, **Tyman** and **DFS**, which were up 20-30% in relative terms after their respective trading updates, whilst **Sthree** and **Polar Capital** were up c. 10% in relative terms. The strongest performer in the Fund was also in the small cap sector – **McCarthy & Stone** (up 70% relative), which received a bid from private equity. The bid was a welcome signal that there is deep value in the UK equity market and the Fund.

The commodity sectors continued to be mixed. Oil underperformed, particularly **BP** (down 10% relative). BP is now on a forward free cashflow yield of 20-25%. Mining performed slightly better than the market, with our two small caps **Kenmare** and **Central Asia Metals** doing well.

Portfolio activity

After a few quiet months in terms of portfolio activity (as we waited for the portfolio to breathe and for some positive relative performance to start to register), we were more active in September.

Small caps, as highlighted above, performed well. We sold our position in McCarthy & Stone after the abovementioned bid was announced. Whilst a counterbid is a potential outcome, McCarthy & Stone is one of the most affected by Covid-19 given the nature of its customer base, which could deter other acquirers. We also have plenty of other stocks with sizeable upside to rotate into. We also marked our positions in **DFS**, **Randall & Quilter** and **Tyman**, which were also strong. We added to the small caps which were more sluggish – **Galliford**, **Keller**, and **Kenmare** (before it moved higher), where the repositioning of its asset base to a new ore body reduces risk and triples free cashflow. We have previously laid out (in this paper) how significant the upside is in the small cap part of the Fund. October was the first month this year that this element of the Fund started to gain traction. In our view, there is plenty more to come from this segment, which remains c. 17-18% of the Fund's total capital.

Elsewhere we restructured our banks positions. We have indicated before that there are a few stocks in the Fund (less than 5% of total capital) that have significant upside but do not have the same multi-pronged fundamental dynamics of the majority of the Fund. One of those stocks is **Lloyds Bank**, which has started to trend higher. Where we have found better ideas, we have gradually reduced Lloyds, and we will make the final adjustment if the shares respond to any positive events (e.g. a Brexit solution or a vaccine). We switched part of Lloyds into **Natwest Group**. Compared to Lloyds, it is cheaper (0.35x book value); it has the most capital of any of the UK banks (astonishingly it announced in its results last week it has tier 1 capital of 18.2%) and will therefore most likely be one of the first to return to the dividend list; it has a new management team that is restructuring the residual legacy issues; and it is more exposed to the positive operational changes, such as mortgage spreads widening. The majority of our bank exposure (**Barclays**, **Standard Chartered**, **Natwest Group** and **Lloyds**), which is c. 11% of the Fund, is now in the valuation band of 0.35x -0.4x book value, with ample, and in most cases excess, capital. All of these stocks should, over time, trade on (at least) 0.8x book value.

WPP was strong in the early part of the month following its trading statement in the previous month but also a series of its peers' statements which suggested activity was recovering. Its earlier-than-expected reinstatement of the dividend has also helped sentiment across the summer. We marked our position to 300bp.

Elsewhere we added to **BP** which remained weak despite better-than-expected results. On its cut dividend it yields 8%. We also added to **Aviva**, which, unlike the banks sector highlighted above, remained weak. As we pointed out last month, it has started a refocusing exercise under a new chief executive. The Singapore business was sold for four times the multiple the whole group trades on, and there were continuing rumours that multiple bidders were lining up for its French businesses. The new CEO acquired £1m worth of stock in August at a price 15% higher than where the shares now sit. Modelling the likely sales, deleveraging and share buybacks with excess proceeds, we estimate c. 60p earnings per share. The stock trades on a P/E ratio of 5x and yields 8% (on an assumed cut dividend). We also added to **Vistry** and **WM Morrison**.

Outlook

We have noted for the last two months that corporate results have been largely better than expected, and this trend continued in October, particularly within banks and small caps. There were four main reasons for this: 1) investors had been too pessimistic; 2) the economy has thus far recovered faster than expected; 3) the policy response has been larger than expected; and 4) management actions have been positive. As indicated above, the second lockdown will challenge the second factor, but the other factors will continue to be positive as we move through the early part of 2021. Most of the Fund is on the right side of the Covid-19 spending shift, with only c. 3% in highly affected sectors (UK property, **Easyjet** and **National Express**).

The Fund has responded positively for short periods when the market narrative has briefly changed (e.g. early June, early September). We saw this again during October in a relative sense.

We are about to enter a period of intense news flow, with the US election outcome, a potential Brexit conclusion and the possibility of a Covid-19 vaccine all due imminently. These three factors will set the tone for markets for the next 6-12 months. We expect the Fund to recover very strongly if we see either: a Brexit resolution, a Biden victory/Democratic Senate or a Covid-19 vaccine. Longer term, rising inflation expectations, increased M&A – where the bid for McCarthy & Stone, is unlikely to be the last given where valuations in the Fund reside – and a continued economic recovery in 2021 (as Covid-19 restrictions are lifted) will all help.

We continue to expect strong Fund dividend growth from the Covid-19-affected nadir of 2020. The trough yield in 2020 is c. 3.8%, moving towards 5.5-6% in 2022 when the full effect of 2021's dividend decisions flow through ex-dividend dates.

2020 has been a very challenging year for the Fund and we appreciate investors will be both disappointed and frustrated. As we showed in our Outlook section last month, the Fund typically bounces back strongly following periods of significant underperformance (i.e. the TMT bubble, the GFC). We believe we will see a similar recovery this time. As we have shown in recent papers, we have an excellent set of exposures in the Fund. Our portfolio companies are increasingly on the front foot after adjusting to the new normal. We have a lot of exposure to parts of the economy that have seen spending shift in their favour and very limited exposure to the sectors deeply affected by Covid-19.

The latest lockdown announcements will clearly challenge economies in the near term, but the very modest valuations across the Fund should provide some insulation during what should be a short-lived period of softer economic activity, assuming the latest lockdowns run to weeks rather than months.

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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