Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: November 2021

Active sector bets for the month ending 31 October 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.35	3.20	+7.15
Industrial Metals and Mining	14.22	7.50	+6.72
Media	8.01	3.11	+4.90
Household Goods & Home Construction	5.61	1.55	+4.06
Construction and Materials	5.12	1.55	+3.57

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.35	-9.35
Closed End Investments	0.00	6.94	-6.94
Personal Care, Drug and Grocery Stores	3.29	7.15	-3.86
Beverages	0.00	3.76	-3.76
Tobacco	0.00	2.98	-2.98

Active stock bets for the month ending 31 October 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Vistry Group	3.16	0.11	+3.05
Legal & General	3.71	0.70	+3.01
Barclays	4.37	1.37	+3.00
Standard Chartered	3.48	0.51	+2.97
WPP	3.45	0.49	+2.96
Phoenix Group	3.12	0.17	+2.95
ITV	3.09	0.16	+2.93
Anglo American	4.28	1.38	+2.90
Aviva	3.52	0.63	+2.89
BP	5.73	2.84	+2.89

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.68	-5.68
Unilever	0.00	4.08	-4.08
HSBC	0.00	3.65	-3.65
Royal Dutch Shell	1.79	5.41	-3.62
Diageo	0.00	3.38	-3.38

Performance to 31 October 2021 (%):

	1 month	Year to date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**1.84**	**23.95**	**326.50**	**£2,173mn**	**£2,540mn**
Lipper UK Equity Income mean*	0.45	14.99	195.90		
FTSE All-Share TR Index (12pm adjusted)	1.32	15.15	219.71		

Discrete 12-month performance (%) to:

	31.10.21	31.10.20	31.10.19	31.10.18	31.10.17
JOHCM UK Equity Income Fund – A Acc GBP	63.60	-30.92	2.39	-3.13	21.92
FTSE All-Share TR Index (12pm adjusted)	35.48	-18.85	6.78	-1.34	13.29

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

We continue to believe that markets are underestimating the trajectory of the UK economic recovery. This is due to ingrained pessimism surrounding the UK, coupled with more recent factors (such as the Delta variant of Covid-19) that have caused volatility in the economic recovery. The government's latest budget shows they are pro-growth with many supply-side measures announced to stimulate growth alongside spending initiatives on a series of infrastructure projects such as the energy transition. The recovery in the economy has been materially stronger than expected, which has created, with the change in corporation tax rate and higher national insurance contributions, a much healthier public borrowing profile. Unemployment will peak much lower than previous expectations at around 5%, which is driving wage inflation up. It is not inconceivable that wage inflation could be in the 4-5% bracket next year. This needs to be considered when one assesses the strength of household free cashflow. All too often, and particularly in the media, we only hear the negatives - rising living costs (petrol, gas, electricity). Nominal GDP growth next year (real GDP plus inflation) will be 8-9%. The UK economy is clearly in better shape than the consensus view.

This is why the Bank of England, after sticking to its 'inflation is transitory' narrative for much of the year, has had to do a sharp pivot to prepare the market for a rise in interest rates – possibly as early as this month. This is in line with most other global central banks with a number of second line countries (outside the G7) increasing interest rates and most others warning that QE will be tapered and interest rates will increase sooner than expected. As a result of this there was a material move up in 1-2 year interest rates globally this month. This backdrop has major implications for asset allocation. We note that whilst investors in aggregate are the most underweight in bonds as they have ever been, they remain very overweight the parts of the equity market that would not do well should bond yields continue to move higher. There is a stark anomaly here – both cannot be right.

In the US, activity seems to be picking up pace once again as Covid-19 cases decline; the Conference Board's consumer confidence index rose in October whilst new home sales hit a six-month high. Furthermore, all of the real time indicators suggest a meaningful pick up in employment, although the widely followed non-farm payroll data had yet to reflect that change due to some technicalities around how and when that data is collected. We expect that situation to change in the coming months. In contrast, data from China has continued to be soft, partly due to problems with electricity supply driven by weather and commodity price spikes. PMI data from the region has also been weaker, although the Caixin reading suggested an improvement this month. Data is likely to be volatile in the coming months due to the ongoing power issues, Evergrande fall-out concerns and a desire to reduce Covid-19 cases ahead of the winter Olympics, offset by further monetary policy easing.

The results published by our stocks and engagements with managements suggest growth has picked up in September / October as the Delta variant has started to fade. Most stocks in the Fund are still beating expectations. A good example – linking back to labour markets – was Page Group, which warned to the upside during the month highlighting September was close to +30% versus 2019 compared to July and August which were +5-10% versus 2019. As noted above we suspect some of the aggregate economic data in the next few weeks, such as the non-farm payrolls, will start to show strength versus the last few months, which have been sluggish due to the Delta variant.

Rising commodity prices are part of the reason for higher inflation. Copper and oil continued to rise during the month, with oil making a new multi-year high. These increases, coupled with the labour cost pressures highlighted above and supply chain pressures, are pushing input costs up. One of the key differences this cycle versus previous ones is that the visibility of inflation and the firmness of demand means the ability of firms to pass through cost increases is higher. We have not seen many of our stocks warn due to cost pressures (which would be normal). This pricing power, due to the current circumstances, also means inflation will be higher for longer. This dynamic is one reason why the central bank's 'transitory' narrative proved wrong.

Performance

Stock markets started the month poorly but rallied to new highs towards the end of the month. The FTSE All-Share Total Return index (12pm adjusted) finished modestly up (1.32%). The Fund outperformed its benchmark with a return of 1.84%. Year-to-date the Fund is up 23.95% while the benchmark is up 15.15% over the same period. Looking at the peer group, the Fund is ranked first quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked second quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

In comparison to September, sector trends were less clear in October, with more stock specific deviations. The one clear trend was the outperformance of the banks, which rose on the back of rising yields and mainly strong results. The sector continues to look well-set given low valuations (still on less than 0.7x book value), returns that are rising (to more than 10%), excess capital, excess provisions, which will be released next year, and, as a consequence, rising distributions. All our holdings are actively buying back shares as well as increasing dividends.

Other risers include **Anglo American**, which bounced back from a poor month in September; **Tesco**, which had very strong results (including the commencement of a buyback); **Randall & Quilter** (which has lagged); and **Endeavour Mining**.

The detractors, **DS Smith**, **ITV** and **Kier**, to name a few examples, moved lower due to an unfavourable market mix and lack of interest as opposed to any negative newsflow. We expect these names to rebound in due course. The first two are vulnerable to M&A activity given their strategic positions and ultralow valuations.

The other laggard was Petrofac, as a result of the temporary effect of new equity being raised. We discuss this in more detail below.

Portfolio activity

Whilst October was a positive month for performance overall, our portfolio was a mixed bag with some stocks lagging while others made new highs. This dynamic was the main reason behind most of the portfolio adjustments during month.

A number of our large active positions performed well, which meant we had to trim our positions to keep them at c. 300bp. **Glencore**, **Barclays**, **Legal & General**, **BP** and **Phoenix** all fit into this category. Similarly, some of our small-cap stocks continued to trend higher and we adjusted their weightings accordingly. Our small-caps have generated more than 300bp of relative performance this year, despite only representing c. 18% of the Fund's total capital. We expect continued strong performance from this segment of the Fund given the solid operating momentum across most of our names here. The average upside to prudently set target prices remains at c. 60% in this part of the Fund. Indeed, on the first day of November, U+I, was taken over by Land Securities at a +70% premia.

On the negative side of the ledger, **Petrofac** was weak. It has been in the ‘difficult’ basket within the Fund for over three years. The prevailing issue has been an outstanding SFO investigation that has materially impacted its ability to win new work. In October, the SFO and the company agreed a resolution to this, which has drawn a line under the situation and will allow the company to exploit its potential. It has a large pipeline of potential work being bid for (c. $42bn) including a pivot to projects in the energy transition space. Following the SFO settlement, the Board launched a refinancing exercise that included new equity. We had trended our weighting down over time, but used this to increase it given the upside that could now be unlocked. Our pro forma weighting (which will be seen in the Fund in November when the transaction settles) is c. 75bp. Our normalised earnings forecast is 30p versus a share price of 130p.

Elsewhere as noted above, a number of other stocks were weak. We added to **Diversified Energy Group**, **Kier**, **DS Smith**, **ITV,** and, earlier in the month, when it was weak, **Drax**.

We continued to add to last month’s new additions – **National Express** and **Stagecoach**, which are still discussing a merger. Our combined position is now c. 55bp with roughly half in each. **First Group** announced a tender offer for c. 40% of its share capital from the proceeds from the sale of its US operations. The tender price (at 105p) is c. 30% above our average entry price, but it is unlikely we will tender any stock as, on our calculations, the stock is worth between 185p and 215p, this is based on pro forma numbers, (accounting for the tender offer/reduced number of shares) assumes a P/E of between 10-12x on normalised earnings and 60p of additional value in the balance sheet that should come back to shareholders over time. First Group is c. 100bp of the Fund.

Fund dividend

We have materially increased our forecast for 2021 Fund dividend growth as the year has progressed. The latest upward adjustment this month is to expect growth of 62-64% (previous guidance was ‘approaching 60%’) which compares to a start-of-year forecast of c. 37% growth. The confidence around this is very high with c. 95% of all dividends either paid or already declared.

Based on growth of 63%, the Fund’s dividend yield for 2021 is projected to be around 4%.

Dividend growth will continue to be strong in both 2022 and 2023. As noted previously we expect to be back at the pre-covid dividend per unit level by the end of 2022, which would equate to a yield of c. 5%.

Outlook

The market continues to edge higher and the Fund continues to gently outperform the benchmark. Whilst the Fund is close to its all-time absolute high (which was reached in the middle of October), we remain very confident about the future trajectory. The main foundations for this confidence are:

- Covid 19 has shifted growth towards our portfolio. A number of our stocks have seen material market share uplifts or are exposed to themes such as the acceleration in the energy transition, the shift from plastics to cardboard, increased spend on infrastructure etc. Collectively these developments have created a powerful tailwind behind a large part of the Fund. This is highlighted below:

- Covid-19 has also led to a pivot in inflation – this is a major turning point given 20 years of deflation and falling bond yields. Higher inflation and higher bond yields are a powerful tailwind to 'value' generally and financials specifically.
- As a result of the first two points, the profit recovery in the Fund has been sharp – much sharper than most observers would expect. The table below takes a sample of stocks from the larger sectors and shows profit in 2022 (forecast) vs 2019 (actual). The difference across this sample, which covers a quarter of the Fund, is +38%. Most newsflow is putting upwards pressure on forecasts across the Fund.

Stock	2019 Profit (actual)	2022 Profit (forecast)	Change	Valuation
Barclays	£6.2bn PBT	£7.2bn PBT	+16%	7x PE / 0.6x Book
AngloAmerican	$10bn EBITDA	$15bn EBITDA	+50%	16% FCF Yield
norcros	£34m EBIT	£41m EBIT	+20%	8x PER
PageGroup	£147m EBIT	£190m EBIT	+30%	17x PER
dfs	18 EPS	28p EPS	+52%	10x PER
Vistry	111p EPS	142p EPS	+27%	8.5x PER
drax	30p EPS	60p EPS	+100%	9.3x PER
bp	49c EPS	62c EPS	+26%	8x PER
TESCO	18.5p EPS	21.5p EPS	+19%	13x PER
		Unweighted average	+38%	

- These trends have meant the Fund dividend has recovered quicker than expected. The Fund yields 4% this year and 5% next year. With any downward dividend adjustments likely to have been made during the pandemic, this dividend base should be seen as secure. We expect it to grow further from this base.
- The valuation of the Fund is very low. The differential price to book of the Fund versus the market is close to the widest it has ever been. As mentioned above, the average upside in the small-cap part of the Fund is c. 60% and all of the major large-cap sectors (i.e. banks, insurers, mining etc) look materially undervalued.

This confluence of accelerating profitability in our holdings, the inflation / interest rate pivot (which is closing the gap between the 'value' and 'growth' parts of the market), and the ultra low valuations across the Fund is a powerful cocktail that should underpin further absolute and relative upside. As the baton is seemingly passed to the 'value' side of the market, this is a very exciting time to be running this 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

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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.

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Sources for all data: JOHCM/Bloomberg (unless otherwise stated).