**Professional Investors Only**

# JOHCM UK Equity Income Fund

Monthly Bulletin: December 2023

## 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 30 November 2023:

### Top five

| Sector | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| Construction and Materials | 8.73 | 0.41 | 8.32 |
| Life Insurance | 9.34 | 2.38 | 6.96 |
| Banks | 13.86 | 9.08 | 4.78 |
| Industrial Metals and Mining | 11.04 | 6.58 | 4.46 |
| Household Goods and Home Construction | 5.08 | 1.19 | 3.89 |

### Bottom five

| Sector | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| Pharmaceuticals & Biotechnology | 0.00 | 10.49 | -10.49 |
| Personal Care, Drug and Grocery Stores | 0.00 | 7.38 | -7.38 |
| Closed End Investments | 0.00 | 6.24 | -6.24 |
| Tobacco | 0.00 | 3.26 | -3.26 |
| Beverages | 0.00 | 3.06 | -3.06 |

# Active stock bets as at 30 November 2023:

## Top ten

| Stock | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| Aviva | 3.44 | 0.51 | 2.93 |
| Barclays | 3.88 | 0.98 | 2.90 |
| Phoenix | 3.03 | 0.15 | 2.88 |
| NatWest | 3.38 | 0.51 | 2.87 |
| DS Smith | 3.01 | 0.16 | 2.85 |
| Paragon | 2.84 | 0.05 | 2.79 |
| Glencore | 5.18 | 2.46 | 2.72 |
| Standard Chartered | 3.33 | 0.66 | 2.67 |
| Bellway | 2.75 | 0.13 | 2.62 |
| BP | 6.06 | 3.59 | 2.47 |

## Bottom five

| Stock | % of Portfolio | % of FTSE All-Share | Active % |
|---|---|---|---|
| Diageo | 0.00 | 2.72 | -2.72 |
| HSBC | 2.23 | 5.28 | -3.05 |
| Unilever | 0.00 | 4.23 | -4.23 |
| Shell | 2.09 | 7.70 | -5.61 |
| AstraZeneca | 0.00 | 6.66 | -6.66 |

# Performance to 30 November 2023 (%):

| | 1 month | Year-to-date | Since inception | Fund size (£m) | Strategy size (£m) |
|---|---|---|---|---|---|
| **Fund – A Acc GBP** | **4.73** | **-0.68** | **322.70** | **1,459** | **1,741** |
| Lipper UK Equity Income mean* | 4.14 | 1.85 | 208.03 | | |
| FTSE All-Share TR Index (12pm adjusted) | 2.61 | 3.17 | 239.85 | | |

## Discrete 12-month performance (%) to:

| | 30.11.23 | 30.11.22 | 30.11.21 | 30.11.20 | 30.11.19 |
|---|---|---|---|---|---|
| **JOHCM UK Equity Income Fund – A Acc GBP** | -1.63 | 5.27 | 24.60 | -16.49 | 9.83 |
| FTSE All-Share TR Index (12pm adjusted) | 2.00 | 6.67 | 15.71 | -9.72 | 11.67 |

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

Having highlighted in recent months that the rate of UK inflation was set for a substantial slowdown in October 2023, it was heartening to see the 210bps fall in the annual rate to 4.6% and the positive market reaction to the data. Very quickly, investors priced out the risk of any further monetary tightening in the UK and began anticipating interest rate cuts in the second half of 2024. Bond yields fell across all durations, with the 2 and 10-year around 25bps lower. However, as we have been discussing for several months, the most significant impact of UK inflation falling below 5% may well be on domestic consumers, whose activity levels have been somewhat becalmed in recent months due to uncertainty about where interest and mortgage rates might peak. As such, it was noticeable that the GFK UK consumer confidence survey, taken the week after the inflation print, saw a strong recovery this month of 6 points and once again sits very close to the highest level for 21 months. Equally striking was this week's Lloyds Bank Business Barometer survey, which rose to its highest level since February 2022. It showed companies' hiring intentions reaching their highest level for 18 months, with anticipated trading forecasts for the year ahead touching a six year high. This comes at a time when employment markets have returned close to an equilibrium level, with the vacancies/unemployment ratio hitting 0.68 in September vs 1.02 a year earlier. As such, wage growth has begun to slow but remains healthily positive, increasingly so in real terms, which is beginning to be reflected by the Asda Income Tracker, in which the October report showed average weekly discretionary incomes (after non-discretionary bills are paid) were rising by 12% year-on-year, the strongest rate of annual growth since July 2021. However, the average household's spending power is still running 9% below the 2021 peak. The UK Autumn Statement passed without major incident and will add a modest amount to employees' spending power.

In the US, this month also delivered a lower-than-expected inflation print, with CPI coming in flat versus September and 3.2% higher on an annualised basis. Similar to the UK, bond markets reacted across all durations, with yields 20-30bps lower at the shorter end and 50bps lower at the longer end, with the 30-year closing the month below 4.5%. For the most part, economic activity has remained resilient in most areas, including housing, and the Thanksgiving long weekend appears to have seen strong consumer activity in keeping with gently improving consumer confidence surveys. The Fed's minutes from their last policy decision meeting commented that they saw "aggregate demand moderating in the face of tighter financial and credit conditions and labour markets were reaching a better balance". The perception that US rates have peaked, combined with concerns around fiscal deficits and next year's election, saw the US dollar weaken during the month by around 4% against most other major currencies.

The absence of a wider escalation of hostilities in the Middle East, as well as the ceasefires agreed between the protagonists in Israel and Gaza, saw the oil price fall below the levels of early October before the incursions into Israel were made. Relatively full gas storage facilities and the difficulties OPEC+ have had in agreeing on a further supply cut also contributed to the decline. Elsewhere in the commodity space, iron ore rose another 5% despite continued sluggish manufacturing data and surveys in China.

Inflation data across Europe has also continued to surprise to the downside, with French inflation at 3.8%, its lowest level since January 2022. The surprise election result in the Netherlands raised the prospect of more fractious discussions around European Union membership.

## Performance

November saw a partial recovery of the prior month's difficult performance, with the FTSE All Share rising by 2.61% over the period, and the Fund outperformed, rising 4.73%. Year-to-date, the Fund is down -0.68%, whilst the FTSE All Share is up 3.17%.

Looking at the peer group, the Fund is ranked in the 4th quartile within the UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked 1st quartile over three years, 3rd quartile over five years, 2nd quartile over 10 years and is the best Fund in the sector since inception in 2004.[1]

The softer inflation data in the UK and US, and the commensurate fall in bond yields and interest rate expectations had a marked impact on stock market leadership in November. Many stocks in interest rate-sensitive sectors, such as housebuilders, rose significantly, with **Bellway** up 15% relative and **Vistry** up 10% relative, with the start of a recovery in mortgage approval data also helping. Elsewhere amongst this housing supply chain cohort, **Norcros** (15% relative) delivered a set of resilient interim results, whilst **Tyman's** exposure to the US housing sector saw it outperform by 10%. Real estate stocks also responded positively to the macro developments, with **Land Securities** up 8% relative.

The turn in the interest rate cycle also drove better performance from some other early cycle sectors, such as recruitment stocks **SThree** (17% relative) and **Page** (18% relative). Robust interim results and a well-articulated medium-term strategy saw **Marks and Spencer** continue to move ahead (14% relative). Amongst financials, most banks recovered from the absolute share price falls they experienced in October, with **NatWest** up 9% relative despite the government's statement about a likely divestment of their stake in 2024. **Polar Capital** rose (10% relative), assisted by better equity markets and a solid set of interim results.

Oil stocks generally underperformed as OPEC struggled to deliver another production cut, which saw both **BP** and **Shell** down around 8-9% relative. Amongst our smaller names, **Petrofac** was particularly weak (-50% relative) as the market anxiously awaited news on the group's progress in securing bonding arrangements from banks to support their major contract wins. Conversely, **Energean** recovered strongly (17% relative) as the Israeli/Hamas war entered a ceasefire. **ITV** delivered a soft Q4 advertising update (-7% relative), and **Vodafone** fell (-5% relative) and even corrected for a heavy ex-dividend adjustment, despite making some progress with their portfolio rationalisation programme.

## Portfolio activity

The Fund established a new position in the real estate group **Hammerson** in November. Valuations in the sector have been under pressure for some time, particularly following the infamous 2022 Autumn budget, which saw bond yields rise substantially, leading to downward valuation adjustments. However, over the last four months, this situation has reversed considerably as inflation expectations have fallen,

[1] Source: Lipper

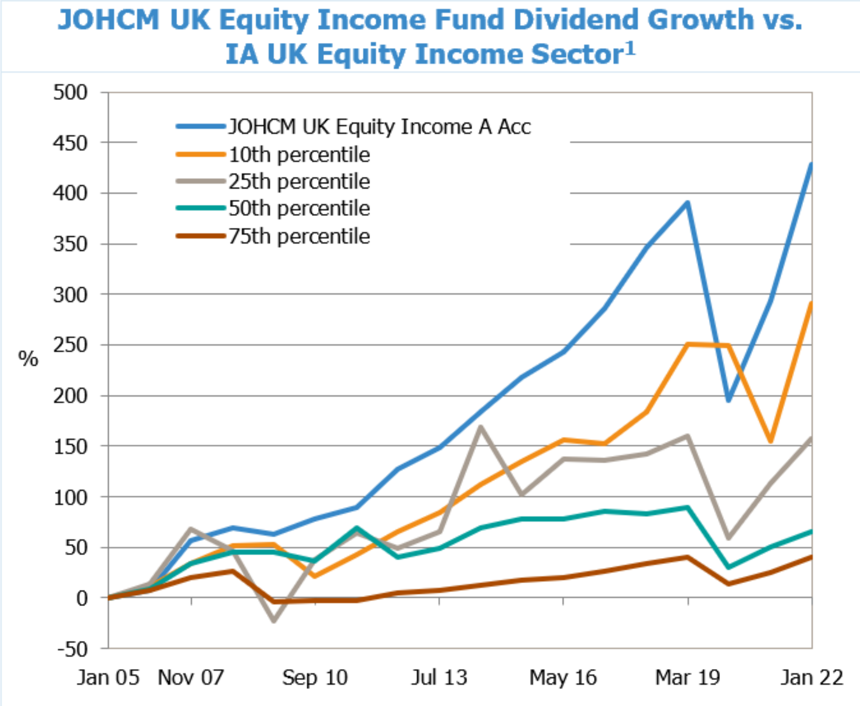
and, in due course, we would expect valuations to stabilise and then begin to rise. Over the last few years, the segment of real estate that saw the greatest fall in valuations has been retail, particularly shopping centres. However, with rents having fallen 50-70% from their peak and signs of a recovery in physical retail activity relative to online, there is the potential for a recovery, particularly given the c8% yields these assets currently sit at. To be clear, it is only likely to be the prime shopping centres that will witness this demand recovery, but those are the types of assets that Hammerson own, such as the Bullring in Birmingham. Furthermore, Hammerson has been on a path of self-help-driven recovery in recent years, having sold a series of non-core assets, and that process is likely to continue via the monetisation of their stake in Value Retail, which is a series of stakes in outlet shopping destinations like Bicester village in the UK. Such a sale would dramatically improve the balance sheet and might allow some capital return; it would also shine a light on the large discount to net asset value (50%), and whilst there is some execution risk around the disposal programme, the shares have considerable upside potential. Anecdotal evidence from tenants of some of Hammerson's assets, such as Marks and Spencer, has been extremely positive about repositioning centres, such as the Bullring, as legacy department store space has been repurposed and re-let.

Elsewhere, we continued to add positions in the banking sector as more evidence emerged that the pace of deposit migration into term deposits has begun to slow as interest rate expectations fall. We added to **Currys**, where the sale of their Greek business improves the balance sheet and shows that trade values for their businesses are considerably higher than the current stock market valuation. The improving macroeconomic outlook in the UK and in the Nordics is likely to see investors reconsider the group's very modest market capitalisation (c£520m) relative to annual sales of more than £9bn.

The sharp fall in interest rate expectations drove some of the housing sector constituents higher, and we used the opportunity to shave our holding in Vistry. Elsewhere, both **First Group** and SThree were trimmed following strong relative performance. **Glencore** recovered somewhat, having successfully negotiated the purchase of Teck Resources' coal business, and we trimmed our holding modestly, given the relatively modest dividend yield for 2024. **TP ICAP** has performed strongly relative to other financial stocks, and we kept our weighting under control through some modest sales.

## Dividend Update

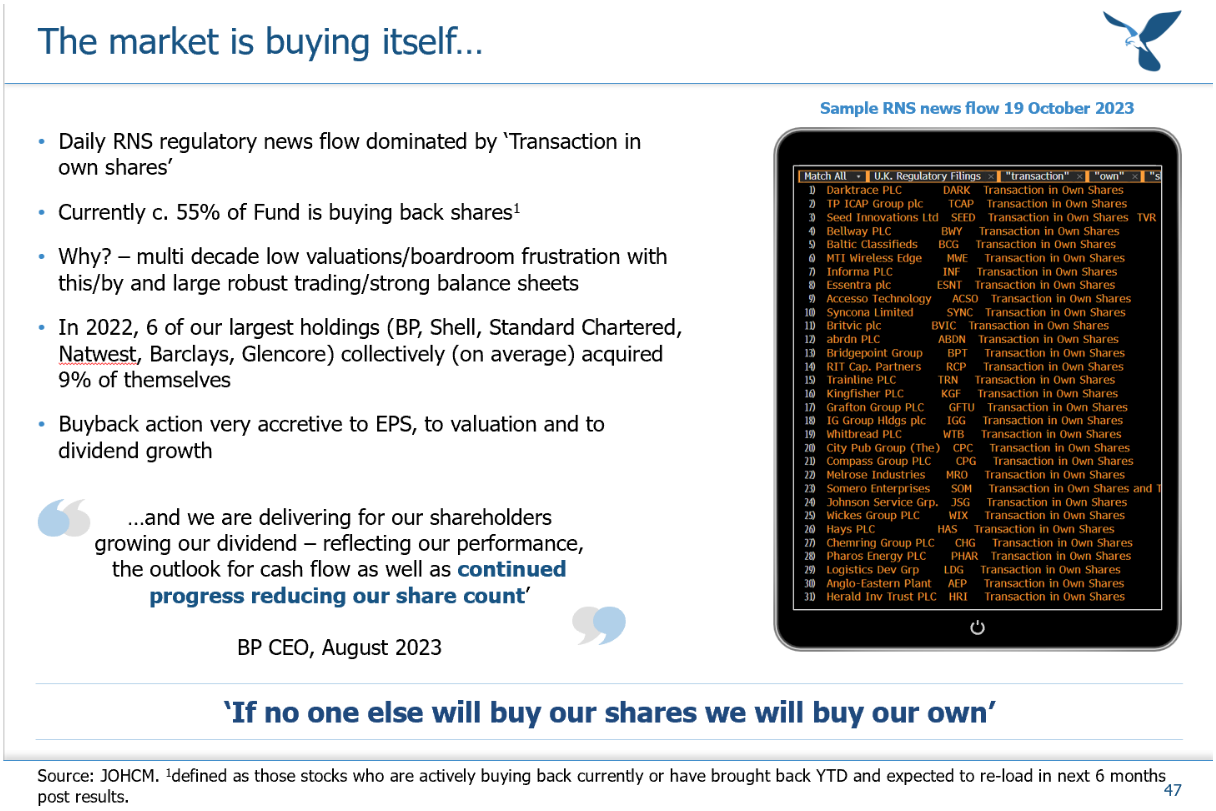
The Fund is now at the beginning of its 20th year, having started on 30 November 2004. Over this period, the Fund dividend has grown by an average of c.9% every year. This includes navigating two of the most significant 'risk' events in the last 50 years, namely the Global Financial Crisis (GFC) and COVID-19. Our first full-year dividend was 4.3p in 2005, and in 2023, the equivalent number will be just below 25p, more than a fivefold increase. This cashflow increase is one of the main reasons why the Fund has performed strongly in an absolute sense since launch (up c322%) and is the best-performing fund in its peer group. The graph below shows our dividend growth against different percentiles in the IA UK Equity Income Sector. The outperformance pre-COVID-19 is clear, as is the recovery post-COVID-19 versus the wider peer group.




Source: Thomson Reuters Lipper, JOHCM UK Equity Income A Acc vs. IA UK Equity Income sector.

Our guided growth rate for the Fund dividend in 2023 is currently 3-7%, having upgraded it from initial guidance of 1-5%, which we established this time last year. We are currently running around 6% growth, and we will confirm the final growth rate at the beginning of 2024. Only two material dividends are left to be declared at the stock level across the Fund, so the risk around the guidance is low.

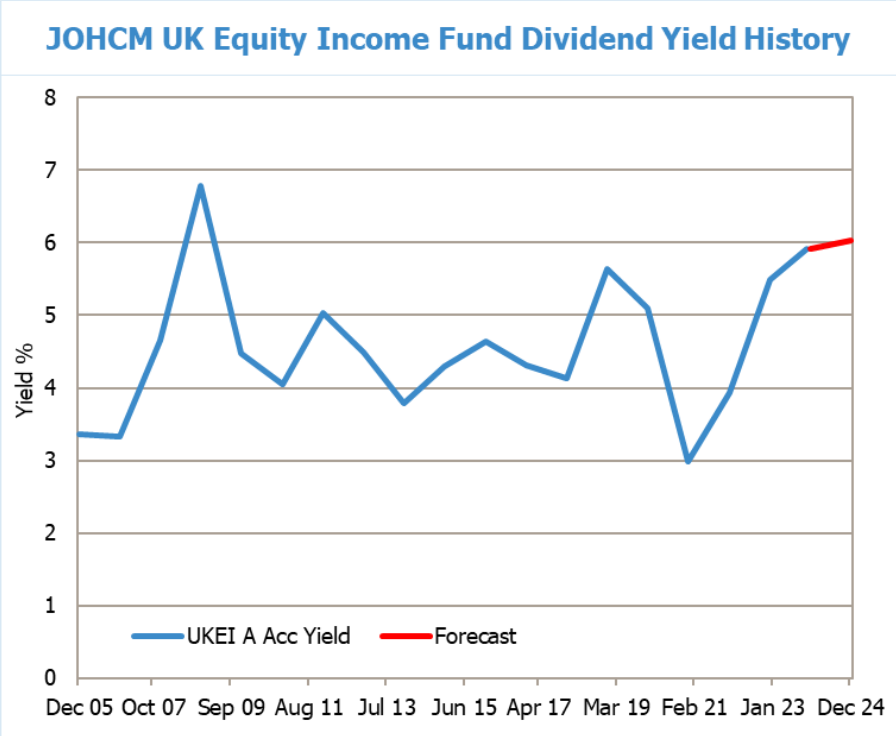
We have completed our detailed bottom-up modelling of dividends on a stock-by-stock basis for 2024. As usual, we have taken a prudent approach to reflect the more challenging current economic outlook. There are clear areas of dividend strength such as the oil, banking and insurance sectors. These sectors, along with the mining sector, make up most of our large-cap holdings, approximately 50% of the Fund. More broadly, post-COVID-19 aggregate dividend cover is very strong and over half of the Fund is currently engaged in share buybacks, reflecting strong balance sheets. Share buybacks create a safety buffer before any dividend adjustment is needed if the current economic environment becomes more challenging. All else being equal, the same billion-pound dividend cost will create dividend growth due to the lower number of shares in issue. This is a powerful second derivative effect of buybacks, which we see in numerous stocks. We have reproduced a slide from our current presentation pack below, clearly highlighting these dynamics.




In respect of boardroom frustrations around low UK equity valuations, a notable trend is emerging, with companies resorting to strategic buybacks to address the challenge. This is particularly evident in sectors such as banking, where buybacks are predominantly used to boost dividends. Over time, the anticipated effect is to amplify dividend growth. Some boards have even pivoted entirely to this approach, such as Vistry, which, during the autumn, maintained a 2x payout ratio through a buyback instead of a dividend, citing future return mechanisms contingent upon share price dynamics. Our forecast incorporates a shift towards lower dividends and increased buybacks from 2024, signifying a short-term dip but projecting higher returns in the medium term. In light of the UK market's persistently low valuations, this strategic shift poses a material risk to near-term dividends.

The other significant risk to the UK aggregate dividend flow and our Fund 2024 dividend growth forecast is the direction of currency rates. We have used a GBPUSD rate of 1.25 in our forecasts. The sensitivity of the Fund dividend to a further $0.05 recovery in GBPUSD is c-1%.

Taking all these factors together, our formal 2024 dividend growth forecast for is for a flattish outturn. This reflects five factors – 1) the dividend vs share buyback battle noted above, 2) the dividend trajectory in parts of our domestic UK holdings, where an expected recovery in the economy, as discussed above, is likely to manifest itself in higher 2024 final dividends which would impact the Fund dividend in 2025, 3) a temporary reduction in the flow of dividends in the mining sector due to the acquisition of part of the Teck businesses by Glencore (which is using more of its 2024 free cashflow to de-gear, 4) the FX point above where we feel there is more risk of £ appreciation from here than depreciation, and finally, 5) a desire to be prudent. We will update this as the year progresses, particularly if there is a further temporary material shift from dividend to buyback due to the valuation dynamics noted above; we will highlight the shape and impact of this.




Source: Data to 31 December 2024 includes JOHCM estimates. JOHCM estimates of future performance based on evidence from the past performance and current market conditions and is not an exact indicator. Based on 'A' Accumulation share class price on 11 October 2023 (429p).

Despite a strong track record on dividend growth, robust balance sheets and strong dividend cover, the 2024 Fund dividend yield at around 6% is close to the highest it has ever been. In fact, as the chart above shows, the dividend yield has only ever been higher during one timeframe – the GFC. It did not stay high for long, as the Fund performed very strongly in 2009/10 (combined 64.59% in absolute terms and 9.93% in relative terms), and the Fund dividend yield re-rated / fell to c 4%. We believe we are at a similar point now.

## Outlook

Inflationary pressures have begun to subside in most parts of the world, and the UK no longer looks like a unique economy with an inflation 'problem'. Base effects were largely responsible for the UK's reduction in the annual rate for October, and similarly, investors will probably need to wait until February and March before there is another meaningful fall to below 4%. However, we anticipate that UK consumers will begin to behave more confidently in the coming months, with mortgage re-financing rates c100bps lower than in early July and over £250bn of post-COVID excess savings still sitting in bank accounts. With business confidence rising too, it is not inconceivable to see UK economic activity surprise positively in the coming months, which could dampen expectations of imminent interest rate cuts. A similar situation could pertain to the US, where the recent steep falls in bond yields in anticipation of rate cuts in 2024 have loosened policy already, thus making these rate cuts less likely to materialise. We do not see this as a problem for much of the market, but it may well impact stock market leadership. We continue to believe the best opportunities lie in financial, cyclical and domestically focused stocks.

With the UK market looking so modestly priced relative to all other developed markets, this kind of positive economic outturn, as well as the fact that the UK's political landscape for the next 12 months looks somewhat easier to predict than elsewhere in North America and Europe, should progressively attract international investors to these shores. We acknowledge this process has been painfully slow thus far, but it must inevitably happen at some stage as the valuations on offer are simply too modest relative to the companies' prospects. Whilst the UK market is unlikely to deliver significant dividend growth in 2024 for the reasons we outline above, we believe that earnings multiples often in the 4-7x range, free cash flow yields in the mid-teens and a fund dividend yield close to 6% offer many reasons for optimism.

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