J O Hambro
Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: October 2017

Active sector bets for the month ending 30 September 2017

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.28	2.90	+6.38
Construction & Materials	6.17	1.53	+4.64
Banks	15.74	11.27	+4.47
Oil & Gas Producers	15.98	11.98	+4.00
Mining	9.38	6.03	+3.35

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.78	-5.78
Pharmaceuticals & Biotechnology	3.22	7.54	-4.32
Equity Investment Instruments	0.40	4.40	-4.00
Beverages	0.00	2.88	-2.88
Personal Goods	0.00	2.54	-2.54

Active stock bets for the month ending 30 September 2017

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.91	0.87	+3.04
BP	6.84	3.88	+2.96
Standard Life Aberdeen	3.38	0.49	+2.89
Lloyds Banking Group	4.87	2.03	+2.84
Barclays	4.14	1.38	+2.76
Rio Tinto	4.37	1.72	+2.65
DS Smith	2.84	0.20	+2.64
ITV	2.89	0.27	+2.62
National Express Group	2.51	0.06	+2.45
Morgan Sindall Group	1.89	0.02	+1.87

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.50	-4.50
GlaxoSmithKline	0.00	3.03	-3.03
Diageo	0.00	2.55	-2.55
Unilever	0.00	2.13	-2.13
Prudential	0.00	1.95	-1.95

Performance to 30 September 2017

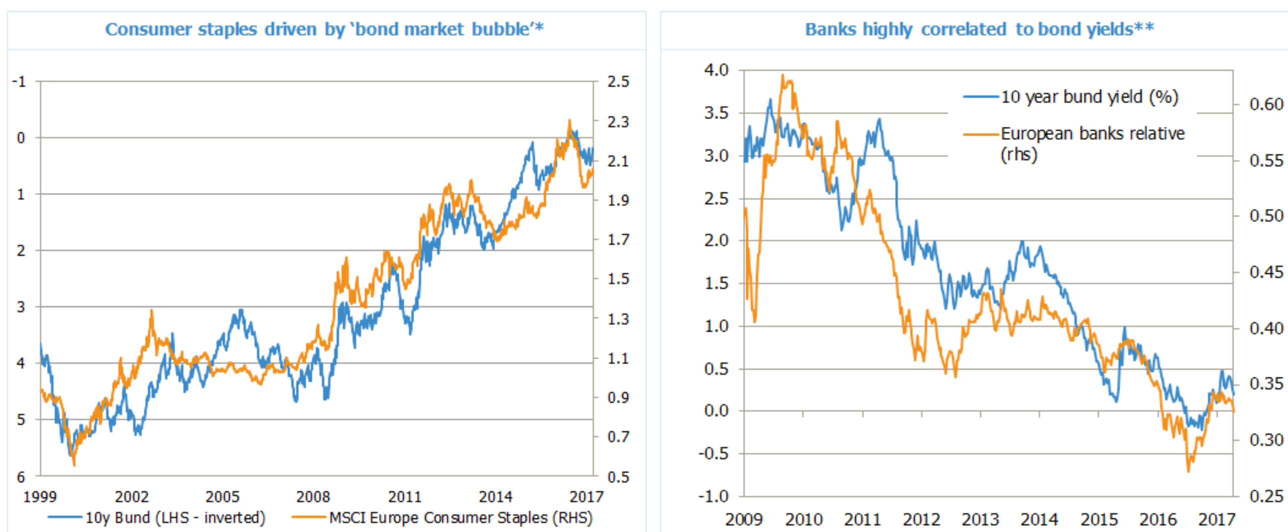
	1 month (%)	Year to date (%)	Since inception (%)	Fund size
JOHCM UK Equity Income Fund	**1.53**	**11.69**	**270.60**	**£3,384mn**
Lipper UK Equity Income Mean*	0.14	7.63	165.39	
FTSE All-Share TR Index (adjusted)	-0.06	8.33	170.94	

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 – The start of a new era?

September was a pivotal month in the debate on monetary policy normalisation. It is likely that it will be marked as the month when it became clear that we are at a global turning point in monetary policy. The Federal Reserve signalled clearly at its September meeting that it would likely raise rates in December and will start to unwind QE from October. We laid out our view last month that the Bank of England should, given evidence of reduced spare capacity and record employment, start to remove the emergency stimulus it injected post the Brexit vote. In its September meeting, whilst the vote to change policy stayed at 7:2 against doing so, the wording of the statement indicated that rates could increase in November. This has been followed by a number of speeches from members of the Monetary Policy Committee (MPC) making this a near certainty. We have also had similar rhetoric from the European Central Bank, where they will start to reduce the quantum of QE in October. Whilst these may not be coordinated actions, it is clearly helpful that the key central banks have a similar roadmap as it will reduce the risk of large foreign exchange moves. Bond yields have risen markedly as these events have unfolded. The US 10-year treasury moved up by 15bp to 2.30% across the month, whilst in the UK there has been close to a 35bp increase in the 10-year gilt yield to c.1.35%.

As we have indicated before, understanding these trends and the likely trajectory of interest rates is critical from an equity market perspective. Our Fund has a clear tilt away from bond proxies towards cyclicals and financials, both of which will benefit if interests rates continue to move up.



Source: *Bank of America Merrill Lynch as at 14 April 2017. **Credit Suisse research as at 12 April 2017.

The other dynamic linked to the MPC change in commentary noted above was a strengthening of sterling. We have commented before that we thought views around sterling were excessively pessimistic. Continued strength in a number of UK data points (retail sales, household savings data and employment), coupled with the MPC commentary, moved the GBP/USD rate up 5% during the month. There was a similar move against the euro. This again had a marked impact on the mix in the stock market with the (over-owned) overseas-earners underperforming.
We were also encouraged by the rise in oil prices during September. Oil has tracked higher (to a two-year high) as a result of strong demand (particularly from China but also reflective of the

synchronised global growth picture we are currently seeing), OPEC supply cuts and the US rig count starting to show modest falls. The latter is an important guide to US shale growth in 2018. The modest fall in US rigs, coupled with evidence of rising costs and less productive secondary wells, make us more confident that shale growth will not be so vibrant that it destabilises the oil market in the near term. The rise in oil prices is also important to the inflation/interest rate/bond yield and central bank discussion, as its rise will lead to firmer inflation data points as we move towards 2018.

The other important issue which will potentially consummate before the end of the year is President Trump's tax plan. Whilst we are cautious, given the lack of any legislative success since he became president, were the tax reforms to be successful it would have a marked impact on consensus GDP forecasts for the US and would also lead to an increase in US and global interest rates. A success on tax reforms would also likely clear the path for the next focus point, which is infrastructure.

The change that will cement the trends noted above will be an increase in wages, in both the UK and the US. We covered the reasons why we think this will happen, particularly in the UK, in last month's update. Whilst official data (which is very dated by the time it comes out) was limited during September there was plenty of anecdotal evidence. The removal of the public sector pay cap, a number of profit warnings partly linked to rising wage pressures (Greene King, Card Factory), commentary from our recruitment agency holding, Sthree, indicating that wage growth in placed employees doubled from 4% in their H1 to 8% in their Q3, and commentary in the Bank of England Agents' report that a number of industries were seeing skills shortages, all point to an acceleration of wage growth over the next 12 months.

Performance

The market was flattish during September, with the FTSE All-Share Total Return Index (12pm adjusted) posting a decline of 0.06%. The Fund performed markedly better in returning 1.53%.

Year-to-date the Fund is up 11.69% versus the benchmark return of 8.33%. Looking at the peer group, the Fund is ranked first decile within the IA UK Equity Income sector over one year to 30 September 2017. On a longer-term basis, the Fund is ranked first decile over ten years and since launch (November 2004), and first quartile over three years and over five years.

Large parts of the market were pressured by the rise in both sterling and bond yields highlighted above. Overseas earners and defensive bond proxies underperformed. The Fund remains very underweight these areas and relative performance benefited as these trends, which we expect to continue, started to manifest.

The Fund was also assisted by its overweight position in oil as both of the UK oil majors, **BP** and **Royal Dutch Shell**, outperformed by 6-7% as the oil price lifted and continued evidence of improving free cash flow at both companies emerged. Both stocks yield nearer 6% compared to c. 7% around a month ago. The oil sector performance was partly offset by profit taking in the mining sector.

The rise in sterling started to benefit some of our UK domestic-exposed stocks, namely **ITV**, **Halfords** (which had a good trading update) and **Hollywood Bowl** (where its main competitor reported like-for-like sales of c.10% for the last two months over the summer). The trend was not uniform, with other stocks such as **DFS** underperforming. We continue to take a careful and selective approach in this area to capture the material valuation opportunity in a sensible, risk controlled manner.

A number of our small caps also performed well, with **Morgan Sindall** bouncing back from profit taking in the previous month and **Vitec** performing strongly following the announcement of one of the best acquisitions (in terms of price, fit and potential) that we have seen in the last decade. Despite being one of our dollar earners **AstraZeneca** was also strong.

On the negative side, there were few stock-specific issues, with the only other notable area of sluggish performance aside from the miners being our life insurance stocks which underperformed modestly.

Portfolio activity

We added two new stocks to the Fund in September – **Palace Capital** and **Central Asia Mining**.

Palace Capital has been one of the best performing small cap property stocks over the last three to four years, doubling its net asset value (NAV). We participated in a placing, which funded the acquisition of a portfolio of commercial properties, predominately in the South East. This portfolio, which was acquired from a family office, was undermanaged and has significant opportunity for value-enhancing management actions. We acquired our position at a 20% discount to our estimate of pro forma NAV (adjusting for a dividend the new shares will receive shortly after issue), with a dividend yield of 5.7%. This stock adds to our basket of small cap regional property exposure, which also includes **Real Estate Investors** and **Mckay**.

The other stock, Central Asia Mining, has been a company we have been monitoring for a while. Its core business, which has been executed on time and under budget, is a high-margin surface-leaching copper mine in Kazakhstan. We participated in a placing that was conducted to fund the purchase of a high-margin zinc mine in Macedonia. Similar to the Palace Capital example above, there are asset management opportunities for the Central Asia Mining management team to focus on, given the previous ownership structure of this asset. Zinc and copper are two metals that we want the Fund to have more exposure to over the medium term, given the potential for changes in supply and demand dynamics (e.g. electric vehicles). We were able to enter this stock on a free cash flow yield of 15% and a dividend yield of 7%.

We also continued to add to last month's new stock **Hammerson**, **Bovis Homes** (following a good strategic update from the new chief executive) and **Keller** (following a good capital markets presentation).

Capital tension in the Fund is currently high with few stocks that are flashing red either in a valuation or risk sense. To fund some of the above purchases we reduced our position in **Brewin Dolphin**, which continues to look well-placed but is one of our most expensive stocks (on a P/E of 15x) and also continued to reduce our position in **AstraZeneca**, which has bounced back strongly following the disappointment of the Mystic trail in late July. There remains a number of upside drivers at AstraZeneca including the oncology pipeline, which, aside from Mystic, has been developing well. We also anticipate a return to revenue growth in 2018, but these positives need to be balanced against the negatives, such as the makeup of current earnings (which are heavily exposed to one-off gains) and high leverage. We also reduced our position in **Laird**, where our longer-term normalised earnings forecast has fallen due to a change in the competitive dynamic of the markets its connected vehicle division operates in and nearer term potential pressures on its Apple-related business, due to the reported sluggish reception of the iPhone 8 and iPhone X.

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, 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. 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 last month, the dividend growth of the Fund remains robust – expected to be between 9-11% in 2017. The Fund currently yields 4.25%. This starting yield, strong dividend growth, 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

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