JOHCM UK Equity Income Fund

Monthly Bulletin: October 2018

Active sector bets for the month ending 30 September 2018:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.34	3.25	+6.09
Banks	15.93	10.23	+5.70
Mining	10.68	6.11	+4.57
Oil & Gas Producers	18.26	14.10	+4.16
Construction & Materials	4.86	1.63	+3.23

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.31	-8.31
Tobacco	0.00	4.42	-4.42
Equity Investment Instruments	0.57	4.74	-4.17
Beverages	0.00	3.02	-3.02
Personal Goods	0.00	2.34	-2.34

Active stock bets for the month ending 30 September 2018:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	7.82	4.74	+3.03
Aviva	3.79	0.80	+2.99
Lloyds Banking Group	4.74	1.79	+2.95
ITV	3.06	0.24	+2.82
Standard Life Aberdeen	3.00	0.38	+2.62
DS Smith	2.75	0.25	+2.50
Glencore	4.00	1.58	+2.42
Barclays	3.49	1.23	+2.26
National Express Group	2.15	0.07	+2.08
Vodafone Group	3.78	1.84	+1.94

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	3.37	-3.37
AstraZeneca	0.00	3.09	-3.09
GlaxoSmithKline	0.00	3.07	-3.07
Diageo	0.00	2.69	-2.69
Unilever	0.00	1.93	-1.93

Performance to 30 September 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund - A Acc GBP	**0.51**	**-0.10**	**291.50**	**£3,730mn**
Lipper UK Equity Income mean*	-0.36	0.10	175.60	
FTSE All-Share TR Index (12pm adjusted)	0.07	1.38	186.78	

Discrete 12-month performance (%) to:

	28.09.18	29.09.17	30.09.16	30.09.15	30.09.14
JOHCM UK Equity Income Fund – A Acc GBP	**5.64**	**20.87**	**10.53**	**-1.18**	**8.09**
FTSE All-Share TR Index (12pm adjusted)	5.84	12.62	16.43	-2.79	6.46

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

Despite the very public fall out in Salzburg, it is noticeable that sterling/US dollar actually rose slightly during September, having started the month at $1.296/£. The pound continues to grapple with the shifting probabilities of a number of very different Brexit scenarios, but the relative stability over the last few weeks probably reflects the majority view that a deal of some sorts will still get agreed, coupled with the growing chance of some kind of second vote/referendum. It also acknowledges the fact that sterling continues to look undervalued on a purchasing power parity basis, and that short-term economic activity, particularly from consumers, continues to be quite strong.

On that front, the latest UK Labour Report showed a meaningful acceleration in average weekly earnings, with the three-month regular pay average at 2.9% (the fastest rate for three years), whilst yet another all-time high for vacancies (833,000) suggests labour shortages may worsen further in the short term, with obvious implications for future wage awards. August‘s retail sales growth of 3.3% year-on-year showed that consumer confidence remained relatively elevated, even after the best of the summer weather had passed. This combination of stronger activity, rising wages and higher oil prices all contributed to a much higher than expected inflation print of +2.7%. With this backdrop, it seems likely that the Bank of England will continue to tighten policy, even with the political uncertainty.

Tighter monetary policy remains the focus of the Federal Reserve, too, despite the continued criticism of this approach from President Trump. But consistently strong data, consumer confidence at an 18-year high, building wage pressures and a rapidly expanding budget deficit mean that Governor Powell is unlikely to change course over the next 12 months. It is too early to discern any meaningful economic impact on domestic activity from the Trump administration's tariff strategy. However, it has clearly caused a degree of market nervousness across a swathe of asset classes, particularly those concentrated on emerging markets. Nonetheless, further evidence emerged during the month that the Chinese domestic policy response to loosen monetary/fiscal policy has continued to stimulate activity, with electricity production and housing transactions both showing progress over the last few months. In this context, it is surprising that commodities such as copper are still around 20% lower than their peak levels earlier in the summer; yet noticeably the copper price began to recover in September, rising 5%.

The sense that inflationary pressures are mounting across the world was reinforced by some relatively hawkish comments from Mario Draghi during the month. He specifically referred to tightening labour markets pushing up wage growth across the Continent and that he expects this process to accelerate further. But in the short term the market's focus in Europe was on both

Brexit and the Italian budget, both of which somewhat restrained the rise in bond yields, although the French 10-year government bond still moved up by 15bps during the month.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) was up fractionally during September (0.07%). The Fund modestly outperformed, returning 0.51%. Year to date the Fund is virtually flat at -0.10% and lags the index (1.38%).

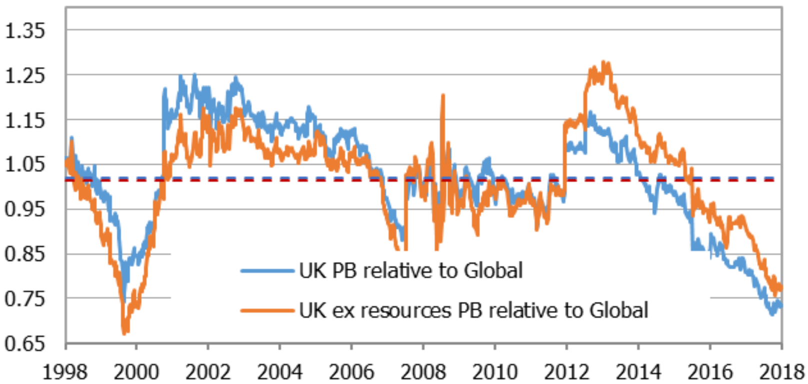
Looking at the peer group, the Fund is ranked second quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked first decile over three years, five years, 10 years and since launch (November 2004).

In contrast to August, the main drivers of the market were the oil and mining sectors. There was a significant bounce across this area, helped by the rise in the oil price to a new cycle high and also evidence that China is stimulating its economy (to offset trade tariff economic pressure), particularly in the copper intensive electricity grid network infrastructure, as noted above. All our stocks outperformed, with notable moves from **Diversified Gas & Oil** (up 12% relative following results) and **BP** (up 7% relative).

Despite the rise in bond yields our financials struggled, which is somewhat anomalous. Banks were sluggish, particularly **Barclays**, whilst **Hammerson** and **TP ICAP** were also weak. The Fund owns **CMC**, which had a profit warning towards the end of the month driven by low market volatility in August / early September. This stock was down 21% relative. Offsetting this were very strong results from **Randall & Quilter**, which was up 21% relative.

Elsewhere, domestic stocks were mixed. Certain areas like housebuilders were strong, but large parts of the domestic complex (retail, building products, etc.) remained under pressure. The chart below shows that the price-to-book of the UK market versus the World is at levels not seen since the TMT bubble. This is the whole UK market, within which the domestic part of the market is even cheaper. It is this valuation opportunity, caused by Brexit, which we have been increasing exposure to in a careful manner over the last 12 months. This has been a headwind for Fund performance in September and wider year to date. As the Brexit outcome becomes clearer, we believe there could be a material closure of this valuation gap.

UK price to book vs. World



Source: Credit Suisse

September and October tend to be higher risk months for profits warnings. It's a time when boards can see whether or not their companies will reach consensus earnings expectations based on the trend line. We had two warnings during the month: CMC, noted above, and **Low & Bonar** (down 20% relative). Part of the issue at the latter was rising raw material costs and the impact on profits of delayed pass through to the customer base. This adds to the evidence noted above on rising inflation pressures.

Portfolio activity

The above-noted strength in both the oil and mining sectors pushed weightings across the area towards either formal (300bp overweight at a stock level) or informal (c. 10-11% in the mining sector) limits. Consequently, we top sliced our exposure to maintain discipline. **BP** and **Glencore** remain our biggest active exposures in these two sectors. The latter still sits on a spot free cash flow yield of c. 12-15%, even after a modest recovery in its share price.

In the domestic sectors, where, as highlighted above, there were anomalies in performance, we added to **Forterra** and **ITV**. Brick-maker Forterra has fallen over 22% since May as its largest shareholder has been a persistent seller. During that time the company has performed well operationally and announced a new brick plant capital project. On a pro-forma basis, bringing the impact of the new plant into our forecast agenda, the stock is on a PE of 7x and would yield nearly 6% on an unchanged dividend policy. We expect the latter to be adjusted given the balance sheet will be close to net cash even after the investment in the new brick plant. This would increase this dividend yield.

Also in UK domestics, we continued to add to a position we established in July but have not commented on before: **McCarthy & Stone**, the market-leading housebuilder in the retirement homes market. For the last two years it has performed poorly, unaided by the 'Help to Buy' scheme (which has boosted the mainstream housebuilders) but more affected by the malaise in the second-hand transactional market (as potential buyers of McCarthy & Stone's homes cannot sell their existing homes). The company has also been hurt by potential government policy changes on ground rents.

We started buying the stock at a 20% discount to book value. Late in the month, the company held a capital markets day. This laid out ambitious targets for ROCE, cost reduction and implied margin. There remains material upside if these targets can be delivered.

We noted last month that we had materially reduced our position in **Sainsbury's**, due to persistent data that suggested trading had remained sluggish compared to the peer group. This was confirmed in the monthly Kantor data on market shares in the food retail sector. Prior to this, we had further reduced the position, which was c. 45bp overweight at the month end. We will continue to monitor near-term data versus the regulatory mood music around the Sainsbury/Asda combination. The CMA's assessment of the transaction will be announced around the middle of next year, and, as we said last month, there would be material upside if the deal is permitted.

In financials, we continued to add to **Barclays** and **Standard Charted**, both of which are on c. 0.65x tangible book value. We also added to **Raven Property Group**, **TP ICAP** and **Paragon**.

Outlook

As we said last month, many of the valuation signals we look at are flashing green. After a period of sustained underperformance by 'value' stocks versus 'growth' stocks globally, the level of underperformance by 'value' is now back in similar territory to where it was at the height of the TMT bubble in 1999. Growth stocks, the technology sector, bond proxies and consumer staples have all prospered as QE and low interest rates have dominated. As interest rates normalise and central banks' balance sheets contract, we expect this trend to reverse. We showed in the chart in the above section that a similar situation is evident in the valuation of UK assets vs the World – a direct result of Brexit. Both of these trends have created a material value opportunity within the market between the 'haves' and the 'have-nots' – the oil, mining and financial sectors, UK domestics and small caps, all areas in which the Fund is currently focused.

Last month we upgraded our guidance for Fund dividend growth to 12-13% for 2018, with the risk remaining to the upside. The Fund went ex-dividend the Q3 on 30 September – of 5.21p per unit (Accumulation A class), up 29% year on year. We will provide a final view of the 2018 dividend growth and our first formal view for 2019 in our December monthly bulletin. The Fund yields 4.6% for 2018 based on the current guidance.

As we look forward to the end of 2018 and into 2019, with the above valuation observations at the forefront of our minds, we remain cautiously optimistic that we can continue to deliver further absolute and relative progress.

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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