J O Hambro
Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: October 2019

Active sector bets for the month ending 30 September 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.79	3.62	+6.17
Life insurance	7.71	3.38	+4.33
Banks	13.35	9.64	+3.71
Oil & Gas Producers	16.19	13.09	+3.10
Mining	9.00	6.28	+2.72

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.24	-8.24
Equity Investment Instruments	0.00	5.23	-5.23
Beverages	0.00	3.70	-3.70
Tobacco	0.00	3.63	-3.63
Personal Goods	0.00	5.34	-2.84

Active stock bets for the month ending 30 September 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Standard Life Aberdeen	3.32	0.29	+3.03
BP	7.45	4.47	+2.98
Aviva	3.63	0.67	+2.96
Barclays	4.08	1.12	+2.96
Lloyds Banking Group	4.58	1.68	+2.90
DS Smith	3.09	0.19	+2.90
Phoenix Group Holdings	3.05	0.16	+2.89
ITV	3.07	0.20	+2.87
Hammerson	2.79	0.09	+2.70
Glencore	3.79	1.17	+2.62

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.18	-4.18
GlaxoSmithKline	0.00	3.65	-3.65
Diageo	0.00	3.33	-3.33
British American Tobacco	0.00	2.90	-2.90
Unilever	0.00	2.31	-2.31

Performance to 30 September 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**7.73**	**9.85**	**273.70**	**£2,998mn**
Lipper UK Equity Income mean*	3.35	11.65	176.81	
FTSE All-Share TR Index (12pm adjusted)	2.60	14.51	194.57	

Discrete 12-month performance (%) to:

	30.09.19	30.09.18	30.09.17	30.09.16	30.09.15
JOHCM UK Equity Income Fund – A Acc GBP	**-4.55**	**5.64**	**20.87**	**10.53**	**-1.18**
FTSE All-Share TR Index (12pm adjusted)	2.72	5.84	12.62	16.43	-2.79

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

Mario Draghi marked the end of his tenure as ECB President with a further deposit rate cut and a commitment to "open ended" quantatitive easing, despite public opposition to these measures from a significant number of other ECB council members. This opposition reflects the fact that further monetary stimulus is unlikely to prove very effective given where the interest rate curve currently sits across Europe. In this regard, Draghi's comments at the September 12th press conference about how policy priorities needs to shift were instructive: "Now it is high time for fiscal policy to take charge", and, "In view of the weakening economic outlook…governments with fiscal space should act in an effective and timely manner." Furthermore, the bond market's muted response to the restart of unlimited QE suggests that investors recognise that we are on the cusp of a regime shift in the priorities of economic policy-makers. Clearly, this shift has been driven by the continued weakening global economic performance over the summer, particularly in the industrial sectors of Continental Europe. With German Manufacturing PMIs in the low 40s, it is easy to see how policy is likely to shift towards some form of fiscal stimulus in the coming months.

In the US, Fed Governor Powell has also been presiding over a split committee in terms of a policy response to the global economic outlook. This divergence of views stems from the fact that the US economy has continued to advance this year, particularly driven by consumer spending and a solid labour market. However, business investment has started to fall due to uncertainties around the Trump-China axis: "Our business contacts around the country have told us that trade policy is discouraging them from investing in their businesses" - Jerome Powell, September 18th. As such, the latest rate cut was described as "insurance" against downside risks to the world economy and markets are now split over whether we will see any further easing of policy before the year end. Developments in the US-China trade dispute are likely to be the key dynamic here, particularly with President Trump losing some support in his heartland, according to opinion polls, increasing his need for a perceived successful resolution.

In the UK, the pantomime in the House of Commons reached new levels. The ongoing uncertainty has continued to nibble away at economic growth over the last quarter. Whilst the labour market remains relatively tight, the number of vacancies has begun to decline modestly (from a record high), as businesses continue to be cautious ahead of the 31st October Brexit deadline. In contrast, UK consumer confidence actually rose slightly in September and activity remains positive but volatile depending upon weekly developments in Westminster and unseasonal weather patterns. The Johnson/Javid-led administration has committed to a major fiscally-driven expansion, particularly focused upon infrastructure spending and corporate tax incentives, which could provide a material offset to any short-term Brexit economic impacts. The Labour party has also committed to an expansionary fiscal agenda, albeit with a different list of priorities, were they

to assume control of parliament. With the UK's public finances much improved over the last five years, any kind of political resolution is likely to see expansionary policy, which does not appear to be priced into the valuation of UK assets.

Economic activity in China has continued to be comparatively sluggish, with the trade dispute offsetting the impact of easier monetary policy. Elsewhere, the attack on two major oil processing facilities in Saudi Arabia proved to have only a fleeting impact on oil markets, as the facilities are relatively quickly being returned to full production. Nonetheless, the rising political risk in the region is clear and provides an additional underpin to energy prices.

Performance

September saw a powerful market mix change as political and central bank policy developments translated into a material shift in market leadership. In this context, the Fund had one of its strongest relative months since its launch in 2004, returning 7.73% versus a 2.60% return for its benchmark, the FTSE All-Share Total Return index (12pm adjusted). As we show in the 'Dividend update' section below, whilst this has been a useful move for the Fund in relative terms, it is a small move in the context of what we consider to be the Fund's material undervaluation. Year to date the Fund has returned 9.85% against the benchmark return of 14.51%. There remains much to be done.

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

The majority of the Fund performed well in September. Our small cap positions were up strongly (**Severfield**, **Sthree**, **Lookers**, **Rank**, **Randall & Quilter** all rose more than 10% relative) and our financials holdings performed well, notably our banks and insurance names.

Some stocks that have been under pressure bounced back strongly. **Hammerson** was up 22% relative, although the shares still trade at less than 50% of our estimate of trough net asset value despite this rally. **Standard Life Aberdeen** was up 12% relative, but this still leaves the UK-based asset management business valued at close to zero once its stakes in its three listed holdings (Phoenix Group, HDFC Life Insurance and HDFC Asset Management) and excess capital are stripped out. Examples such as these highlight the material valuation opportunity that resides in the portfolio.

Whilst there was strong performance in a number of areas, the announcement of an agreed takeover of **Galliford Try's** housebuilding and partnerships businesses by **Bovis Homes Group** was met largely with indifference, with both shares up in line with the sector. Assuming this transaction completes, using sensible assumptions and a low exit p/e of just 8x would yield 100bp of additional performance for the Fund. In normal market conditions, more than half of this uplift would be reflected in share price moves in the affected stocks upon the announcement of the deal. The lack of active money and the pressure on domestic-facing stocks within the UK market means this will take longer to feed through.

The Fund also benefited from the underperformance of its large void areas – tobacco, pharmaceuticals and beverages all fell. Profits warnings from Imperial Tobacco and Pearson (we own neither stock) also helped relative performance.

Within the Fund **Petrofac** and **Halfords** were the main detractors (both down c. 7% relative). The former requires an uptick in new orders for sustained outperformance, while the latter had a weak trading statement at the start of the month.

Portfolio activity

The sharp rotation in the market, as described above, meant we made a number of changes to the Fund. We continued to reduce our positions in **HSBC** and **National Express**, which are either within 10% of our estimate of full value (HSBC) or the Fund's dividend criterion (National Express). We also reduced the weights of a number of stocks that performed well during the month. **Paragon**, **Easyjet**, **TP ICAP** and **Sthree** are good examples, although all four remain core

positions. We sold **Catco** ('C' shares) in a tender offer above the current screen price. This has been a disappointing performer because of insurance events in 2018.

On the addition side, we increased our weighting in last month's new name, **Legal & General,** to 1% of the Fund. This was largely funded from our HSBC reduction. Legal & General rallied slightly during the month but still trades on a p/e of 7.5x and yields 7.5%.

We added to **Hipgnosis Songs**, which held a convincing capital market event. Growth in music streaming and the changing legislation on what percentage of revenue accrues to the songwriter underpin a strong growth trajectory. The ordinary shares, which we own, are now fully invested, so this growth will start to feed through. The recently announced issue of 'C' shares, intended to raise £300m, would mean the company is close to FTSE 250 status when the share classes merge in due course.

We also trimmed **McCarthy & Stone**, which has performed well and where the dividend yield is now below 4%.

The mining and the oil sectors were weak, particularly in the first half of the month. We added to **Anglo American**, **Rio Tinto**, **BP** and **Royal Dutch Shell**.

Dividend update

During September we published a paper 'Deciphering the dividend gap and our 2020 dividend vision', which we attach separately for those that may have missed it.

In that paper, we upgraded our guidance for 2019 Fund dividend growth to c. mid-single digit growth. This remains a prudent estimate of where the final figure will likely end up, particularly given positive news flow on dividends even since we published this paper. We view this as good outcome given that we delivered 18% Fund dividend growth in 2018, making for a high base line comparator. We will provide a final update on this guidance at the start of December.

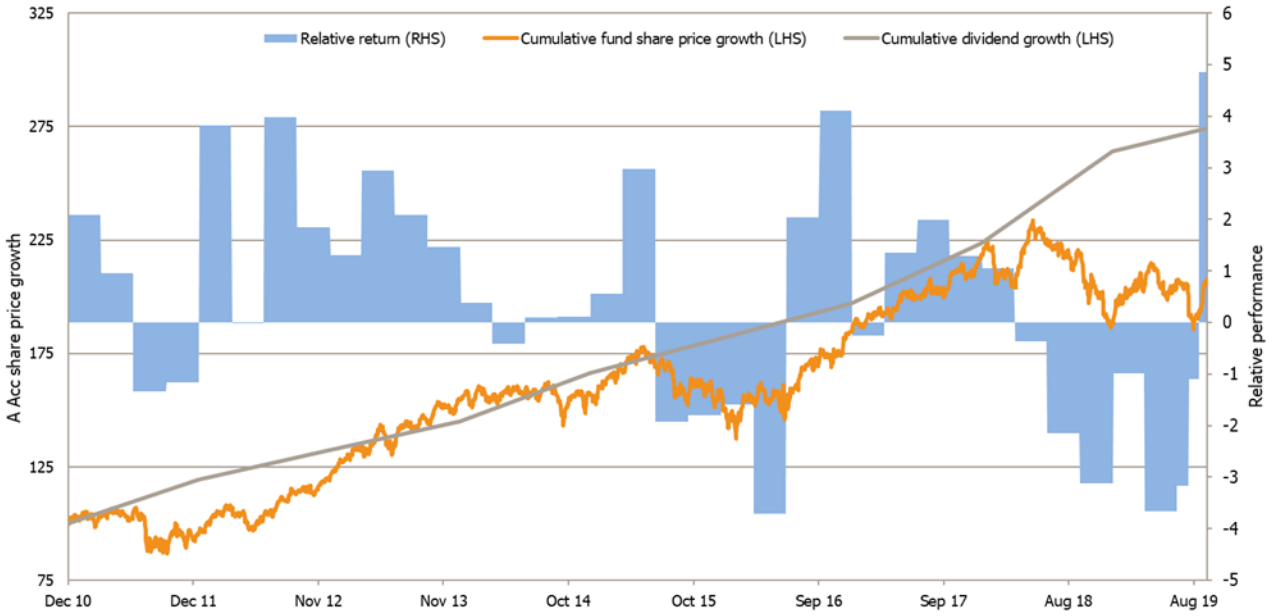
The Fund went ex dividend at the end of September, with the discrete Q3 2019 dividend being 5.5p per unit ('A' accumulation share class), which represents a rise of 6.4% year on year. The Fund dividend has grown 7.6% year-on-year over the first three quarters of 2019. On current guidance of mid-single digit growth, the Fund yields 5.4% for 2019.

In the 'Deciphering the dividend gap' paper, we also provided our first guidance for the Fund's 2020 dividend. It highlights why we are confident we will grow the dividend next year. The initial stock-by-stock analysis suggests a robust growth rate of 8-10%. Importantly, this is before we apply our risk buffer. We have factored in a larger than normal buffer for next year. On top of our usual allowance for company dividend risk, this larger-than-normal buffer reflects the potential for sterling to rally sharply on any clear Brexit outcome. Our initial formal guidance, after the application of our buffer, is for low single-digit growth in the Fund dividend in 2020.

Why are confident we will grow the dividend in 2020? Firstly, the dividend cover in the portfolio is c. 2x, which is better than the wider market. Secondly, the Fund's holdings have significantly less debt than the market (with only three stocks with a net debt to ebitda over 2x). Thirdly, a high proportion of our holdings (c. 42%) are buying back shares. This creates a cushion that would protect the dividend flow were earnings outcomes to be worse than expected. Based on this initial guidance, the Fund yields c. 5.5% for 2020.

We have provided below an updated version of the graph that was in that paper. It shows the gap between the Fund dividend trajectory and the unit price remains significant, even allowing for the small closure in that gap following better Fund performance in September.

The gap between the Fund's unit price and dividend remains close to its widest ever level



Source: JOHCM/Bloomberg as at 20 September 2019. *Dividend growth from 31 December 2018 to 20 September 2019 is based on a 5% growth estimate (i.e. 4% annualised for 2019).

It is worth noting that if the announced acquisition of **Galliford Try** by **Bovis Homes Group** were to complete, it would change the dividend growth estimates provided above for 2019 and 2020, as Bovis has announced it would pay its final dividend in 2019 rather than 2020.

Outlook

As highlighted above, market leadership saw a marked change in September. This is critical, as many unit holders have understandably asked us over the last few months what could drive a change in the dynamic between growth and value. We take great encouragement that, on the face of it, not that much changed (particularly bond yields) and yet the result was particularly pronounced. Clearly, the main difference over the last couple of months has been that the debate around fiscal policy needing to take the baton from monetary stimulus has become more public and increasingly embraced by central bankers around the world. With valuations of growth/momentum stocks at such an extreme relative to value stocks, this is a key development and helps explain the intra-market dynamic in September. It is also noticeable that the failure of WeWork to float and the poor performance of high profile IPOs such as Peloton is very similar to what happened at the peak of the TMT bubble in March 2001, when the likes of Lastminute.com fell so spectacularly on listing.

We have recently published many pieces of work that highlight the parallels between 2001 and today. They all suggest that the relative recovery of value will be very pronounced when it arrives. As such, September's performance should only be seen as the potential start of this process. Even after the moves seen in the month, the Fund still yields 5.5% prospectively, which is close to its highest ever level, whilst the price-to-book multiple for the stocks we own is barely above 1x. Combined with a Fund dividend cover of just above 50% and comparatively low levels of leverage, we feel the portfolio continues to offer tremendous absolute and relative value, even with the political and economic uncertainties that currently prevail. The discount being placed on UK-listed stocks looks particularly extreme at present. At some stage, a path to resolve this issue will emerge, whilst the shift towards a global fiscal stimulus grows stronger each month and will help realign the value versus growth valuation dynamic, which has become unsustainably stretched. The Fund is well placed to benefit from these changes.

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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