



JOHCM UK Equity Income Fund

Monthly Bulletin: October 2020

Active sector bets for the month ending 30 September 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.34	3.26	+7.08
Mining	13.85	7.59	+6.26
Media	9.09	3.53	+5.56
Food & Drug Retailers	6.40	2.28	+4.12
Banks	9.50	6.06	+3.44

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.44	-10.44
Equity Investment Instruments	0.00	6.89	-6.89
Tobacco	0.00	4.06	-4.06
Beverages	0.00	3.61	-3.61
Personal Goods	0.00	3.18	-3.18

Active stock bets for the month ending 30 September 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix Group	3.41	0.20	+3.21
WPP	3.56	0.38	+3.18
Barclays	3.98	0.89	+3.09
Tesco	4.17	1.11	+3.06
Anglo American	4.25	1.22	+3.03
Legal & General Group	3.61	0.58	+3.03
ITV	3.13	0.13	+3.00
Vistry Group	3.03	0.07	+2.96
DS Smith	3.16	0.20	+2.96
BP	5.31	2.42	+2.89

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.96	-5.96
GlaxoSmithKline	0.00	3.81	-3.81
British American Tobacco	0.00	3.37	-3.37
HSBC	0.00	3.23	-3.23
Diageo	0.00	3.22	-3.22

Performance to 30 September 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	-4.48	-35.24	164.40	£1,492mn	£1,844mn
Lipper UK Equity Income mean*	-1.22	-22.38	132.32		
FTSE All-Share TR Index (12pm adjusted)	-2.05	-19.86	145.92		

Discrete 12-month performance (%) to:

	30.09.20	30.09.19	30.09.18	30.09.17	30.09.16
JOHCM UK Equity Income Fund – A Acc GBP	-29.25	-4.55	5.64	20.87	10.53
FTSE All-Share TR Index (12pm adjusted)	-16.51	2.72	5.84	12.62	16.43

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: “ignore Chicken Licken pessimists” – Andy Haldane, Bank of England chief economist

Last month, we highlighted the imbalanced reporting by the UK media of the economic recovery since May. This point was picked up and elaborated on by the Bank of England's chief economist, Andy Haldane, in a speech on 30 September:

“My concern at present is that good news on the economy is being crowded out by fear about the future.”

With UK Q3 GDP likely to rise by c. 20%, there is no doubt that the economic recovery has thus far exceeded even the most optimistic economists' forecasts. Indeed, as Mr Haldane points out, UK GDP has been rising, on average, by around 1.5% per week since the end of May. The result is that the Bank of England now expects GDP to be only 3-4% lower than its pre-Covid-19 levels by the end of September.

Despite a rise in unemployment during that period of around 1 million, this recovery has been driven by consumer expenditure. This has manifested itself in a number of areas: retail sales are now above the levels at the start of the year; UK mortgage approvals in August hit their highest level for that month for 13 years; and spending on other big-ticket items, such as cars and furniture, has recovered dramatically. This is despite the fact that consumer confidence surveys have remained very weak. This recovery has not, however, been matched by corporate spending. Business investment is still running at 20-30% lower levels than pre-Covid-19.

The trajectory of further near-term economic improvement is, of course, likely to be tempered by the recent rise in coronavirus cases and the tighter lockdown restrictions. However, even a slowing improvement is still likely to leave the UK economy in a much stronger place than most envisaged in April. Furthermore, the recent adjustments to the job support scheme are likely to reduce the anticipated rise in unemployment, with Haldane, for example, now assuming a better-than-expected further 500,000 job losses by the end of 2020. He also points out, however, that “pessimism can be as contagious as the disease”. As such, it will be fascinating to see whether UK consumers rein in their spending over the next few weeks, or whether they carry on, particularly in areas related to their personal environment and home.

Elsewhere in the world, economic activity in the US slowed a little over the late summer as one-off spending boosts from tax rebates/cheques have faded. Retail sales still grew by 0.8% month-on-month in August, but this was a slowdown compared to the previous periods. Like the UK, activity

in housing markets is very robust, with existing home sales close to a 14-year high. The Federal Reserve made it clear that it will leave policy loose until it sees a pick-up in inflation and would be happy to let it overshoot in the short term. As we have mentioned before, medium-term inflation expectations have risen considerably over the last few months – the 10-year inflation break-even is now at around 1.65%.

Elsewhere in the world, the industrial economic recovery in China has continued to strengthen. This is reflected not only in PMI surveys and industrial output, but by iron ore and copper prices at close to six-year highs. However, there has definitely been a stalling of economic momentum in Continental Europe, with a number of the purchasing managers' surveys weakening this month as virus cases have picked up and as politicians have failed to make progress on further economic stimulus packages. The Brexit negotiations are clearly entering a critical phase for both Europe and the UK.

Performance

The market fell in September, with the FTSE All-Share Total Return index (12pm adjusted) returning -2.05%. The Fund underperformed with a return of -4.48%. The Fund remains significantly behind year to date (-35.24% versus -19.86%), with most of the underperformance arising after the pandemic first broke.

Looking at the peer group, the Fund ranked fourth quartile within the IA UK Equity Income sector for September. On a longer-term basis, the Fund is ranked fourth quartile over three years and five years, second quartile over ten years and first quartile since launch (Nov 2004).

The drivers of the negative relative performance over the month have existed since the start of Covid-19, with defensive parts of the market performing strongly. Our top five sector underweights – pharmaceuticals, equity investment trusts (where the biggest component is the Scottish Mortgage Trust), tobacco, beverages and personal goods, which collectively are close to 30% of the UK market – all outperformed. This was partly due to the risk-off mentality of the market (linked to Covid-19 developments), and partly due to sterling falling in the middle of the month on Brexit concerns.

Occasionally we see how positively the Fund responds when there is a potential break in the current narrative. For example, the Fund had one of its best ever days in relative performance terms at the start of this week – it was up c. 135bp after a flicker of Brexit negotiation positivity and a slight rally in sterling. This shows the polarised state of the market, the extremity of market positioning and also highlights the extremely low valuations within the Fund. The comments in the Outlook section discuss what could change the current market narrative.

Financials were weak. In the main this was not driven by any specific negative news flow, but rather the general market tone and, in the UK, the moves to step-up Covid-19 restrictions. **Barclays** and **Legal & General** were particularly weak. **Aviva** held up better due to the announcement of asset sales (further detail below).

Our paper & packaging stocks **Mondi** and **DS Smith** were both up 15% relative. In commodities, oil stocks were weak but this was partly offset by strength in certain mining stocks. The best performer was **Kenmare**, which announced the successful move of equipment from one mine to another. This complex, high-risk transfer creates a much higher output profile that leaves the stock on a free cash flow yield of over 30%.

UK domestics were mixed. Some performed well, such as **Severfield**, **Countryside** and **ITV**, whilst others like **Wm Morrison** and **Vistry** were down c. 10% relative.

Portfolio activity

September was another quieter month for the Fund in terms of portfolio activity. As we mentioned last month there are two main reasons for the more muted activity. Firstly, we believe there is currently tremendous upside in the Fund. Secondly, the majority of our holdings have repositioned themselves and are now on the front foot in terms of a post-lockdown recovery. Further examples of this are discussed below. For now, we should be patient, let the portfolio breathe and allow the upside to come through.

We added to **Wm Morrison**, which, despite being a clear Covid-19 beneficiary, is down 14% year to date. The switch from eating out and working in offices to working from home has meant like-for-like sales are up 10%. Alongside this, the company has continued to reposition its pricing architecture (along with **Tesco**), which means the competitive threat of discounters is less acute. Wm Morrison also has a multi-pronged online strategy, including partnerships with Amazon and Ocado. It is taking market share in both online and the physical store estate. These dynamics, in our view, should have led to a re-rating rather than a de-rating. Tesco and Morrison, which trade on c. 10%+ free cash flow yields, are collectively c. 6.5% of the Fund.

We also added to **Hipgnosis Songs** (2.5% of Fund), which conducted a placing to fund the purchase of a large catalogue of songs. This business remains very well placed, with music streaming growing strongly and the songs acquired being managed more aggressively. It was clear from a capital markets event during the month that the valuers were likely to reduce the discount rate (which is currently a very high 9%) in the next few months, which will step change the net asset value upwards. Hipgnosis also increased its dividend payout during the month.

We continued to add to **Aviva** (3.3% of Fund). It has started a refocusing exercise under a new chief executive. The Singaporean business was sold for four times the multiple the whole group trades on, and there are rumours the French and Italian businesses are also to be sold. The new CEO acquired £1m worth of stock during the month. Modelling the likely sales, deleveraging and share buybacks with excess proceeds, we estimate c. 60p earnings per share. The stock trades on a P/E ratio of 5x and yields 8% (on a cut dividend).

Elsewhere, we also added to **Vodafone** and **Standard Chartered**, which were both weak.

Our small cap exposure is now just over 17% of the Fund after one of our largest holdings in this area, **Diversified Gas & Oil**, was promoted to the FTSE 250. News flow from this part of the Fund was largely positive during the month, but there were some anomalies in terms of share price performance. Trading accelerated (e.g. **DFS**, **Galliford Try**, **Eurocell** and **Redde Northgate**), with a key theme being the switch in spending from travel, commuting costs and eating out towards homeware spending. Management teams remain cautious on the outlook from here. For example, DFS's best case scenario (of three cases outlined) of flat like-for-like sales from this point to the end of the year contrasts with the current run rate of +30-50%. Its best case would be our worst case. Analysts, and subsequently, share prices have largely followed ultra-cautious management guidance. We added to a number of these names.

We reduced our weight in **Mondi**, which rallied as a series of price increases were announced across its businesses and also by competitors. It is one of our most expensive stocks on current and recovered earnings. The sector is also a key beneficiary of environmental trends as the switch away from plastic packaging towards fibre/cardboard packaging accelerates. Both these positives also affect our larger holding in the packaging sector, **DS Smith**. Together they account for c. 4% of the Fund.

Outlook

We noted last month that corporate results were better than expected. This trend continued in September. There were four main reasons for this: 1) investors had been too pessimistic; 2) the economy has thus far recovered faster than expected; 3) the policy response has been larger than expected; and 4) management actions have been positive. In certain parts of the market this has started to flow tepidly into share prices. This is encouraging.

Covid-19 continues to develop. Case numbers are not being mirrored in hospitalisations or deaths. And whilst there are local lockdowns, politicians seem unlikely to put more severe national lockdowns in place. In certain countries the fact that case numbers are not tracking deaths appears to be leading to a change in policy approach – the relaxation of measures in Belgium for example. This is clearly not happening in the UK, where the response is focused on a worst-case outcome and where the initial aim of protecting NHS capacity seems to have moved to reducing deaths to negligible levels at all costs.

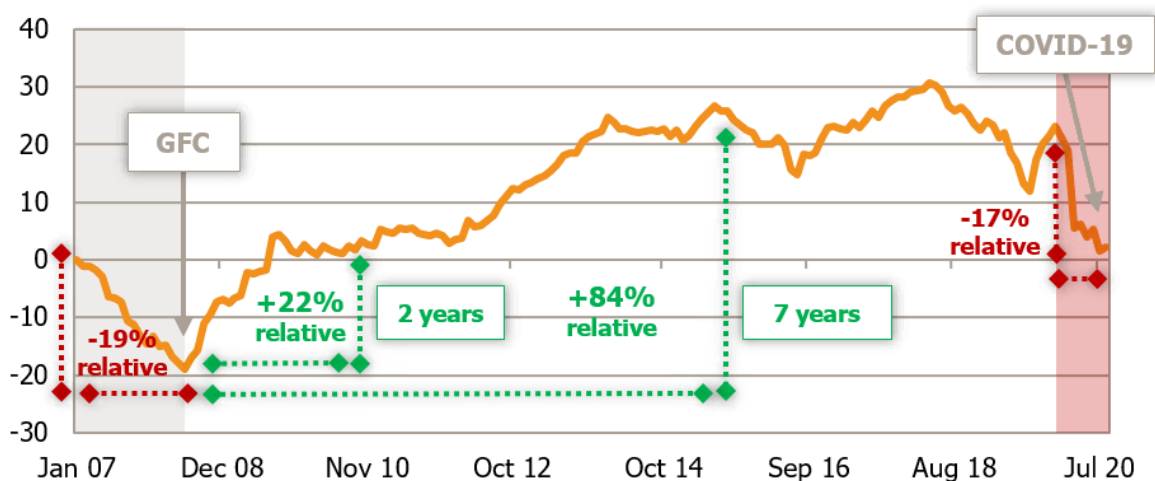
We note above that the Fund has leapt into life for short periods when the market narrative has briefly changed. We will see if this occurs in the near term in a more sustained way, with both Brexit developments (if conclusive) and a Covid-19 vaccine being potential game-changers.

Longer term, rising inflation expectations, increased M&A – we have started to see more activity in September such as William Hill and G4S – and a continued recovery in economies will all help.

We continue to expect strong Fund dividend growth from the Covid-19-affected nadir of 2020. The trough yield in 2020 is c. 3.7%, moving towards 5.5-6% in 2022 when the full effect of 2021's dividend decisions flow through ex dividend dates. We will provide a full update on the Fund's 2021 dividend outlook next month.

This has been a very challenging time for the Fund, and we appreciate investors will be both disappointed and frustrated. The chart below highlights the relative return performance of the Fund since 2007. It shows the performance weakness has been severe since the start of Covid-19 (before Covid-19 we were within c. 4% of our relatively high watermark). It shows this period of underperformance has been over a much shorter duration that the previous material drawdown, which came during the global financial crisis. On both of these occasions, the negative relative performance was similar. The chart also shows the type of recovery that can happen following these events. It can be sharp and material. There was a similar shape to performance after the TMT bubble when Clive managed the Newton Higher Income Fund.

Relative return: JOHCM UK Equity Income Fund (GBP) vs. FTSE All-Share TR Index



Source: JOHCM/Bloomberg as at 31 August 2020.

We believe we will see a similar recovery this time. As we have shown in recent papers, we have an excellent set of exposures in the Fund. Our portfolio companies are increasingly on the front foot after adjusting to the new normal. We have a lot of exposure to parts of the economy that have seen spending shift in their favour, and very limited exposure to the sectors deeply affected by Covid-19. The valuation upside in the Fund is material, which we hope will flow through in the short to medium term.

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

This document is for professional investors only.

Source: JOHCM/Bloomberg unless otherwise stated. All mentions of relative performance refer to the Fund's benchmark, the FTSE All-Share Total Return index (12pm adjusted). Issued and approved in the UK by J O Hambro Capital Management Limited (the "Investment Manager"), which is authorised and regulated by the Financial Conduct Authority. JOHCM® is a registered trademark of J O Hambro Capital Management Limited. J O Hambro® is a registered trademark of Barnham Broom Holdings Limited. Registered address: 1 St James's Market, St. James's, London SW1Y 4AH. Registered in England and Wales under No: 2176004. Telephone calls may be recorded.

The information in this document does not constitute, or form part of, any offer to sell or issue, or any solicitation of an offer to purchase or subscribe for Funds described in this document; nor shall this document, or any part of it, or the fact of its distribution form the basis of, or be relied on, in connection with any contract.

The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Allocations and holdings are subject to change.

Recipients of this document who intend to subscribe to any of the Funds are reminded that any such purchase may only be made solely on the basis of the information contained in the prospectus in its final form, which may be different from the information contained in this document. No reliance may be placed for any purpose whatsoever on the information contained in this document or on the completeness, accuracy or fairness thereof.

No representation or warranty, express or implied, is made or given by or on behalf of the Firm or its partners or any other person as to the accuracy, completeness or fairness of the information or opinions contained in this document, and no responsibility or liability is accepted for any such information or opinions (but so that nothing in this paragraph shall exclude liability for any representation or warranty made fraudulently).

The distribution of this document in certain jurisdictions may be restricted by law; therefore, persons into whose possession this document comes should inform themselves about and observe any such restrictions. Any such distribution could result in a violation of the law of such jurisdictions.

The information contained in this presentation has been verified by the firm. It is possible that, from time to time, the Fund manager may choose to vary self imposed guidelines contained in this presentation in which case some statements may no longer remain valid. We recommend that prospective investors request confirmation of such changes prior to investment. Notwithstanding, all investment restrictions contained in specific Fund documentation such as prospectuses, supplements or placement memoranda or addenda thereto may be relied upon.

The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

Investments fluctuate in value and may fall as well as rise. Investors may not get back the value of their original investment.

Past performance is not necessarily a guide to future performance. Dividend yield quoted is prospective and is not guaranteed.

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.

The Investment Manager may undertake investments on behalf of the Fund in countries other than the investors' own domicile. Investors should also note that changes in rates of exchange may cause the value of investments to go up or down.

J O Hambro Capital Management Ltd is licensed by FTSE to redistribute the FTSE All-Share TR Index, the "Index". All rights in and to the Index and trade mark vest in FTSE and/or its licensors (including the Financial Times Limited and the London Stock Exchange PLC), none of whom shall be responsible for any error or omission in the Index.