Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: October 2021

Active sector bets for the month ending 30 September 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.48	3.10	+7.37
Industrial Metals and Mining	14.50	7.44	+7.06
Media	7.89	3.13	+4.76
Household Goods & Home Construction	5.64	1.56	+4.08
Construction and Materials	5.12	1.60	+3.52

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.11	-9.11
Closed End Investments	0.00	6.92	-6.92
Personal Care, Drug and Grocery Stores	3.36	7.59	-4.23
Beverages	0.00	3.74	-3.74
Tobacco	0.00	3.17	-3.17

Active stock bets for the month ending 30 September 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	5.87	2.77	+3.10
Barclays	4.40	1.31	+3.09
Vistry Group	3.18	0.11	+3.07
Phoenix Group	3.23	0.17	+3.06
Legal & General	3.67	0.68	+2.99
Anglo American	4.24	1.29	+2.95
Glencore	4.83	1.89	+2.94
Aviva	3.58	0.65	+2.93
WPP	3.38	0.48	+2.90
ITV	3.00	0.17	+2.83

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.61	-5.61
Unilever	0.00	4.31	-4.31
Royal Dutch Shell	1.82	5.29	-3.47
Diageo	0.00	3.36	-3.36
HSBC	0.00	3.30	-3.30

Performance to 30 September 2021 (%):

	1 month	Year to date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**-0.02**	**21.71**	**318.80**	**£2,133mn**	**£2,500mn**
Lipper UK Equity Income mean*	-1.26	14.51	193.93		
FTSE All-Share TR Index (12pm adjusted)	-0.41	13.65	215.54		

Discrete 12-month performance (%) to:

	30.09.21	30.09.20	30.09.19	30.09.18	30.09.17
JOHCM UK Equity Income Fund – A Acc GBP	58.40	-29.25	-4.55	5.64	20.87
FTSE All-Share TR Index (12pm adjusted)	28.31	-16.51	2.72	5.84	12.62

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

The month was dominated by the very active debate surrounding how transitory, or not, inflationary pressures currently are, and how quickly central banks should be taking action to reduce stimulus measures. The debate has been made more complex by the fact that, in the short term, economic activity in Q3 2021 has been dampened in most Western economies by the spread of the Delta variant. It is encouraging that cases have begun to drop considerably in the US and most European countries in September.

In the US, 10-year bond yields rose around 20bps to 1.51% during September, with most of the increase coming in the last few days of the month. This followed the statement from the Federal Reserve indicating that the tapering of asset purchases was likely to begin in Q4 2021. Furthermore their future projections strongly implied that interest rates would begin to rise during the first half of 2022. Although the latest monthly CPI print of +5.3% annual growth continued to show a slowing of inflation due to base effects, it was noticeable that the Fed raised their year-end forecast for CPI to 4.2%, despite claiming that they predominantly saw this inflationary phase as transitory. Whilst the US non-farm payroll data disappointed in August at +235,000, the data appears to have been somewhat distorted. Real-time economic indicators in September show a pick up, particularly in mobility and housing, as new Covid-19 cases have begun to fall.

In the UK, the same debate around inflation, policy tightening and shorter-term economic trajectory has also been very lively. The August annual CPI of +3.2% was an increase from July's 2.0% and reflected the biggest monthly gain for over 20 years. However over half of this gain was due to base effects from August 2020 when the 'Eat out to help out' scheme saw deflation in the hospitality sector. However, the labour market tightened further during the month with 241,000 jobs added in August meaning that more individuals are now in paid employment than in February 2020 and the vacancy number passed 1 million for the first time. Companies are experiencing labour shortages in a number of areas, not just the high-profile HGV driver situation. It seems very likely that wage growth will accelerate further. Base effects make tracking the monthly wage growth data difficult at present but over the last two years, average earnings have grown by around 3.4% pa and this may well rise in the coming months, particularly because CPI will probably exceed 4% by the turn of the year as further input cost inflation, including energy, gets passed through the system.

However, shorter-term economic activity in the UK has slowed somewhat during Q3, although the July monthly estimate of 0% growth, due to the impact of the 'pingdemic' looks too cautious to us and is contradictory to the message from the labour market. It is also very different to company

commentary across this period, which remains very upbeat. Furthermore housing related activity remains extremely strong, with August mortgage approvals barely falling back despite the ending of stamp duty incentives. GDP for Q2 was also quietly revised up from the 4.8% which was initially printed, and viewed as disappointing at the time, to 5.5% which would have been viewed positively.

It is against this backdrop that the MPC policy statement showed that two of the nine members of the committee voted to curtail the asset purchasing programme and further commentary from the Governor of the Bank of England hinted at small interest rate rises in the near term. This was despite the announcement of an increase in national insurance during the month, which is the first material fiscal tightening seen since the pandemic and which will raise an incremental £12bn pa. However, it should not be forgotten that UK consumers still have around £200bn of unspent savings that have accrued since the pandemic began and this should provide a material offset against any policy tightening, or the short-term impacts of rising energy bills. This more hawkish language from the Bank of England contributed to UK 10-year bond yields rising 40 bps to around 1.0%.

The German election result was even closer than expected, and, as such, it is probable that it will take some time before a workable coalition is established. However, it is likely that it will include the Greens who will push for a very expansive infrastructure programme which could be quite stimulatory. Elsewhere, the Evergrande crisis deepened further and is likely to depress short-term growth in China, but also accelerate moves to loosen monetary policy in the coming months.

Sharply rising commodity prices were a feature of the month, particularly oil, gas and coal; in many respects this reflects years of under-investment in what are seen by many investors as ‘sunset’ industries, but which will still have an important role to play for the next 15-20 years at least. In contrast, iron ore fell around 25% this month, partly driven by concerns about contagion in China from the failure of Evergrande as well as the fact that the price had been surprisingly resilient during 2021. Other key commodities such as copper fell more modestly (c.10%) as Chinese slowdown worries were somewhat offset by limited new supply and the prospect of future growth from the energy transition to renewables.

Performance

Stock markets were volatile in September, with the FTSE All-Share Total Return index (12pm adjusted) finishing modestly down (-0.41%). The Fund slightly outperformed its benchmark with a return of -0.02%. Year to date the Fund is up 21.71% while the benchmark is up 13.65%. Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked third quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

Beneath the surface, there were some material sector differential performances. The oil sector performed very well – particularly **BP** (up 15% relative) as oil / gas prices rose markedly. **Petrofac** was also up c. 50% following the resolution of a long running SFO inquiry. In contrast the mining sector was weak, driven by the fall in certain commodities (e.g. iron ore) and wider concerns regarding China following the Evergrande situation. **Anglo American** was particularly weak (down 10-15% relative). This was somewhat offset in the Fund with **Glencore** up 10% relative - helped by its lack of exposure to the falling commodities and having more energy related exposure.

The financial sectors, particularly domestic UK banks, but also insurance, picked up as bond yields rose towards the end of the month. **TP ICAP** fell after poor results and **Polar Capital** underperformed due to its asset mix being very tech-heavy.

In contrast to the banks, UK domestics – e.g. housebuilders – fell with the main drivers being the rise in rates, the fall in sterling and commentary about higher living costs (e.g. energy, NIC contributions). The latter is only half the story – as we mention above, there is still £200bn of excess savings following lockdowns and wages are also rising quickly.

Small-caps continue to post strong results with **Sthree** and **Galliford Try** both up 10%+ relative after theirs. The common theme across the majority of results (including these two stocks) is that profitability will be much higher post-Covid than it was pre-Covid due to growth, changing market dynamics, and management actions. The market has not fully priced this in for large swathes of the Fund.

Drax also performed well – up 18% relative, following the publication (finally) of an analyst note that mapped out in detail the (high) option value embedded in this company. COP 26 later this month and likely government announcements on carbon capture policy will be an important milestone.

Portfolio activity

After a quieter month in August, we were more active in September. We have been very cautious on having or building exposure to areas hit hard by the pandemic. We are unlikely to focus on some areas, particularly those with ongoing structural pressures, such as property, in the near term, but other areas have companies that will recover strongly and have good long-term prospects. A strong balance sheet is also a prerequisite before any stock is added to the Fund or even considered.

We had deliberately run down our position in **Easyjet** and reduced it at points when 're-opening' sentiment was running high. Over the pandemic, its balance sheet had weakened due to cash losses during periods when travel was not permitted. Easyjet needed a rights issue and this was subsequently announced in September. It was sufficiently large enough to remove balance sheet risk and creates the headroom for the company to invest in taking market share. Through the rights issue itself and the weakness in the shares at the start of the process, we have approximately doubled our holding to c. 100bp of the Fund. There has been a large reduction in capacity across the European airline sector across the last 18 months as a result of Covid-19. This, coupled with pent up demand, should lead to a strong recovery from 2022 onwards. Easyjet trades on around 6-7x normalised earnings.

We also added **National Express** back to the Fund during the month. We had previously exited it at c. 310-320p in Q1 2021 on valuation grounds. It announced an all share merger (which is in reality an acquisition) of **Stagecoach**. This transaction, if and when consummated, will be 10-12% earnings enhancing and will strengthen the balance sheet. The earnings uplift, coupled with the upside that has opened up due to the fall in the share price since our sale, has created meaningful upside. The proforma group trades on 6x normalised earnings. In due course this should be 10-12x. We acquired both stocks, with a combined position of c. 50bp. Our total position across the travel sector – including our other recent addition, **First Group,** is now c. 250bp.

To fund the above additions we continued to reduce **WM Morrison**. Our position at the end of the month, as the bidding is about to end with a one-day final auction process (on 2 October), is close to zero. The current price already discounts a c. 5% increase above the latest bid. We also marked our large positions e.g. **BP**, **Legal & General** and **Barclays** as positive performance took them above our 300bp active position soft limits. As noted above, our best positioned small-cap stock, **Sthree** (focused on global recruitment in STEM markets), performed well and we marked our position back to 165bp.

Other additions included several laggards: **TP ICAP** (which, as noted above, had poor results during the month), **National Grid** (which fell as bond yields rose) and **ABRDN** and **Bellway**

Fund dividend

Last month we materially increased our forecast for 2021 Fund dividend growth. Our current guidance is for growth of 'approaching 60%' for 2021 which compares to a start-of-year forecast of c. 37% growth. The confidence around this is very high with 90% of all dividends either paid or already declared.

The 'approaching 60%' growth forecast is based on the expected cash dividends to be received in 2021. If we look at our fiscal year 2021 forecast dividends (which include the final dividends which will be paid in the first part of 2022) versus fiscal year 2020, our forecast has risen from the c. 60% growth (made in January 2021) to 'above 80%' now.

The Q3 Fund dividend declared at the end of September was up c. 150% year on year. Looking further ahead, our forecasts show continuing strength in dividend growth, with an aggregate picture indicating the Fund's dividend will get back to (or above) where it was in 2019 around the end of 2022. This is despite the recent falls in commodity prices, which will temper our forecasts in this sector. It should be noted that aside from the fall in iron ore and the platinum complex (which

impacts Rio Tinto and Anglo American), other commodities have held up better. Our forecasts for Glencore's dividend will consequently need to rise meaning there will be some offsetting intra-sector factors.

Based on growth of 60%, the Fund's dividend yield for 2021 is projected to be around 4% and using the 80% growth forecast, including the full calendar effect, it would be 4.5%. If we move back towards the pre-Covid-19 dividend per unit the Fund would yield c. 5%.

Outlook

Are bond yields rising for the right reason? Having waited for more years than we care to remember to see bond yields begin to increase, we now find ourselves having to confront the question around the reason for the move. Is it because markets can finally see an end to quantitative easing and emergency levels of interest rates? Or is it because input inflation is getting out of control and that will bring economic growth to a shuddering halt, leading to some kind of 'stagflationary' environment? As so often seems to be the case with stock markets and economists, there is a real danger that we are already worrying about the next problem before we have even enjoyed the benefits of the recovery from the last one. It is fair to observe that economic growth has slowed during the last quarter but this can entirely be put down to the impact of the delta variant, which has stalled the re-opening of parts of the economy, particularly international travel, and has dented consumer confidence somewhat, despite high levels of savings and employment. However, we are still in the midst of a mid to high single digit GDP growth year and with the real prospect of something similar next year.

Of course investors can question whether central banks might make a policy error at this stage of the cycle and that can never be ruled out, but the stark reality is that interest rates and bond yields are simply too low in both nominal and real terms and that policy makers need to address this fact whilst economies are in a strong recovery phase, as they are currently. As such, tapering, monetary tightening and selective removal of fiscal stimulus are all appropriate tools to be considered and used over the next couple of years. At times this will cause angst and volatility in markets but that's just how it needs to be. Regular readers know that, whilst we agree that many of the input cost increases we currently see are likely to fade over time, the transmission mechanism into higher wages, particularly for the more lowly paid cohorts of the working population could well prove to be much stickier. As such we expect interest rates and bond yields to be much higher in two years time than they are today.

If this thesis is correct, it has huge implications for what types of stocks will perform well in the coming months and years and with so much valuation support on our side, both in absolute and relative terms, we are very excited about how the Fund should continue to perform. The very strong dividend recovery that we are also witnessing adds yet another dimension to the attractiveness of our cohort of stocks. It is clear that other commentators are behind the curve in appreciating how quickly dividends will recover and grow in the UK market.

As we mentioned in our report last month, we presented at an industry conference in late September on the prognosis for inflation, interest rates and how this could change equity market leadership. For those that are interested, a copy of the presentation is available here.

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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