



# JOHCM UK Equity Income Fund

Monthly Bulletin: November 2022

## Fund Overview

- The Fund aims to generate long-term capital and income growth through active management of a portfolio of UK listed equities.
- Established income investors James Lowen and Clive Beagles abide by a strict dividend yield discipline, which leads to an emphasis on higher-yielding stocks and promotes a naturally contrarian style.
- The Fund will typically have significant exposure to small and mid-cap stocks, often giving the portfolio a different holdings profile to many other income funds.
- Benchmark: FTSE All-Share Total Return Index.

## Active sector bets as at 31 October 2022:

### Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.99	2.37	7.62
Industrial Metals and Mining	11.94	6.93	5.01
Construction and Materials	6.40	1.41	4.99
Household Goods & Home Construction	5.36	0.97	4.39
Media	7.07	3.29	3.78

### Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.43	-10.43
Personal Care, Drug and Grocery Stores	0.00	7.48	-7.48
Closed End Investments	0.00	6.41	-6.41
Tobacco	0.00	4.40	-4.40
Beverages	0.00	3.95	-3.95

## Active stock bets as at 31 October 2022:

### Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
ITV	3.05	0.11	2.94
Phoenix Group Holdings	3.11	0.18	2.93
Barclays	4.01	1.08	2.93
Legal & General	3.55	0.62	2.93
NatWest	3.44	0.52	2.92
DS Smith	2.99	0.17	2.82
Aviva	3.33	0.53	2.80
BP	6.75	4.00	2.75
Glencore	5.71	2.96	2.74
Standard Chartered	3.27	0.58	2.69

### Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.65	-3.65
HSBC	0.00	4.06	-4.06
Unilever	0.00	4.53	-4.53
Shell	3.09	8.07	-4.98
AstraZeneca	0.00	6.82	-6.82

## Performance to 31 October 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
<b>Fund – A Acc GBP</b>	<b>4.84</b>	<b>-8.11</b>	<b>294.50</b>	<b>1,819.00</b>	<b>2,119.00</b>
Lipper UK Equity Income mean*	3.44	-8.44	179.80		
FTSE All-Share TR Index (12pm adjusted)	2.61	-5.26	209.78		

### Discrete 12-month performance (%) to:

	31.10.22	31.10.21	31.10.20	31.10.19	31.10.18
<b>JOHCM UK Equity Income Fund – A Acc GBP</b>	-7.50	63.60	-30.92	2.39	-3.13
FTSE All-Share TR Index (12pm adjusted)	-3.11	35.48	-18.85	6.78	-1.34

Past performance is no guarantee of future returns. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus. 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 UK's transition to a less radical, more managerial Prime Minister restored a degree of calm to markets. UK 10-year bond yields fell 40bps during October and closed the month at exactly the same level they were before former Chancellor Kwasi Kwarteng's expansionary budget statement. In contrast, US 10-year yields rose 40bps during the month and in Germany they were flat. In general, inflation prints came in ahead of expectations, notably in Italy at 12.85% and Germany at 11.6%; over 40% of the annual rise in inflation is directly due to energy cost increases. In the UK, the annual rate breached the 10% level, with food and beverage costs the most impactful in the last month.

Despite these high inflation prints, a degree of dovishness has begun to permeate into Central Bank's language. In October, officials in Canada, Australia and the European Central Bank were keen to infer that the trajectory of monetary tightening is likely to flatten somewhat in the coming months. As we highlight in the outlook section below, many influential members of the Fed have publicly expressed similar views. To be clear, they are not suggesting that rate increases are about to stop, but that the scale of rises may begin to reduce before flattening out, probably early in 2023.

Why is this happening now? Firstly, there is clear evidence that tighter financial conditions are slowing activity in several economies. For example, US pending home sales are now running 30% lower than a year ago and rents are beginning to fall, whilst price deflation is clear in areas such as freight rates and used car prices. At the aggregate level, composite PMI indicators across Europe and the USA suggest that a real contraction has indeed begun. Secondly, there is a growing recognition that increasing interest rates may be a blunt and ineffective tool for reducing inflationary pressures driven predominantly by supply side constraints. In many regards more capacity and Capex is required rather than creating an environment that is likely to deliver less. With that in mind, we would expect Central Banks to progressively de-emphasise their short term desire to restore inflation to their 2% target and to look at broader impacts on economic activity whilst accepting a higher-for-longer inflation rate, suggesting that the policy 'pivot' may be closer than many market participants assume.

The UK has delayed the publication of its Autumn Statement by a couple of weeks, probably so that the economic projections can not only reflect the current slowdown in economic activity, but also to reflect the substantial reductions in debt cost projections from 5 weeks ago, both for Governments and Households, as bond yields and mortgage costs have fallen back from the late September highs. These reductions may, in time, see a modest improvement in business and consumer confidence indicators, which are currently at 2-year lows. The official zero-Covid policy continues to impact activity in China, with manufacturing and services PMIs now below 50.

## Performance

After a difficult September the UK market saw some recovery, with the FTSE All Share total return index up 2.61%. The Fund also recovered, rising by 4.84% and outperforming the market. Across both September and October, which were seen and will be seen as one of the most volatile periods in UK political history, the Fund was flat in relative terms. Year to date the fund is down 8.11%, behind the index return of -5.26%. Looking at the peer group, the fund was ranked 1<sup>st</sup> quartile in October and is ranked 3<sup>rd</sup> quartile within the UK Equity Income sector so far in 2022. On a longer-term basis, the fund is ranked 2<sup>nd</sup> quartile over three years, 3<sup>rd</sup> quartile over five, and 1<sup>st</sup> quartile over ten years and since launch (Nov 2004)<sup>[1]</sup>.

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<sup>[1]</sup> Source: Lipper Hindsight

There were several positives to draw out in Fund performance trends in October, including a general bounce back in risk assets (and associated weakness in certain defensives where the Fund is largely not present).

First, despite the challenging macroeconomic conditions, operational performance remained largely positive. We had several trading updates which highlighted performance better than expectations. These included most of the Banks (benefiting from higher interest rates with some offset from higher costs and prudent provisioning) and other names like **DS Smith**, **Lookers** and **Ibstock**, which all guided forecasts up to varying degrees. The themes amongst these results were pricing power, nominal vs real (see Outlook section) and stronger than expected margins. There were no material disappointments relating to 2022 performance, although there were some downgrades for 2023 (e.g. housebuilders to reflect likely volume weakness, **Wickes** to reflect higher energy costs). Operational performance has been much better than expected, and share prices responded. **DS Smith** outperformed by 10%, **Lookers** by 15% etc.

Second, the combination of low share prices, strong operational performances and robust balance sheets meant more stocks joined the share buyback list, with **Hipgnosis** and **Lookers** initiating buybacks.

Third, domestic stocks bounced back strongly from the 'Mini Budget' period at the end of September. **Galliford Try**, **Norcros**, **Redde**, **DFS**, **Curry's** and **ITV** were up around 10% in relative terms, with many higher than at the start of September. So despite the political travails, domestic stocks are performing better. Why? Valuation support is kicking in.

Fourth, there was some evidence that executive management may be taking action into their own hands to unlock value. For example, there was speculation that ITV (up 15% relative) was investigating the sale or part sale of its Studios business. We value this at more than the current market cap i.e. the current market cap would imply a negative value for the ITV broadcast business. If the rumours are true, then the stock could double. In addition, **First Group** announced the sale of its historically owned business, First Transit, where it had an associated earn-out. This, coupled with excess capital from the sale of assets related to Greyhound (another recently sold business), should support a return of c. 25% of its market capitalisation in due course.

Other areas of strength were the oil sector and the Fund's two recruitment stocks (**Page** and **Sthree**).

**Drax** underperformed due to volatility in government policy on energy price caps and windfall taxes, which should be clarified in November. The Fund's dollar earners also struggled (Lloyd's insurers, **TP ICAP**) and, despite promising results, **Standard Chartered** underperformed.

## Portfolio activity

We sold our small position in **Endeavour Mining** in October. This goldminer, possibly the least well-known constituent of the FTSE 100, performed well across our ownership, contributing 10bp to relative and absolute performance. Factors driving the exit decision included less valuation upside than elsewhere in the portfolio and the likely continued elevation of single country / geography risk.

Most other sales were driven by stocks performing well and hitting our 300bps maximum active position, including ITV, **NatWest Group** (before the fall at the end of the month) and DS Smith. As noted above, the oil sector was strong, and we trimmed certain stocks (e.g. **Petrofac**) to keep weightings in check. At the start of the month, dollar-driven exposure was strong as the currency peaked. **Lancashire** was trimmed due to this factor.

No new names were added in October. 2022 is likely to be the year we have added the least number of new holdings. This is a function of strong operational execution from the majority of stocks (meaning less reason to re-assess) coupled with the ultra-low valuation picture, perpetuated by ongoing events which heighten risk aversion, such as the Ukraine War, government change in the UK and material outflows from the UK market. Now is the time to put the 'foot on the ball' and be patient, as most stocks have 75-300% upside.

With that as a context, most of the Fund remained in 'add' territory. At the start of the month, all domestic UK stocks were weak in the aftermath of the 'mini budget'. So we added to **Bellway**, **lbstock**, **Wickes**, **Lloyds Bank** and **First Group**. As indicated above the 'Mini Budget' (the last week in September / first week in October) could mark the low point for domestic UK stocks, given subsequent performance.

## Dividend Update

We recently upgraded the forecast for 2022 Fund dividend growth, to c. 35%. With very few dividends still to be announced, we are running slightly above this level. 2022 has been a very encouraging year for dividend delivery, with the Fund dividend due, based on the guided growth mentioned above, to end the year 10% above the pre Covid 19 level. The yield on the Fund for 2022 is c 6%. We expect Fund dividend growth for 2023 to be at least mid-single digits in 2023. We will provide a final dividend update for 2022 and formal guidance for 2023 in our December report at the start of January.

## Outlook

New Prime Minister, Rishi Sunak, has a difficult task ahead of him as he looks to reduce the fallout from recent political events. Whilst the media has been distracted, there have been a number of positive developments in economic variables. These have partly been driven by the step-change in credibility Sunak and Hunt have created. UK bond yields are nearly back to where they were pre-Kwarteng's budget (which in due course will be followed by mortgage rates), gas prices have collapsed from their August highs, we remain at almost full employment in the UK and profit levels remain close to record highs - all of these factors slip under the news radar. We expect the cost-of-living issues to ease in 2023 as inflation falls back.

With these points as a context, despite the strong rhetoric and several sharp upward movements, we believe that we are approaching a 'pivot' in central banks' interest rate moves (and the associated narrative), and stocks exposed to the real economy could recover dramatically. Given the stretch in valuations in the UK market, it could be similar to the 'vaccine' moment from a market performance perspective. We saw some evidence of this narrative change towards the end of the month when the Canadian Central Bank increased rates less than expected and a dovish outlook statement came from the European equivalent. The comments below from Lael Brainard suggest the Fed will approach a similar point in the next few months. This week's Fed and Bank of England rate rises may be the last outsized moves.

"Lags in transmission mean that policy actions to date will have their full effect on activity in coming quarters."

"The combined effect of concurrent global (monetary) tightening is larger than the sum of its parts."

"At some point, risks could become more two-sided."

*Lael Brainard – Fed Vice Chair, Chicago, 10 October 2022*

The market's obsession with perceived growth (and defensives) and its disregard for value is taking time to shift, as value has barely recovered relative to growth despite much higher interest rates. The adjustment (where it has occurred) has happened quicker elsewhere in

the world, with the Nasdaq down 10-20% more than broader US indices. This trend is likely to continue given the very poor results season we have seen from most of the FAANGs. In the UK, the adjustment has been delayed as many of the long duration stocks (which would normally fall as interest rates increase) are defensives which have been underpinned by the rush to perceived safety created by the current geopolitical problems and the recent volatility in British politics. This will change.

Valuations across our Fund are extraordinarily low, with many P/E ratios below 5x, free cash flow yields in the 15-30% range and numerous stocks trading below asset value, some even below the value of their net cash. Valuations cannot stay here - there will be multiple takeovers from overseas buyers at substantial premiums if the market doesn't adjust.

Analysts and commentators have probably overestimated the earnings fall that will come from the expected Western world recession, as they are too focused on real GDP and not enough on nominal GDP. Most companies' revenues will grow with nominal GDP as they pass on price increases and broadly maintain margins, even if they see some volume decline. We see evidence of that from the likes of DS Smith in packaging (which as noted above guided profit forecasts materially higher) and from **WPP** in advertising, which guided its revenue expectation slightly up. Of course, some companies won't be able to pass on all costs, but many will, and yet most stocks are discounting an earnings fall of 25-50%.

The Fund's dividend yield is c 6% this year and around 6.5% next which would be close to its highest ever level. The quality of that dividend is high, with pay-out ratios around 40% (vs 50% pre-Covid) and very strong balance sheets (only three stocks with a net debt to EBITDA above 2x). Around 50% of the Fund is currently engaged in share buybacks which would be curtailed before any dividend adjustment.

We have rarely felt so strongly that the time to put capital into the Fund is now. Some clients redeemed in the summer of 2020, during the depths of the COVID despair, and that felt wrong (as indeed it was), but the timetable for a vaccine solution was unclear then, so it was difficult to dissuade them. This time, given the points above, the path to stronger returns is much easier to foresee.

## 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](mailto:info@johcm.co.uk) or visit our website at [www.johcm.com](http://www.johcm.com)

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Investments include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.

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.

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