Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: September 2017

Active sector bets for the month ending 31 August 2017

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.43	3.02	+6.41
Construction & Materials	6.98	1.50	+5.48
Banks	15.78	11.19	+4.59
Oil & Gas Producers	15.59	11.22	+4.37
Mining	9.74	6.55	+3.19

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Tobacco	0.00	5.87	-5.87
Equity Investment Instruments	0.44	4.42	-3.98
Pharmaceuticals & Biotechnology	3.39	7.36	-3.97
Beverages	0.00	3.01	-3.01
Personal Goods	0.00	2.69	-2.69

Active stock bets for the month ending 31 August 2017

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Rio Tinto	4.91	1.87	+3.04
Aviva	3.84	0.88	+2.96
Standard Life Aberdeen	3.44	0.49	+2.95
BP	6.53	3.59	+2.94
Lloyds Banking Group	4.68	1.91	+2.77
DS Smith	2.95	0.21	+2.74
Barclays	4.09	1.37	+2.72
National Express Group	2.58	0.06	+2.52
ITV	2.60	0.25	+2.35
Glencore	3.77	1.75	+2.02

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	4.59	-4.59
GlaxoSmithKline	0.00	3.09	-3.09
Diageo	0.00	2.67	-2.67
Unilever	0.00	2.25	-2.25
Prudential	0.00	1.95	-1.95

Performance to 31 August 2017

	1 month (%)	Year to date (%)	Since inception (%)	Fund size
JOHCM UK Equity Income Fund	**-0.08**	**10.01**	**265.00**	**£3,257mn**
Lipper UK Equity Income Mean*	0.52	7.44	165.86	
FTSE All-Share TR Index (adjusted)	0.90	8.40	171.11	

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.

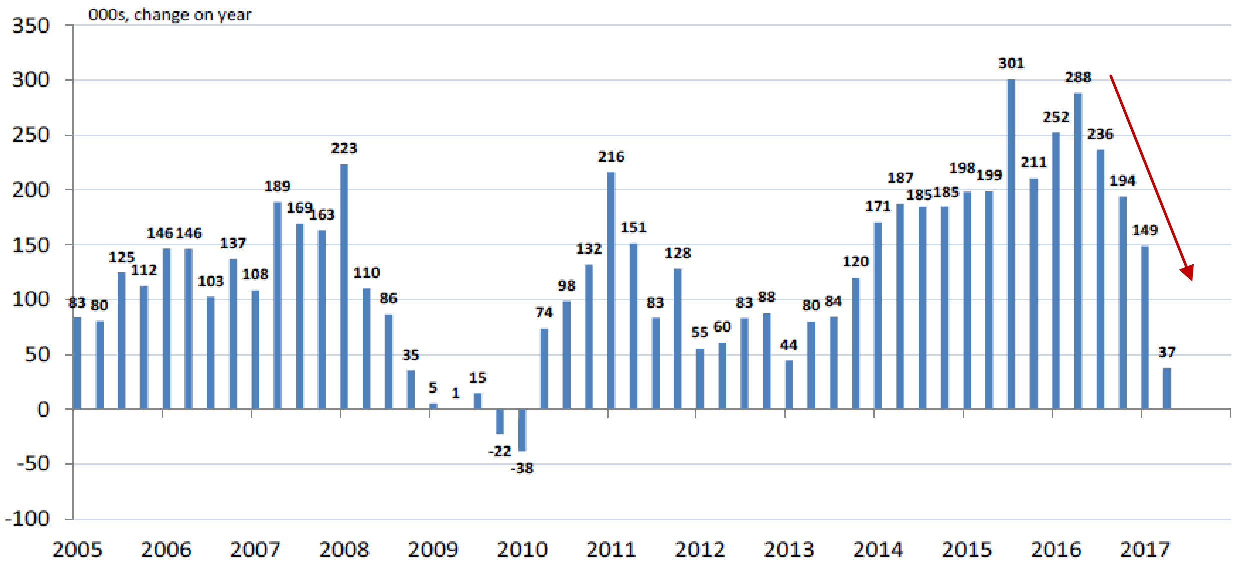
Economic developments – UK employment focus

In Q1 2017, the Bank of England amended its assessment of the equilibrium rate of unemployment from 5% to 4.5%. The equilibrium rate was deemed to be the point at which the slack in the labour market becomes sufficiently limited, so that wage inflationary pressures start to accelerate. Cynical observers, including ourselves, saw this move as a convenient excuse to allow the Monetary Policy Committee to continue to run with its ultra-loose monetary policy for a few months longer, as UK unemployment at the time was around 5%. Six months later and unemployment has just fallen below the Bank's new equilibrium rate, with the latest figure of 4.4% marking the lowest level since 1975. Yet real wage growth is currently negative, so will the Bank have to revise the equilibrium rate lower again, or is there any evidence of emerging wage inflation?

On closer examination, there are signs that wage growth is likely to accelerate from here. Firstly, the latest data from the Office for National Statistics (ONS) shows an acceleration from 1.8% per annum three months ago, to 2.1% per annum last month; it is also worth noting that this data is notoriously slow to be published (2.1% represents an average of the three months to June) and also highly subject to subsequent revisions (much like many of the UK's official statistics – for example, the GDP numbers have been revised higher by around 0.5% per annum over the last seven years). Furthermore, as we have written about many times before, the employment participation rate amongst people aged 16-64 years old is 78.7%, an all-time record high, and is unlikely to go much higher. It should also be noted that the ONS's measure of under-employment (people who would like to work more hours) has been falling rapidly too in recent months. The growth in employment of 334,000 in the last 12 months has all been into full-time jobs; the number of people on zero-hours contracts has actually been falling.

In many respects, however, the biggest change dynamic in the employment market in the last few months has been migration. Over the last five years, around 60% of job growth has been accounted for by people born outside the UK. One of us, (Clive) vividly recall, while stepping off a bus at Green Park on the morning after the Brexit vote, overhearing two English-born tradesman animatedly discussing the consequences of the vote. Extensively diluting their colourful language, the key quote was along the lines of "it's brilliant…once they all disappear back home, our wages are going to absolutely rocket!" Well, 12 months later, it appears that this dynamic is beginning to play out as EU nationals are proving to be less willing to move to the UK for work. The number of people born in other EU countries and working in the UK rose only 2% in the last year, the lowest rate of growth since 2010, and compares to a growth rate of over 15% in mid-2016. Indeed, if you excluded workers from Romania and Bulgaria (who were only able to access the UK more recently), the number from the rest of Europe has fallen by 2% in the last year. This dynamic is clearly down to a number of factors including uncertainties about post-Brexit opportunities, being made to feel less welcome, more job opportunities on the 'recovering' Continent and a shift in relative pay levels due to sterling's depreciation.

EU-born workers in employment in the UK (change on year)



Source: ONS and Jefferies International

In aggregate, these developments suggest a gradual tightening of supply in the UK labour market. However, what makes this change particularly interesting at the moment is that it coincides with a domestic economic backdrop which is somewhat stronger than most commentators acknowledge. There are a number of UK economic indicators suggesting that current economic activity is proving resilient. Credit growth accelerated in June to 4.3%, and critically saw corporate lending growing faster than unsecured personal lending for the first time since 2013. Export volumes in H1 2017 are up around 6% on the prior half-year, undoubtedly boosted by sterling's depreciation and the subsequent improvement in competitiveness. This devaluation boost has provided the economy with a major buffer to offset Brexit uncertainty, and it also manifests itself in the very strong hiring intentions seen in a number of corporate surveys. At the same time, whilst the UK consumer is suffering from modestly negative real wage growth at present, due to the impact of imported inflation, consumer confidence has actually risen slightly over the last couple of months according to market researcher GfK. We also suspect that the economy had a boost from “staycations” over the summer, due to the weak currency and inward tourist traffic, which has continued to be strong despite the terrorist incidents. Lastly, UK mortgage approvals hit their highest level for over a year in July.

In summary, we have a situation where the supply of labour is beginning to shrink whilst the demand for labour is firm, suggesting that a rise in the price of labour, via accelerating wage inflation, is inevitable. The reason this is so important is because this is the key dynamic that the Bank of England are focused upon when deciding whether to begin to tighten monetary policy. Some members of the Monetary Policy Committee, such as Michael Saunders, have already started to vote for rate rises, and we suspect others will join him in the coming months as it becomes very clear that the UK has little spare capacity in the economy. With UK ten-year bond yields trading at only around 100 bps, we believe that such moves will have a major impact on markets during the next 12 months, particularly if the Federal Reserve continues on its tightening path and if ECB President Draghi begins to withdraw stimulus, too.

Performance

Against a market that was flattish in August, with the FTSE All-Share Total Return Index (12pm adjusted) posting a modest rise of 0.90%, the Fund underperformed in returning -0.08%.

Year-to-date the Fund is up 10.01% versus the benchmark return of 8.40%. Looking at the peer group, the Fund is ranked first decile within the IA UK Equity Income sector over one year to 31

August 2017. On a longer-term basis, the Fund is ranked first decile over ten years and since launch (November 2004), and first quartile over three years and over five years.

The end of the results season was broadly positive across the Fund. Notably we were not exposed to any of the major profit warnings that occurred during the month: Provident Financial, WPP or Dixons Carphone.

The Fund's underperformance was mainly driven by three factors. First, the rebound in consumer staples as a result of a global fall in bond yields, principally due to uncertainties about North Korea. Secondly, weakness in UK domestics driven by sterling weakness and general negative sentiment around UK earnings - our UK construction holdings, which make up c.10% of the Fund and are a key component of our UK domestic positioning, saw some profit-taking after a strong period of performance year-to-date. Finally, the last factor was weakness in financials, which can be linked to both of the other two drivers highlighted above, namely the fall in bond yields and pressure on domestic names.

Offsetting these negative trends was a very strong performance from the mining sector, with our names up 5-10% relative. This was attributable to strong results, better-than-expected free cash flow and positive dividend surprises. We discuss the latter point in more detail below.

We also saw some strong stock-specific performances. **Thomas Cook** was up c.10% relative, continuing to benefit from strong results in July but also the more recent announcement of the Air Berlin insolvency. **Charles Stanley**, up c.15% relative, benefited from consolidation in its sub-sector (Rathbone's proposed acquisition of Smith & Williamson which has subsequently been dropped). Charles Stanley, given its size and valuation, could well become a participant in this well-established theme of industry consolidation. **Morses Club**, a competitor of beleaguered Provident Financial, was up c.20% relative following a positive profit warning and refinancing. Its business has benefited from the troubles at Provident Financial, with Morses being able to hire agents from Provident Financial to start new territories. The upside surprise was driven by a greater-than-expected number of new hires and each new hire delivering sales/profit quicker than expected. **St Ives** also bounced strongly (up 25%) following an in-line statement.

Portfolio activity

We made a number of changes to the Fund during August, adding one stock whilst selling three others.

The sales were **Saga, Segro** and **Go Ahead**. We start with the latter, which over the life of our holding added c.35bp to the Fund's relative performance, and which we sold for a number of reasons. Competition in rail has continued to intensify, which was most recently evident during August when Go Ahead lost its London Midland contract to Abellio. This leaves Go Ahead with two rail franchises – one of which is the troubled Thameslink franchise and the other, Southeastern, where it is in a tough three-way competition to hold it when the franchise expires in late 2018. The other business in the group is the bus operations, which, like all UK bus operators, is facing pressures from rising costs (wage pressure) and lower usage (caused by a number of factors including the ongoing rise in internet retailing). Factoring all of these points into the valuation agenda left the stock fully valued in our view.

Saga was also sold largely on valuation grounds. At c.13x EPS, it was one of our more expensive stocks. The sale also reflected the maturity of the pricing cycle in UK motor insurance (its dominant profit earner), longer-term structural risk in motor insurance (both similar reasons to the recent sale of Esure), and finally the profit cost of moving to a low capital-intensity business model, which will act as a headwind of c. 7-8% of EBIT per annum for the next 3-4 years.

The one portfolio addition was **Hammerson**, one of the market leaders in ownership of retail property assets. It may appear odd for us to add this stock to the Fund given our commentary on the structural pressures confronting the retail sector, but there are a number of factors which lay behind the decision. First, valuation – which ultimately all investment decisions need to come back to – the stock is trading on a 30-35% discount to net book value and yields close to 5%. More fundamentally, when one looks under the bonnet we find a number of aspects that are anomalous with that valuation: 1) it is the market leader in premium outlets across Europe, which is a high growth area, with valuable franchises such as Bicester Village; 2) it has exposure to Europe (c.

30% of NAV), predominantly via France and Ireland, thus is benefiting from the wider European economic recovery, and will also see a sterling NAV benefit from the recent renewed FX weakness; and 3) the retail assets it does own in the UK tend to be focused around large, well invested (or to be well-invested), destination retail centres. If the stock was on a 15% discount to NAV, which better reflects these positive points but also acknowledges the residual structural questions on physical retail, there would be more than 30% upside, including the dividend yield. We sold our position in Segro to fund the Hammerson purchase, which has been a strong performer as its logistics property platform has re-rated. Trading on a premium to book value and with a yield close to the market average, it looks fully priced.

Elsewhere in the wider financials sector, we added to the UK banks (both **Barclays** and **Lloyds Banking Group**) which continued to be weak, primarily driven by the weakness in bond yields noted above. We also added to **Paragon** and **TCAP**. The **Standard Life** and **Aberdeen Asset Management** merger consummated during the middle of the month, which, coupled with strong share price performance, meant the active position in the new merged entity was greater than our maximum focus point of 300bp. We therefore trimmed the position to move it back to that level. We also trimmed **Brewin Dolphin** following strong performance, which was sustained in the latter part of the month by the proposed, but subsequently dropped, consolidation in its subsector noted above (Rathbone and Smith & Williamson), despite the wider market weakness.

In the construction sector, we continued to trim **Costain** in the early part of the month. It reported strong results in the latter part of August and also announced finality around its one historic legacy contract (Manchester Waste), which, together with price weakness in the last two weeks, means this is now a strong hold. We also added to **Morgan Sindall**, which saw profit-taking following its results. Elsewhere, we also added to **ITV**, **Northgate** and **Halfords**, which were also weak.

Fund Dividend

With the interim results season largely finished, we are upgrading our guidance for Fund dividend growth to c.9-11% (from 6-8%). This would mean the Fund dividend for 2017 would be c.15.75p (A Class Accumulation) and the Fund would yield 4.3%.

The interim results season (excluding the mining sector) was solid and largely in line with our forecasts. The mining sector, where the recovery in metal prices has been faster than the wider market expected – a function of better demand but more importantly very limited supply growth due to the material capex reductions of recent years – has delivered much better dividend growth than anticipated. As noted last month, **Anglo American** came back to the dividend list six months earlier than anticipated with a higher pay-out ratio than expected while **Rio Tinto's** interim dividend was materially higher than our forecast. Our third holding, **Glencore,** delivered a dividend in line with our forecasts but signalled a likely step change up in 2018. The mining sector is the main driver of our dividend growth upgrade, coupled with a shedding of some of the prudence we had baked in ahead of the interim result season across the rest of the Fund. The material improvements in cash flow and dividends in the mining sector are likely to lead to a reappraisal of this sector by the wider investment community.

In terms of the Q3 2017 dividend, which will be declared at the end of September, we expect it to be c.25% higher year-on-year.

We will provide a first formal update for 2018 Fund dividend growth in November/December, but, as we indicated in our June update, the first glimpse into next year looks encouraging.

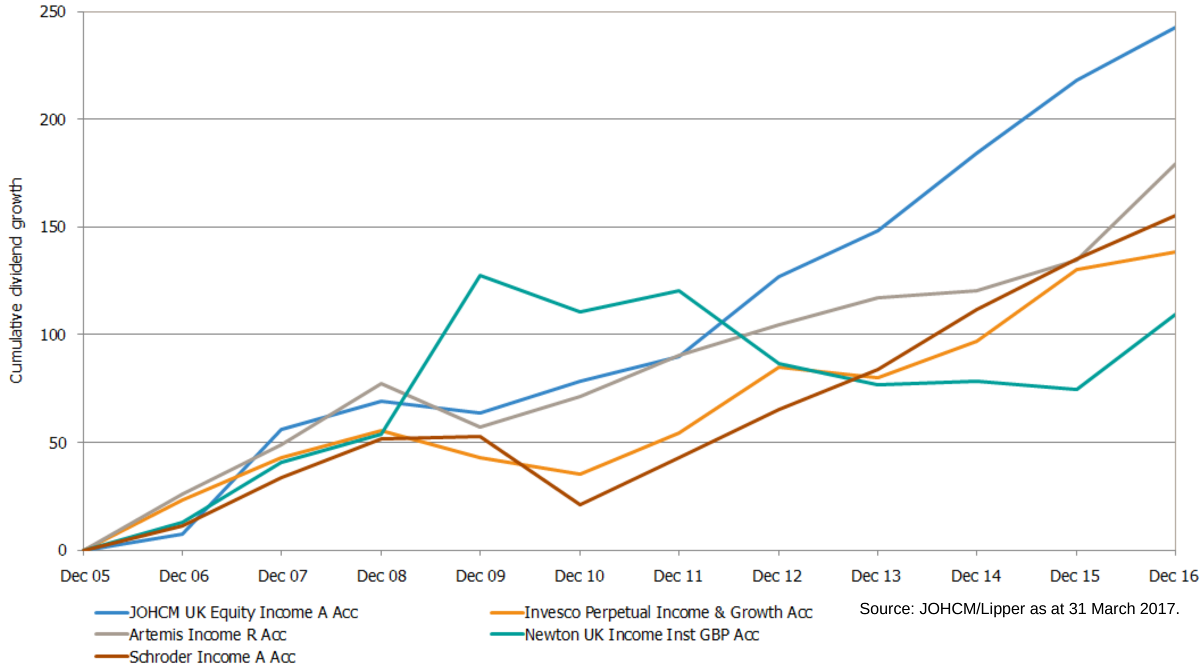
Outlook

The path to policy normalisation has categorically begun in the US and is moving nearer in the UK and Europe. The true distortive impact of effectively zero interest rates in the developed world on various asset classes will only become apparent in future years. However, without doubt it has pushed valuations of many assets and individual instruments to elevated levels that will be hard to justify if the cost of capital rises. The latest rolling over of bond yields has accentuated that position. With this in mind, an element of caution may be appropriate as we approach the autumn. There are also a number of geopolitical risks that also make for a more cautious tone – namely Korea, Trump's progress (or lack of) on policy, the tensions in the Middle East, Brexit etc.

Within the equity markets, we strongly believe that the overvaluation is most apparent in consumer staples and other perceived defensive sectors such as utilities and pharmaceuticals. Conversely, we believe that many of the areas that we are exposed to will respond well to a change of stock market leadership, if monetary policy were to normalise, particularly financials. Elsewhere, valuations in both the oil and mining sectors continue to look attractive to us, whilst there are also selective opportunities in the UK domestic arena too.

The long-term performance of the Fund is heavily correlated to the Fund's dividend growth and the resulting absolute level of the dividend. The chart below shows our dividend growth versus some well-known peers since our Fund's launch in November 2004.

JOHCM UK Equity Income Fund cumulative dividend growth vs. selected peers



Source: JOHCM/Lipper as at 31 March 2017.

As highlighted above, we have upgraded our Fund dividend guidance for the second time this year, to a healthy 9-11% growth for 2017. This positive dynamic is another reason for some cautious optimism from a Fund relative performance perspective, despite the note of caution on the wider market highlighted above.

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 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).

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