Professional Investors Only

J O Hambro
Capital Management Group

JOHCM UK Equity Income Fund

Monthly Bulletin: September 2018

Active sector bets for the month ending 31 August 2018:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.55	3.19	+6.36
Banks	15.75	10.19	+5.56
Mining	10.30	6.00	+4.30
Oil & Gas Producers	17.51	13.61	+3.90
Construction & Materials	5.06	1.69	+3.37

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.49	-8.49
Tobacco	0.00	4.63	-4.63
Equity Investment Instruments	0.57	4.80	-4.23
Beverages	0.00	3.05	-3.05
Personal Goods	0.00	2.56	-2.56

Active stock bets for the month ending 31 August 2018:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.87	0.81	+3.06
Lloyds Banking Group	4.73	1.77	+2.96
BP	7.40	4.48	+2.92
ITV	3.06	0.25	+2.81
Standard Life Aberdeen	3.10	0.36	+2.74
DS Smith	2.82	0.26	+2.56
Glencore	3.94	1.55	+2.39
Barclays	3.38	1.25	+2.13
National Express Group	2.12	0.07	+2.05
Phoenix Group	2.22	0.17	+2.05

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
British American Tobacco	0.00	3.56	-3.56
GlaxoSmithKline	0.00	3.20	-3.20
AstraZeneca	0.00	3.09	-3.09
Diageo	0.00	2.71	-2.71
Unilever	0.00	2.10	-2.10

Performance to 31 August 2018 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-2.92**	**-0.61**	**289.50**	**£3,691mn**
Lipper UK Equity Income mean*	-1.54	0.45	176.71	
FTSE All-Share TR Index (12pm adjusted)	-2.30	1.31	186.58	

Discrete 12-month performance (%) to:

	31.08.18	31.08.17	31.08.16	31.08.15	29.08.14
JOHCM UK Equity Income Fund – A Acc GBP	**6.71**	**19.59**	**6.60**	**-0.66**	**13.06**
FTSE All-Share TR Index (12pm adjusted)	5.71	13.49	13.45	-3.41	9.55

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

Despite the media wailing on Brexit, the current trajectory of the UK economy remains relatively strong (and certainly better than the consensus narrative), particularly the consumer-orientated elements. August saw consistently solid prints from the likes of retail sales, the CBI distributive trades survey and another set of robust employment statistics. Whilst annual rolling wage growth marginally dipped to 2.7%, from 2.8% in the previous month, this is only because the previous month's statistic was revised higher, a fact which seemed to be missed by most of the media.

Furthermore, Markit's monthly survey of current household finances, which measures households' overall perceptions of financial well-being, reported the second-highest reading in its nine-year history. This clearly reflects the powerful combination of near full employment and rising nominal (and, more recently, real) wages. However, it should be noted that the future expectations part of the survey (for the next 12 months) was less strong. This neatly summarises the state of the current overall economy at present: strong current economic performance but a future fear about the outcome of Brexit as well as concerns that there may be further interest rate rises. This concern also manifests itself in a cautious attitude from companies towards investment spending, which is likely to remain the case until the European outcome is clearer.

Whilst at present the US economy is outperforming the UK on most criteria, the one area that it is not is public finances. Whilst the Trump administration's tax reforms and fiscal spending have stimulated faster economic growth, it does leave a budget deficit approaching 4% of GDP and rising. In contrast, the UK's public finances continue to outperform expectations, with the first four months of the current fiscal year showing an £8bn fall in the deficit, predominantly due to strong tax receipts, again helped by full employment. Normally, these differential trends would have a positive impact on the GBP/USD exchange rate, but, for now, that is solely being driven by prospective views on the Brexit negotiations.

Interestingly, a number of large companies are starting to highlight US wage pressures as an issue for margin expectations. Bestbuy, the US-quoted equivalent of Dixons Carphone, noted lowered guidance for the second half and specifically Q3 included "the impact of competitive wage and benefit investments we have made in relation to rising wage rates across the retail industry." Bunzl, the UK-quoted supplier of non-food consumable products which has extensive operations in the US, noted "the economy in the US is strong...this has led to a tight labour market...we are running a higher number of temps and higher overtime currently." As regular readers will know, we think labour market tightness in both the US and the UK will lead to higher wages, higher inflation and higher interest rates.
This labour market picture is one of the main reasons that Fed Governor Powell continues to adopt a relatively hawkish view on further monetary tightening, partly to counter the very loose fiscal

policy referred to above. It is encouraging to see him stick to this path, despite the attempted interference of President Trump. In Europe, forward economic indicators have continued to gently soften somewhat, with the purchasing managers surveys reflecting a slower rate of expansion. The risk of a further leg down in that trajectory from a Turkish contagion looks fairly limited. The Erdogan administration was overly reliant upon the goodwill of the international financial community to fund its growth rate, but there are few similar situations in the region.

The rumbling disagreements over trade continue to impact investor sentiment towards China, but the monetary policy easing by the authorities is clearly leading to a pick up in a number of lead economic indicators, which in time should improve the economic growth rate.

Performance

The FTSE All-Share Total Return Index (12pm adjusted) was down 2.30% during August. The Fund modestly underperformed, returning -2.92%. Year to date the Fund is down 0.61%, behind the index, which has returned 1.31%.

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

For much of August the market was in a risk-off mode, with trade tensions and continued 'noisy' Brexit news flow dominating market sentiment, albeit this trend did change towards the end of the month as sterling strengthened slightly following some more constructive remarks from the EU's chief Brexit negotiator about post-Brexit relations. Trump's trade deal with Mexico also helped boost risk appetite. The Fund performed better (relative to the market) in the second part of the month as these events occurred.

Across the month, the commodity sectors, particularly mining, were weak, whilst some of the sectors we are not exposed to were strong (especially pharmaceuticals and the personal goods sector). The banking sector was also weak despite, in our view, a decent results season. Results across the sector signified the end of legacy costs which impair capital and dividend paying capability. We saw strong revenue growth at both **HSBC** and **Standard Chartered**, and indications that all banks have enough capital and are likely to increase dividends/introduce further share buybacks as we move into 2019.

These adverse trends were partially offset by some strong stock specific performance. **Petrofac** was up 10% relative following good results and a string of asset sales which reduced concerns over its balance sheet strength. **Morgan Sindall** was up 7% relative following solid results and a further earnings upgrade. **Galliford Try** was up 12% relative, after weakness in the previous month. Elsewhere, **DFS** was up 10% relative as the focus turned to its dominant position in its market (over 33% market share and growing). **Standard Life Aberdeen** and **TP ICAP** were also strong, recovering from previous weakness. On the negative side, **Kingfisher** was one of the weakest performers as a trading update that (finally) showed some strength in its UK business was offset by weakness in its French Castaroma business.

Portfolio activity

We sold two stocks from the Fund in August, **AstraZeneca** and **Keller**. Both had performed very well, partly due to good operational delivery, the fall in sterling, (as they are both predominately overseas earners) and in AstraZeneca's case, continued excitement around its pipeline (which was one of the original drivers of us adding the stock to the Fund). AstraZeneca is up 40-45% from its low point in August last year when one of its pipeline drugs had a poor data readout and was exited on a P/E ratio of over 20x. Both stocks had fallen to a market yield. This rotation out of low-yielding stocks into higher-yielding stocks is one of the drivers of Fund dividend growth, which we update on below.

We have also reduced our weighting in **Sainsbury's** to an active bet of 60bp. Further analysis highlighted more upside than we expected should the deal with Asda be cleared by the CMA, but also more downside should it be rejected. Given the current ongoing sluggish relative performance of the Sainsbury stand-alone business, and with the share price already up 40% year to date due to the Asda announcement, we took the opportunity to rebalance our weighting. As the CMA decision is unlikely to be announced before April/May next year, we will continue to monitor the situation.

We also marked **Petrofac** and **Galliford Try** (both added to the Fund this year) back towards their starting weights following strong share price performance.

On the addition side, as noted above, the mining sector was weak for much of the month; we added to all four stocks in this sector (**Rio Tinto**, **Glencore**, **Central Asia Metals** and **Anglo American**). The sector remains just over 10% of the Fund.

We also continued to add to some of our domestic stocks, which remained sluggish: **Forterra**, **Countryside** and recent new addition **Lookers**.

As also mentioned above, the banking sector came under pressure for most of August. We added to **Barclays** and **Standard Chartered.**

Fund dividend

We have updated our analysis of the Fund dividend for 2018 following the interim results season.

The Fund dividend dynamics for 2018 continue to be strong at an underlying level. Notable developments over the last few months have been: (a) the first increase in dividend in four years from BP, which increased its dividend c.3%; (b) the banking sector in clear dividend growth territory as legacy issues finally fall away; and (c) strong growth from a number of the Fund's larger holdings (e.g. Morgan Sindall's interim dividend up 19%, Rio Tinto's interim dividend up 15%, and Aviva's interim dividend up 10%).

We have also rotated a number of lower-yielding names out of the Fund in recent months (like AstraZeneca noted above), with the proceeds invested into higher-yielding stocks. This is a consistent feature of our process and also adds to growth in the dividend at a Fund level.

This underlying position has been improved by sterling's recent continued weakness against the dollar.

The combination of these factors means we increase our forecast for Fund dividend growth for 2018 to 12-13% ('A' accumulation share class). Our previous estimate was 9-10% growth. This remains a prudent estimate and continues to embed an allowance for the recent trend in FX to reverse. Using the midpoint of this range would suggest a dividend per unit of c. 18.25p ('A' accumulation class), which would mean a Fund yield of 4.68%.

As we indicated a couple of months ago, our first look into 2019, driven by the sector comments above, looks positive. As regular readers know, we continue to think sterling will strengthen as the Brexit trajectory becomes clearer, coupled with a growth outlook that is better than the bearish consensus. This will need to be factored into our forecasts. Each 5¢ move on GBP/USD is c.2% on the Fund's (and also similar for the market) dividend level. Net of this, if it were to occur, reasonable growth is still likely. We will provide a first formal update on the 2019 Fund dividend in Q4.

Outlook

Many of the valuation signals we look at are flashing green. As the graph below shows, after a period of sustained underperformance by 'value' stocks vs 'growth' stocks globally, the level of underperformance by 'value' is now back in similar territory to where it was at the height of the TMT bubble in 1999. Growth stocks, the technology sector, bond proxies and consumer staples have all prospered as QE and low interest rates have dominated. As interest rates normalise and central banks' balance sheets contract, we expect this trend to reverse.

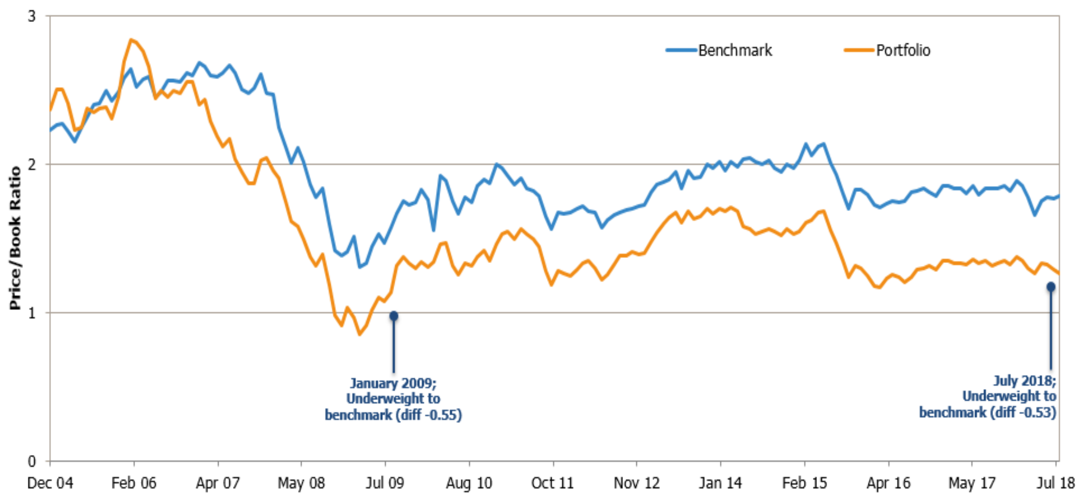
The record outperformance of 'growth' vs 'value' - 'growth' has outperformed 'value' since December 2006

Source: JOHCM/Lipper, based on MSCI World CR indices

The overall market may struggle to move higher and could face a period of sluggish and volatile performance as this adjustment happens, but the performance differential within the market will, in our view, be very marked. The Fund is positioned for this change in leadership.

At the Fund level, we monitor various aggregate valuation metrics to gauge where we are in the Fund's absolute and relative performance cycle. The Fund's price-to-book vs. the FTSE All-Share price-to-book and the absolute Fund dividend yield are two of the main measures we observe closely. As ever, past performance is no guide to future returns, but both have tended to be good predictors of future unit price performance over the 14 years the Fund has been operational. On the former, the graph below shows the picture since inception. The absolute price to book is close to the bottom of its range and in fact, with the exception of the period when the market troughed in 2009, has rarely been lower. Furthermore, the differential (0.53x) compared to the wider market on this metric is also in the top decile of 'relative cheapness' looking at all the monthly data points since inception.

UK Equity Income Price/Book History vs. FTSE All Share



Source: Style Research as at 31 July 2018. Inception date: 30 November 2004. All performance is shown against the FTSE All-Share TR Index (12pm adjusted). The yield is historical and therefore not guaranteed.

As noted above, we have upgraded our guidance for Fund dividend growth to 12-13% for 2018, with the risk remaining to the upside. Using this prudent guidance for 2018 and our likely initial guidance for 2019 (which, as mentioned above, we will formally establish in early December) of mid-single-digit growth means the Fund prospectively yields around 4.90% for 2019. This again is signalling material value versus historic observations.

This picture is mirrored at a stock level, where we have consistently found significant valuation anomalies in the new names added to the Fund in 2018. Whilst part of this opportunity has been created in the domestic market by Brexit and sterling weakness (which we think will ease as clarity emerges over the next six months), some of the new names have come from other parts of the market e.g. Standard Chartered on 0.7x tangible book value and Petrofac on a free cash flow yield of c. 15%.

As we look forward to the end of 2018 and into 2019 with these valuation observations at the forefront of our minds, we remain cautiously optimistic that we can continue to deliver further absolute and relative progress.

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