Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: September 2019

Active sector bets for the month ending 31 August 2019:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Financial Services	9.81	3.45	+6.36
Banks	13.60	9.34	+4.26
Life Insurance	6.97	3.17	+3.80
Oil & Gas Producers	16.36	13.07	+3.29
Mining	8.96	6.06	+2.90

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.48	-8.48
Equity Investment Instruments	0.21	5.32	-5.11
Beverages	0.00	4.03	-4.03
Tobacco	0.00	3.83	-3.83
Personal Goods	0.00	2.95	-2.95

Active stock bets for the month ending 31 August 2019:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
ITV	3.23	0.19	+3.04
DS Smith	3.15	0.19	+2.96
BP	7.44	4.48	+2.96
Barclays	3.95	1.06	+2.89
Lloyds Banking Group	4.45	1.57	+2.88
Phoenix Group	2.98	0.15	+2.83
Aviva	3.43	0.62	+2.81
Standard Life Aberdeen	3.07	0.27	+2.80
Glencore	3.95	1.16	+2.79
Hammerson	2.34	0.08	+2.26

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	4.33	-4.33
GlaxoSmithKline	0.00	3.75	-3.75
Diageo	0.00	3.65	-3.65
British American Tobacco	0.00	2.93	-2.93
Unilever	0.00	2.51	-2.51

Performance to 31 August 2019 (%):

	1 month	Year to date	Since inception	Fund size
JOHCM UK Equity Income Fund – A Acc GBP	**-4.46**	**1.97**	**246.90**	**£2,813mn**
Lipper UK Equity Income mean*	-3.50	7.97	167.62	
FTSE All-Share TR Index (12pm adjusted)	-3.40	11.61	187.11	

Discrete 12-month performance (%) to:

	30.08.19	31.08.18	31.08.17	31.08.16	31.08.15
JOHCM UK Equity Income Fund – A Acc GBP	**-10.94**	**6.71**	**19.59**	**6.60**	**-0.66**
FTSE All-Share TR Index (12pm adjusted)	0.18	5.71	13.49	13.45	-3.41

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

Markets continue to be increasingly polarised. Bond yields have continued to fall, driven by political risk, namely the US / China trade war but also, closer to home, Brexit, as well as slowing economies. There is now a record percentage of bonds in issue globally trading with a negative yield. August saw a remarkable first in this market – the sale of German 30-year Bunds at a negative yield.

More widely across the world, monetary conditions have been loosened, partly by central banks, with the Fed cutting rates by 25bp, and partly by the moves in bond yields referenced above. This loosening of policy coupled with increasing signs that governments (US, UK, China and potentially Germany) are starting to loosen fiscal policy could form the basis for economic activity to stabilise and lead indicators to start a recovery towards the end of the year. Logically, it seems likely that President Trump, who needs a strong economy in 2020 to ensure re-election, will moderate his tone on the trade war. Both of these factors could have a major impact on the global bond market, shape of yield curves and structure of performance within the equity market.

In the UK, the underlying picture looks positive but is currently shrouded in Brexit fog. Annual wage growth accelerated to just under 4% - the highest in a decade. This, coupled with falling interest rates, benign food prices and the impact of the price cap in energy markets means as we move from 2019 to 2020, the average family will have 7% more money year on year to spend on discretionary items. This figure is likely to go up as the Johnson government's first budget (which could come in October) is expected to provide materially positive changes in personal taxation, which will push this figure towards 10%. The spending review this week is also likely to see an increase in current and capital spending, meaning consumer and fiscal policy should underpin a strengthening of GDP growth as we go into 2020. Whilst the UK economy has temporarily slowed due to concern over Brexit, these are powerful drivers underneath the bonnet that could surface over the next 12 months. Prime Minister Johnson's aggressive Brexit tactics are unlikely to create a positive backdrop on a one-month basis (from an fx / stock market perspective). But he has created a better bargaining position (which could create some movement on the Irish backstop), whilst also moving the Conservatives to a more robust position from an election standpoint, as recent polls have shown. Any meaningful Brexit breakthrough or a general election that leads to a Conservative win followed by Brexit is likely to lead to a material rise in sterling and would restore business confidence, adding to the strong consumer / fiscal position highlighted above.

In contrast, Europe continues to slow, particularly industrial activity in Germany. Lead indicators suggest the malaise will continue for the rest of this year. This backdrop has increased pressure on the ECB to loosen policy. Unlike the US, which tightened policy over the last three years thus

creating space to loosen now, there is less flexibility in Europe, which is why commentary around the use of fiscal policy has increased.

Performance

Following strong performance year to date, markets fell in August, with the Fund's benchmark, the FTSE All-Share Total Return Index (12 pm adjusted), returning -3.40%. The Fund underperformed delivering -4.46%. It continued to struggle in relative terms due to the continued leadership of growth, earnings momentum and low volatility stocks. Year to date the Fund has returned 1.97% against the benchmark return of 11.61%.

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

As noted above, bond yields fell materially during the month. This led to the sustained outperformance of more defensive sectors / bond proxies within the equity market. Sectors like pharmaceuticals, personal goods and beverages all rose in absolute terms versus the fall in the wider market. The Fund has limited exposure to these areas, which are fully valued in our view. In contrast, financials, an area we are overweight, underperformed. This was the main driver of the Fund's relative performance this month.

In contrast to the rest of the year, this month we saw stock-specific developments begin to show through in share price performance. This trend helped offset part of the above powerful headwind to relative returns. A number of our small caps outperformed: **Northgate** (up 9% relative adjusting for dividend), **Savannah Petroleum** (up 63% relative), **Morgan Sindall** and **Norcros** (both up 10% relative), **Lookers** (up 17% relative), **U&I** (up 8% relative) and **Rank** (up 19% relative)[*]. Results were generally strong in this part of the portfolio.

The oil sector underperformed, mainly due to **Royal Dutch Shell** moving lower on the back of poor results (we are underweight Shell and have been reducing our position for much of 2019). Our oil names added value. **BP**, which had better results, outperformed slightly, while Savannah (mentioned above) and **Petrofac** also outperformed. Elsewhere, the mining sector underperformed, hurt by the China / US trade narrative.

Vodafone, which cut its dividend in May (whilst expected, it still provided a drag), has rallied strongly since and its share price is close to a one-year relative high.

Portfolio activity

We added one new stock to the Fund in August, **Legal & General**. We owned this stock for the first 10 years of the Fund's life but sold it in 2014 for valuation reasons. Since then it has continued to grow (both in terms of earnings and dividends) whilst the stock price, in common with most financials / UK assets, has languished. We were subsequently able to repurchase it at a lower price than we had sold it for in 2014. The stock is on a P/E yield crossover at 8%. It is the market leader in bulk annuities, which are growing quickly driven by a number of structural factors. It is also one of the leaders in passive fund management (where scale provides cost efficiencies).

To fund the acquisition of Legal & General, we continued reducing our weighting in HSBC, as we have been doing for much of 2019. We have noted in previous bulletins that **HSBC** is at the fuller-valued end of the spectrum within the Fund. In contrast, we continued to add to the UK banks, with both **Lloyds Banking Group** and **Barclays** at c. 300bp active positions. The latter trades on 0.5x its book value.

Elsewhere in financials, we added to **Hammerson** and **Standard Life Aberdeen**. The latter sold part of its stake in HDFC Life during the month. Its stakes in India's HDFC Life and HDFC Asset Management hit all-time highs during the month. These joint ventures, if valued in conjunction with the ongoing share buyback and the stake in **Phoenix** (which we also own), account for more than Standard Life Aberdeen's market capitalisation. This means the UK-based asset manager, which

[*] Relative to the Fund's benchmark, the FTSE All-Share TR index (12pm adjusted).

is forecast to make c. £350m+ in the medium term, is valued at a negative P/E. We also aded to Phoenix.

We sold our small position in **CMC Markets**. This investment has been disappointing across our ownership (mainly in late 2016 and the second half of 2018) due to adverse regulatory developments. There are plenty of opportunities elsewhere in financials, with similar upside, without the ongoing regulatory risk.

We also reduced our weighting in **Vodafone** back to its starting point following the strong performance noted above. Elsewhere we continued to add to **Tesco** (now 1.6% of the Fund) and recent addition **WPP**, which had better-than-expected results.

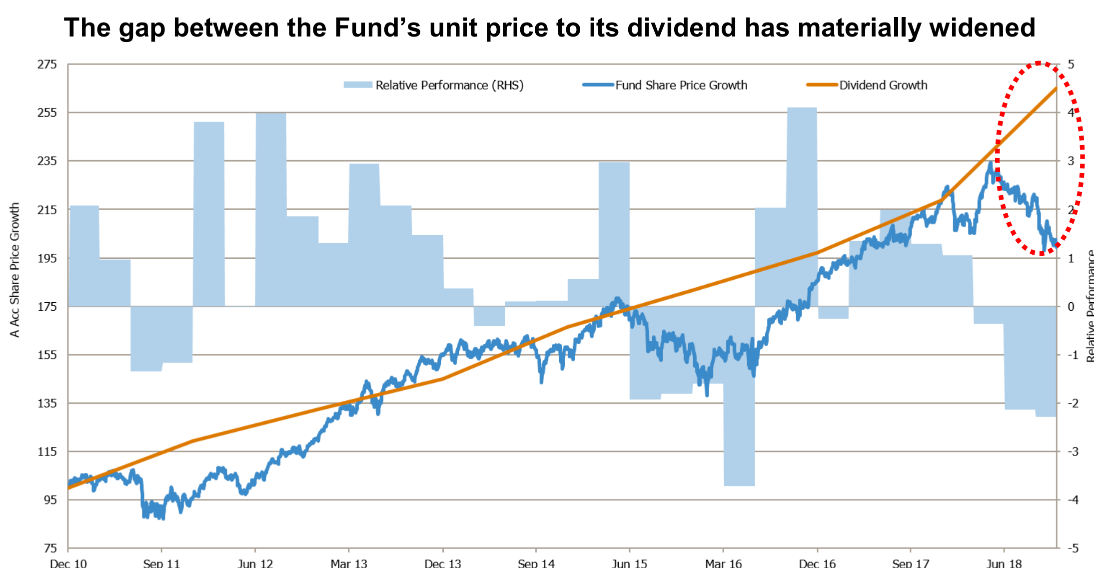
As noted above, the mining sector was weak. We added to **Rio Tinto** and **Anglo American.**

Outlook

Last month we sent out an update to our original 'Mind the Gap' piece, highlighting the growing polarisation in valuations between value and growth stocks. We have also attached the piece to this bulletin, given the continuation of this polarisation (which widened further in August) and the importance it plays in driving performance trends in the market (and the Fund).

The chart below, which was taken from our first 'Mind the Gap' piece, raises the question: how sustainable is the dividend underpinning the Fund? The chart clearly indicates that either the Fund dividend is at risk of a substantial fall (c. -33%) or the Fund is significantly undervalued. To answer this question, we have done a detailed analysis, updating our dividend forecast for 2019 while also looking to 2020. This is earlier than we would normally look to provide guidance on 2020, and we will publish a separate, detailed paper on this subject in mid-September. The outlook is positive: there is risk to the upside compared to our current guidance for Fund dividend growth for 2019, and we expect to grow the dividend in 2020. The Fund yields c. 5.7% in 2019. This is close to a record level and, like the value versus growth analysis, suggests the Fund is materially undervalued.

The gap between the Fund's unit price to its dividend has materially widened



Source: JOHCM

As we said last month, many of the constituents of the 'value' style bucket have very modestly levered balance sheets and often have asset value support at or above the current market valuation. They are also very cheap - the average P/E in the Fund is around 8x. For now, markets are not interested in these stocks. They are deemed either too cyclical, too dull and/or at risk of disintermediation from technological change. We will continue to focus upon valuation rather than momentum, an approach that has served us well over the last two decades, even though it has reaped little reward in the last 12 months.

There are a number of catalysts that could change the market mix: any Brexit resolution, either positive or negative (the latter would at least provide some certainty which businesses and markets could plan against); a general election where the Conservatives prevail (which recent polls suggest is a possibility); Trump changing tack on China ahead of his re-election year; looser monetary policy (which has already happened) stimulating the global economy; increasing signs of fiscal policy being used to stimulate the economy (Germany, China, UK and the US amongst others); or it could just be, as we laid out in 'Mind the Gap', that nothing needs to happen, as was the case in the 1970s with the 'Nifty Fifty' where very high valuations led to significant underperformance). What is clear is that when the market mix changes, whatever the catalyst, it will be very aggressive due to the size of the current valuation disparity, similar to the period after the TMT bubble.

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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