Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: September 2021

Active sector bets for the month ending 31 August 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.38	3.14	+7.24
Industrial Metals and Mining	15.00	8.02	+6.98
Media	7.97	3.14	+4.83
Household Goods & Home Construction	5.58	1.70	+3.88
Banks	10.21	7.09	+3.12

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	9.05	-9.05
Closed End Investments	0.00	6.83	-6.83
Beverages	0.00	3.65	-3.65
Personal Care, Drug and Grocery Stores	3.94	7.52	-3.58
Tobacco	0.00	3.09	-3.09

Active stock bets for the month ending 31 August 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Glencore	4.67	1.62	+3.05
Legal & General	3.66	0.65	+3.01
Aviva	3.66	0.65	+3.01
Barclays	4.27	1.28	+2.99
Vistry Group	3.08	0.11	+2.97
Anglo American	4.50	1.54	+2.96
ITV	3.11	0.18	+2.93
Phoenix Group	3.06	0.16	+2.90
BP	5.32	2.44	+2.88
WPP	3.31	0.47	+2.84

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.38	-5.38
Unilever	0.00	4.29	-4.29
HSBC	0.00	3.28	-3.28
Diageo	0.00	3.25	-3.25
Royal Dutch Shell	1.61	4.60	-2.99

Performance to 31 August 2021 (%):

	1 month	Year to date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**2.95**	**21.74**	**318.90**	**£2,145**	**£2,525**
Lipper UK Equity Income mean*	2.71	16.00	196.75		
FTSE All-Share TR Index (12pm adjusted)	2.65	14.12	216.85		

Discrete 12-month performance (%) to:

	31.08.21	31.08.20	31.08.19	31.08.18	31.08.17
JOHCM UK Equity Income Fund – A Acc GBP	51.34	-20.21	-10.94	6.71	19.59
FTSE All-Share TR Index (12pm adjusted)	26.19	-12.55	0.18	5.71	13.49

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

US 10-year bond yields were little changed during August settling at 1.28% despite continued inflationary pressures. Inflation prints (e.g. those in Europe) tended to be higher than expected, with numerous companies talking about labour market tightness and wage pressures. In the UK labour market data showed vacancies higher than pre-Covid levels, which bodes well for the transition away from furlough schemes. The main theme in our calls with management teams continues to be raw material availability, the (rising) prices of raw materials and the consequent need for price increases. We expect UK inflation to peak around 4% later this year.

In contrast to this, the consensus (evidenced by bond yields and the mix of performance in equity markets i.e. growth vs value) led by central bank commentary, continues to expect this inflationary spike to be transitory. In his Jackson Hole speech in late August Chairman Powell said 'these elevated readings (of inflation) are likely to prove temporary' albeit he did go on to say 'this assessment is a critical and ongoing one, and we are carefully monitoring incoming data'. We think there is a lot of complacency around the use of the words 'temporary' and 'transitory'.

Most of the main central banks have moved 'tapering' onto the agenda in a measured way (partly by the use of the 'transitory' narrative), that has not created the same market volatility that the famous 'taper tantrum' of 2013 did. This is a positive, although it does leave open the risk that they will not react quick enough if growth and inflation are strong and high respectively. It is, however, a positive that they have moved to a position that they are ready to react.

Bond yields have, as noted in previous bulletins, fallen back more than we would have expected since March. As well as the debate over whether inflation will prove transitory or not, a combination of positioning by active managers and the Fed effectively buying back all of the new issuance during the last four months will have had some impact too. Furthermore, product shortages in some industries (particularly semiconductor chips in the auto industry) and the delta variant have led to some loss of momentum in the economic recovery.

We are presenting at an industry conference in late September on the prognosis for inflation, how this will feed through to the equity market, value versus growth and related anomalies in asset allocation. A copy of the presentation will be attached to next month's bulletin for those that are interested.

Performance

Stock markets were up in August, with the FTSE All-Share Total Return index (12pm adjusted) returning 2.65%. The Fund outperformed its benchmark modestly with a return of 2.95%. 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, market trends were lacklustre in August with the usual Summer lull impacting trading volumes, and, to a lesser extent, newsflow.

The food retail sector continued to perform well. A further set of bids for **WM Morrison** moved its shares up 6% relative, with **Tesco** up a similar amount. We touch on this in more detail below.

We saw continued strength in our portfolio companies with results from **Kenmare**, **Keller**, **WPP** and **Raven Group** all better than expected. There has been virtually no negative stock specific newsflow in recent months, which, given the low valuations, bodes well for future performance.

The banking sector modestly outperformed with all of our stocks here producing above forecast results while emphasising strong capital return messages.

On the negative side **ABRDN** (the new name for Aberdeen Standard Life) saw its shares fall despite robust results. The non-life insurance sector fell slightly due to news on loss events (e.g. various US wind storms) and **Phoenix** went ex-dividend badly. Phoenix now yields 8%, which, given its low risk / hedged positioning and its predictability (as back books run off), is astonishing.

Portfolio activity

After a period of increased portfolio activity, August was a quieter month.

The main sale was the continued reduction in our position in WM Morrison. After the first bid from Fortress was announced the shares moved to 265-270p, in line with our publicly communicated view that the business is worth ‘approaching 270p’. There has been two subsequent bids since, with a contest between two private equity led consortia, which has moved the price above this valuation focal point. The latest bid is at a 60% premia to the undisturbed share price. We will continue to reduce our position as newsflow evolves. Tesco has performed well partly due to the developments at WM Morrison but also due to discussion in the media around the likelihood of Sainsbury as a takeover target (not owned). We marked our Tesco position to 250bp overweight.

A few stocks performed very well: **Redde**, **Sthree** and **Paragon**. We marked our positions in these holdings to 160bp, 180bp and 275bp respectively.

No new stocks were added during the month, but we built up the position sizes of the new stocks mentioned in the last few month’s commentaries. The positions in **Dixons Carphone**, **First Group** and **Kier** (3 of the last 4 additions to the Fund) are now all at around 100bp. **Endeavour Mining**, the other new name, is around half this level. Newsflow has been strong for all of these names in the last six weeks with a better dividend at Endeavour and a higher capital return from First Group.

Fund dividend - material increase in guidance

There has been a material uplift in dividend expectations across the Fund in the last two months. This has been driven by: (a) the better-than-expected economic recovery; (b) the strong recovery in the banking sector - partly linked to point (a) - which has meant the PRA has moved capital allocation decisions ‘back to the boardroom’; (c) material free cashflow in the mining sector which has translated into better-than-expected dividend flows; and (d) both the UK oil majors lifting dividends earlier than expected. The percentage of our portfolio companies conducting buybacks alongside dividends is testament to the strength of balance sheets across the Fund. Much of the oil, mining and banking sectors are actively buying back shares (with six of our top ten active positions included in this list).

In January we indicated we were forecasting growth of 37% in 2021 on a cash dividend paid basis. We upgraded this to 42-43% at the end of June. Due to the factors mentioned above we now increase this to ‘approaching 60%’.

As well as healthy dividend growth at a stock level there is another dynamic at work at a Fund level. As the Fund has started to perform better, we are selling stocks on value/yield grounds (e.g. Countryside and Forterra recently) and rotating into new names with higher yields (e.g. **National Grid, Dixons Carphone**). This process creates dividend growth at a portfolio level. In the life of the Fund, prior to Covid-19, we estimated this added 2-3% per annum to Fund dividend growth.

The trajectory of the recovery in the Fund's dividend will be affected by a more material calendar effect than normal in 2021. With most of our companies having a December year end, they declared their 2020 fiscal year final dividends in Q1 2021, during what we saw as the last material phase of the pandemic before vaccinations took effect. Consequently, the normalisation will partly occur in 2022 when the 2021 finals are paid. This is compounded by the fact that for many companies, two thirds of their annual dividend is paid at the final stage. Therefore, the difference between what companies declare as their fiscal year 2021 dividends and what they physically pay during 2021 is likely to be abnormally large.

The 'approaching 60%' growth forecast mentioned above 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) which was upgraded to c. 67-68% in June to 'above 80%' now.

Looking ahead to 2022 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, in late 2022 / early 2023.

Based on growth of 60%, the Fund's dividend yield for 2021 is projected to be 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 5%.

Outlook

The Fund's NAV reached an all-time absolute high in August. We remain c. 4% below our relative high watermark, with further progress on this front impeded since March by the fall in bond yields. Given the scale of the movement in yields, the (relative) performance of the Fund has 'held the line' better than one would have expected. This is due to the strong performance operationally of our holdings.

The results, trading and newsflow momentum from across the Fund has never been as positive as it has been over the last 4-5 months. There is a clear positive 'mojo' factor in the boardrooms of our holdings – whether that is regarding current trading, the desire to grow, the open mindedness to in-organic activity and, as mentioned above, decisions around shareholder returns. These trends are driving earnings upgrades (against a consensus that remains, in our view, too cautious).

We have materially upgraded our expectations for Fund dividend growth for 2021 with growing confidence that we can eclipse the pre-Covid level by the end of 2022 / early 2023. The Fund dividend yield troughed at 2.6% in 2020 (based on the current unit price) – the worst year ever for dividends globally. A return to the pre-Covid level would equate to a yield of c. 5%. This compares to UK 10-year bond yields of 65bp – it does not make sense. The Fund is very cheap on this and indeed every other metric.

We expect economic data to continue to exhibit decent momentum over the next 12-18 months, particularly in the UK. It is clearer now than in early April that inflation will accelerate and likely be much stronger than already rising consensus expectations. This will lead to bond yields rising. In our view, as this happens, it will, like it did in November 2020 and in early 2021, be a further turn of the key that unlocks more of the significant upside that exists in the 'value' part of the market and, more specifically, the Fund.

The confluence of a very strong economic recovery, low valuations and forecasts that are materially too low should bode well for the Fund's absolute and relative performance. We are very confident we can reach new ground on the relative measure in due course, to match August's new absolute high.

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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