Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: October 2023

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 positions as at 30 September 2023:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Construction and Materials	8.37	0.39	7.98
Life Insurance	8.93	2.33	6.60
Industrial Metals and Mining	11.32	6.52	4.80
Household Goods and Home Construction	5.59	1.05	4.54
Banks	14.17	9.72	4.45

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	11.19	-11.19
Personal Care, Drug and Grocery Stores	0.00	7.62	-7.62
Closed End Investments	0.00	6.04	-6.04
Beverages	0.00	3.20	-3.29
Tobacco	0.00	3.19	-3.19

Active stock bets as at 30 September 2023:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.42	0.47	2.95
Glencore	5.45	2.51	2.94
Barclays	4.02	1.09	2.93
NatWest	3.49	0.57	2.92
Standard Chartered	3.63	0.76	2.87
Phoenix	2.90	0.15	2.75
Paragon	2.75	0.05	2.70
DS Smith	2.86	0.16	2.70
Bellway	2.71	0.12	2.59
ITV	2.68	0.12	2.64

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	2.97	-2.97
HSBC	2.22	5.63	-3.41
Unilever	0.00	4.47	-4.47
Shell	2.29	7.88	-5.59
AstraZeneca	0.00	7.19	-7.19

Performance to 30 September 2023 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**3.17**	**3.34**	**339.80**	**1,572**	**1,836**
Lipper UK Equity Income mean*	1.45	2.54	210.57		
FTSE All-Share TR Index (12pm adjusted)	2.17	4.93	245.65		

Discrete 12-month performance (%) to:

	30.09.23	30.09.22	30.09.21	30.09.20	30.09.19
JOHCM UK Equity Income Fund – A Acc GBP	16.87	-10.15	58.40	-29.25	-4.55
FTSE All-Share TR Index (12pm adjusted)	14.49	-4.33	28.31	-16.51	2.72

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

Economic developments in the UK marked a key turning point this month. CPI Inflation continued to fall with a slight reduction to 6.7% in the headline rate and a larger 70bps reduction in the core CPI reading. The fall in the headline rate was despite a 3%+ increase in fuel prices in August and was driven by another 150bps fall in food inflation to 13.4% and a 60bps reduction in services inflation to 6.8%. Headline CPI inflation remains on track to fall below 5% before the end of 2023. At the same time, employment markets continue to normalise with the increase in the supply of labour driving vacancies below 1 million, suggesting wage inflation will progressively slow during the next 12 months.

Consequently, the Bank of England sensibly chose to halt its sequence of interest rate rises, which looks appropriate given the lagged impact on the real economy of the monetary tightening already carried out over the last 12 months. Bond markets quickly priced out any further rate rises, with 2-year bond yields falling 25bps from 5.12% to 4.87% - they are now almost 100 bps lower than the peak of 5.84% in early July. This significant fall in yields has also manifested itself in lower fixed-rate mortgage offers, which in time is likely to bring some stability to the housing market. It is also noticeable to observe that the GFK's UK Consumer Confidence Index hit its highest level for 20 months due to resilient employment markets, rising wages, high savings ratios and falling interest rate expectations. In fact, real disposable incomes grew by 1.2% in Q2 and will accelerate further over the balance of the year. Finally, a further restatement by the ONS of the historic GDP performance of the UK economy since COVID also showed that it is not an outlier as a country compared to the rest of the developed world. The statistics are now more in line with the experience of corporates over this period, which has been a consistent theme of our reports over the last 12-18 months.

In the US, the Fed also chose to leave interest rates unchanged but with the economy generally adapting well to the higher rate environment, Chairman Powell delivered a fairly hawkish commentary around future policy in order to attempt to constrain 'animal spirits'. This led to a marked reaction in the bond market, which had still been pricing in monetary easing early in 2024. Consequently 10-year bond yields rose from 4.1% to 4.54% over the month, and 2-year yields ticked back above 5% as markets adjusted to a likely outcome of rates remaining higher for longer. This increase in yields was also driven by strong energy markets, with the oil price rising over 10% during the month, closing close to $100 as OPEC continued to restrain production and US inventories levels fell to unsustainably low levels.

In Europe, inflation continues to moderate too, but for now, the ECB has continued with a more cautious and hawkish tone, although at some point soon, they are likely to shift their rhetoric in line with the US and UK Central Banks. PMI data for the industrial sectors remains very weak, particularly in Germany, as the sluggish recovery in China impacts activity levels in the manufacturing sectors.

Performance

In contrast to most other global indices the UK market performed well in September (e.g. Nasdaq down 4%). The UK FTSE All Share ended up 2.17% for the month. The Fund performed well, up 3.17%, which was 0.97% above the index. Year-to-date, the Fund is up 3.34%, whilst the FTSE All Share is up 4.93%.

Looking at the peer group, the Fund is ranked in the 2nd quartile within the UK Equity Income sector year-to-date. On a longer-term basis, the Fund is ranked 1st quartile over three years, 3rd quartile over five years, 1st quartile over 10 years and is the best Fund in the sector since inception in 2004.[1]

Our significant sector overweights performed well, with our commodity holdings (oil/mining) generally outperformed by 5-8% relative, whilst the banking sector continues to gently recovery from the ‘risk off’ setback following the SVB situation unfolding earlier in the year. Notable stocks across these areas were **BP** (up 8% relative) despite the news of the resignation of the CEO, **Glencore** (up 11% relative) and **Barclays** (up 5% relative), which benefited from a sell-side note which highlighted the low valuation (PE of < 5x) and the potential from the ongoing strategic review, to release value.

We have commented several times that small caps are starting to show form, and the notable area of strength this month was contracting stocks – **Kier** up 29% relative, **Galliford Try** up 16% relative and **Costain** up 5% relative. All had strong results reflective of strong underlying demand. For example, water spend is expected to rise by 2-4x over the next 5 years compared to the last decade, and the three named companies above are the market leaders in this sector. Galliford Try announced a final dividend 25% above our forecasts and upgraded forecasts again, whilst Kier announced it would return to the dividend list from its next set of results in a meaningful way. Despite the increases in share prices, valuations remain derisory (e.g. Kier is on a PE of 5-6x). Our long-held view is that there should be consolidation in this part of the market to create a large UK construction champion like we see across Europe. The potential upside from synergies and rating due to liquidity would be material (c.50-100% on our estimates). We continue to encourage the boards of our holdings to investigate this material opportunity for all stakeholders.

UK housebuilders were strong pre- and post the interest rate decision noted above. **Bellway** was up 6% relative, whilst **Vistry**, who announced the folding in of its housebuilding business into its partnership homes business, was up 17%.

Aviva outperformed modestly (c.2% relative) following the disposal of its Singapore operations. These contributed less than 1% of group earnings but were sold for 7% of the market cap. We covered last month the significant undervaluation of this sector (see HERE). During the month, we participated in a dinner with the Aviva CEO and FD, where discussions made the momentum of the business and the degree of excess capital clear. As with all management conversations, the gap between the share price and the performance of the business was a key topic of discussion. Aviva continues to yield 9%. **Vodafone** performed well (up 6% relative) following news that it may sell its Spanish operations and **Marks & Spencer**’s (up 5% relative) continued to move forward nicely.

Offsetting these positives were two stock-specific negatives – **Drax** and **Diversified Energy**. Drax fell for several reasons: 1) ongoing noise around whether biomass is good or bad environmentally. In August, the government’s Biomass Strategy 2023 paper indicated ‘the potential extraordinary role which biomass could play across the economy, in power, heating and transportation, including a priority role in bioenergy

[1] Source: Lipper

with carbon capture and storage (BECCS)'. We also note that the Drax power station (Biomass units) produces c.5% of UK electricity, so it is strategically important. Put simply without Drax, system security and capacity would be impaired. 2) Rishi Sunak's general 'row back' on certain aspects of carbon reduction, albeit none linked to Drax's operations, and finally 3) adverse commentary around factoring, which was correct but already fully disclosed in the annual accounts. We believe the fall is overdone. Early in October, we are scheduled to visit the Drax power station. Diversified Energy continued to be weak with a change in Finance Director unsettled the market. In the last three months, we have held a number of discussions with the Chairman, suggesting strategies that could be followed to unlock value. The stocks were down 23% and 12% relatively, respectively.

WPP and **DS Smith** were also sluggish.

Portfolio activity

The absolute and relative performance improvement led to increased activity during the month. As noted above, the oil sector was strong, so we top-sliced BP to keep the absolute position (where it is the largest) in the Fund under control. As mentioned earlier, housebuilders were strong and we marked our position in Bellway to c.275bps absolute and cut our position in Vistry, post the rise noted above by c.50bps to 250bps. The latter change partly reflects our comments on its dividend policy later in this report.

Hipgnosis initially rose as it announced the sale of 20% of its song catalogues to fund a reduction in debt and a share buyback. We sold c.10% of our position at c.96p. The shares subsequently fell as it became clear the terms of the transaction (which are to a connected party) were not optimal. There is now pressure on the board to do something different ahead of a continuation vote due in the next month to realise full shareholder value. We will monitor changes that occur before the vote prior to deciding how to vote. We also continued to reduce **First Group**, which we commented on last month. It still has useful upside but less than nearly every other stock in the Fund.

As noted above, Kier and Galliford were very strong post-results. We slightly reduced our positions to keep weights close to target levels for risk management purposes. They remain as noted above very cheap assets.

The main structural addition was the continued build-up of the recent new position **Inchcape**, now a c.100bp active position. We also added to laggards WPP, Drax and DS Smith.

Whilst small caps have started to perform, in general, a few have not begun to move forward – normally due to large sell orders elsewhere in the market creating a short-term overhang. We added to **Severfield**, which is now on a PE/yield crossover of 6.5x/6.5% respectively and **Kenmare**, which executed its tender offer during the month, which was significantly accretive. This stock is on a PE of 4x and a yield of 10%, with a net cash balance sheet.

EasyJet weakened mainly due to the rise in the oil price, despite a good sell-side briefing which highlighted the step change in the market share they have achieved at their key airports post Covid. This is one reason why their pricing power has

increased, which readers will probably have witnessed themselves. We added to our position.

Finally, we added to **Ashmore** post results. We have held this position at a low level as the business works its way through the 'V' in emerging market debt allocations. Its funds are now performing, and weightings towards emerging market debt are at historic lows, which should collectively lead to a turn in fund flows in due course. Half of the market cap is now represented by excess capital/cash. On a long-term basis, it is on a very distressed valuation. Our weight is now 75bps.

In this section, the prevailing theme is the level of distress and the exceptionally low level of absolute valuations across the Fund.

Dividend Update

We upgraded Fund dividend guidance last month to 3-7% growth for 2023. We continue to run at the top end of this range, with very few dividends remaining to be announced.

The Q3 Fund dividend went 'ex' at the end of September. It rose c.17% year on year. Over the first three quarters, the Fund dividend is up 9-10%. In Q4, we expect the quarterly dividend to fall (by c.10%), which will move the annual growth for 2023 back to the top of the guided range.

We would remind readers that quarterly variations are driven by the mix of stocks we own and the timetable of each stock's 'ex-dividend' date are not indicative of the trend.

Looking out to 2024, our detailed bottom-up analysis suggests the Fund dividend will continue to grow. The 2023 Fund dividend yield is 5.6%, and the early projected 2024 Fund dividend yield is close to 6%. We will provide the first formal guidance for the 2024 Fund dividend growth at the start of December.

A noticeable trend in 2023 has been certain boards switching from dividends to buybacks. The driver of this is the ultralow valuations across the Fund. There is a visible frustration in board rooms around this subject, particularly compared to ongoing robust operational performance. Most of this manifests itself in the use of buybacks to accrete dividends. Some of it is reflected in slower dividend growth than would be the case were valuations not so low and greater buybacks, e.g. banks. Over time, buybacks will enhance dividend growth as fewer shares are in issue for a set amount of dividends. This is now very clear for certain stocks like BP and Aviva. In a small number of cases, boards have (in the short term) totally switched from dividend to buyback. During the month, Vistry kept its 2x payout ratio but effected this via a buyback rather than a dividend. It indicated the return mechanism going forward would depend on where the share price was when the decision was made. We have modelled a lower dividend from 2024+ with a higher buyback. This decision and any more like it would lower dividend growth and levels in the near term but would obviously increase them in the medium term.

Outlook

This month may well mark a critical turning point in the relative performance of UK equities; many commentators have viewed the UK economy as some kind of 'basket case' outlier for the last 5-7 years, starting with the 2016 referendum result. However, with inflation in the UK falling and no longer likely to be an outlier, real wage growth will turn increasingly positive over the coming months. Mortgage rates have fallen by 100bps from their summer peak and UK consumers still have substantial excess savings to draw upon (unlike the US), which have accumulated over the last 3 years. The universally negative view about the UK economy and the UK equity market looks outdated and plain wrong. We are not suggesting that it is about to become a high-growth economy, but the valuations of stocks, as we have shown elsewhere in this report, are priced for a significant contraction.

Furthermore, with rates likely to stay elevated in developed markets for a while, the excessive euphoria in technology sectors and other parts of the 'growth' complex leaves them highly vulnerable to a material correction. In contrast, value and traditionally cyclical parts of the market have not responded (as we would expect them to) to the higher real yield environment. In the US, 10-year real yields are now above 2%, and historically, that has seen value as a style materially outperform. However, the 'AI bubble' seems to have blindsided investors as they chase momentum in large technology shares.

UK equities outperformed the World Index in September, but their performance still lags year to date and the scope for further outperformance is considerable. With the yield on our fund still close to 6%, it can deliver an income return well above that found in government bonds, with the potential for high single-digit growth in that income if we can replicate our previous performance over the last 19 years (where the CAGR in the Fund dividend is c.9% pa). Furthermore, most of our holdings have very high capital return potential, with valuations so low.

Once again, we urge investors to consider whether they have too much of their capital exposed to expensive US mega-cap stocks and not enough in other cheaper markets, including the UK. We believe that the scope for outperformance by the UK and the Fund is very material.

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