Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: April 2022

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.
- The Fund promotes environmental and social characteristics throughout the investment decision making process, please see the following link for further details: https://www.johcm.com/uk/our-funds/fund-details-JOH-UK-EI/johcm-uk-equity-income-fund#sustainability
- Benchmark: FTSE All-Share Total Return Index.

Active sector bets for the month ending 31 March 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Industrial Metals and Mining	15.93	7.70	+8.23
Life Insurance	10.76	2.84	+7.92
Household Goods & Home Construction	5.30	1.23	+4.07
Construction and Materials	5.42	1.37	+4.05
Media	6.75	3.20	+3.55

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.22	-10.22
Closed End Investments	0.00	6.53	-6.53
Personal Care, Drug and Grocery Stores	1.93	6.58	-4.65
Beverages	0.00	3.91	-3.91
Tobacco	0.00	3.63	-3.63

Active stock bets for the month ending 31 March 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Aviva	3.89	0.69	+3.20
Glencore	5.75	2.67	+3.08
Legal & General	3.72	0.66	+3.06
BP	6.00	2.98	+3.02
Phoenix Group	3.15	0.19	+2.96
Standard Chartered	3.39	0.52	+2.87
Vistry Group	2.94	0.09	+2.85
Anglo American	4.79	1.97	+2.82
ITV	2.89	0.12	+2.77
DS Smith	2.85	0.17	+2.68

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	6.39	-6.39
Shell	2.13	6.56	-4.43
HSBC	0.00	4.73	-4.73
Unilever	0.00	3.68	-3.68
Diageo	0.00	3.64	-3.64

Performance to 31 March 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**1.41**	**0.63**	**332.00**	**£2,138m**	**£2,488m**
Lipper UK Equity Income mean*	2.56	-0.15	205.50		
FTSE All-Share TR Index (12pm adjusted)	2.73	1.16	230.77		

Discrete 12-month performance (%) to:

	31.03.22	31.03.21	31.03.20	31.03.19	31.02.18
JOHCM UK Equity Income Fund – A Acc GBP	11.20	5.68	-4.77	-3.73	10.67
FTSE All-Share TR Index (12pm adjusted)	13.03	4.41	-1.20	0.93	4.96

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

On the face of it, investment markets were remarkably stable, given the ongoing conflict in Ukraine. Both the S&P500 and the UK FTSE All Share ended March higher than they were before the invasion on February 23rd; Brent oil prices were only $7-8 above where they were on that day and the USD/rouble exchange rate was flat at 82 despite touching 138 in the first week of March. Developed world bond yields ended higher across the duration spectrum. Whilst the rise in commodity prices and commensurate inflation forecasts would have been expected to move 2-year bond yields higher, the fact that 10-year bond yields in the US are 50bps higher over the month and in the UK 15bps higher is noteworthy and suggests that the media siren wailing over impending stagflation/recession may be somewhat overblown.

During the month both the Fed and the Bank of England increased interest rates by 25bps in response to very strong economic growth, tight labour markets and rising inflationary pressures. Fed governor Jay Powell indicated that they may choose to move rates higher in larger increments in the near-term so as to more rapidly tighten policy. In the UK, one member voted against the increase. This led market participants to conclude that the pace of tightening may be a little more measured. This conclusion was influenced by the further increases in energy prices and a lot of discussion around cost-of-living pressures. Whilst energy poverty will clearly impact some cohorts of society, particularly lower income groups, we continue to believe that at the aggregate level this will be more than offset by full employment, wage inflation accelerating towards 5% pa and the £200-220bn of unspent savings that have accumulated in consumers' bank accounts during the pandemic.

Indeed, this is why economic activity, particularly amongst UK consumers, continues to be positive as COVID restrictions are incrementally eased. Barclaycard spending in February 2022 was 13.7% higher than during the pre-pandemic month of February 2020. Some media commentators have described this month as a "record" month for credit card debt as balances rose by £1.5bn, the highest since records began. However, it should not be forgotten that during the pandemic consumers have been paying down their credit card balances significantly, and even after this rise the unpaid balances are still over £10bn lower than they were 2 years ago. The UK March PMI reading for services was at 61, well ahead of expectations and given that services account for 80% of GDP, a highly significant reading.

The Bank only expects 3.75% GDP growth for 2022. Expansion in January alone was +0.8% implying that there will need to be a dramatic slowdown for the Bank's numbers to be correct. In reality a number closer to 5% looks far more likely. Media commentators also highlighted the small fall in February retail sales of 0.7% (after a very strong January number) but failed to point out that much of this fall was due to lower alcohol and food sales as consumers switch to restaurants and hospitality rather than staying at home. Clearly if the conflict in Ukraine deepens and spreads, a negative impact on the UK (and global) economy cannot be ruled out. The GKF consumer confidence reading of -34 (the lowest since the pre-vaccine approval month of November 2020) reflects that concern. But we think it is important to point out how strong the actual economic data in the economy is at present and with vacancies still running above unemployment levels, this period of strong nominal GDP growth of over 10% pa looks set to continue.

Growth is equally strong in the US, with employment markets now returning to normal. For a period in the second half of last year, employers were struggling to attract workers back into the labour market post-COVID but that has fundamentally changed in 2022. An increase of 431,000 for March non-farm payroll data, following a strong February, reflects a marked acceleration, particularly given the positive revisions to prior months. Global growth, however, is not synchronised, with rolling COVID restrictions impacting China in particular. This month's PMI readings of just below 50 reflect this impact and are likely to lead to further monetary and fiscally stimulative policies in the coming weeks.

Performance

Stock markets were volatile in March, falling materially (c. 5-10%) as the Russia / Ukrainian situation developed through the beginning of the month, before rallying to end higher than they started. The FTSE All-Share Total Return index (12pm adjusted) finished up 2.73%, ahead of the Fund, which returned 1.41%. Year to date the Fund is up 0.63%, compared to 1.16% for the index and -0.15% for peer group. Looking at the peer group, the Fund is ranked 2nd quartile within the IA UK Equity Income sector in the first quarter of 2022. On a longer-term basis, the Fund is ranked second quartile over three years first quartile over five and ten years and since launch (Nov 2004).

One of the main drivers of the underperformance of the Fund was the rapid recovery in the market in the second half of the month. This was due to demand in the futures market, which defaults to large-cap stocks, where the Fund is underweight. This will, we believe, as has happened in the past, percolate down to the mid- and small-cap parts of the market over time. A large number of our small-caps were down more than 10% relative (e.g. **Kier**, **Eurocell**, **Costain**, **Conduit**). We also wrote the value of **Raven Russia** to zero (impact c. 40bp). The stock was suspended pending it being delisted. It is proposed its assets (which are grade-A logistics assets in Russia) will be sold to local management in exchange for a loan note equivalent to their current value, with a coupon attached. There are a range of outcomes which could mean this has value in the future, but given the level of uncertainty, we felt that the prudent decision was to value it at zero for now. **BP**, our only other stock with direct Russian exposure (since reduced) ended the month marginally up vs the market. In totality we believe our indirect and direct Russian exposure was broadly in line with the overall market.

On the positive side the mining sector remained very strong, with the highlight being **Glencore**. **Drax** was also strong. **TP ICAP** has been an issue stock for us in terms of performance for 18 months. In March it was up more than 20% relative to the market. The driver was a public letter to the board by a shareholder highlighting routes in which shareholder value could be restored. Prior to this we had also communicated privately to the board our belief that the data business should be reviewed and sold. We think the data business is worth more than the current market capitalisation of the company as a whole, leaving the other more material parts (from a profits perspective) there for free. The whole group traded on a PE of 5x and a yield of 10% prior to the recovery in March. Other strong stocks included **Aviva**, **Hipgnosis** and **Redde**.

Housebuilders were weak despite strong results as the focus stayed on cladding remediation costs. We expect this to be resolved in the next few weeks, which should lead to a recovery in the sector as the likely cost has been discounted multiple times. **ITV** was weak post results. We would encourage readers to look at our note on the stock, published on our newly created UK blog, Cool Britannia – link here – where we discuss our views on why the share price has fallen. **Barclays** was also weak in line with many financials, impacted by news of a control issue which cost c. 2% of its market cap.

On the last day of the month there was a bid for Brewin Dolphin. The premium was 60%+. This was one of the undisclosed stocks mentioned in last month's update. We had started adding the stock but at the time of the bid still had only a de minimis position, too little to impact performance. But the bid again highlights the degree of undervaluation across the UK market.

Portfolio activity

We sold our position in **Stagecoach**. We had previously acquired this stock when **National Express** (also owned) announced a merger between the two in Q4 last year. The merger was compelling and would have created material upside over time. However, during the month Stagecoach received a private equity cash offer at 105p. We sold our holding into this. This exit was usefully c. 40% above our entry price, albeit at a low multiple of normalised earnings. The proceeds were moved into other stocks, including those mentioned below, with even lower valuations.

The mining sector was very strong – partly due to the Russian / Ukraine situation – we marked our positions towards our model weights to control our overall exposure. Mining is now c. 16% of the Fund. Within the sector, our preference is for Glencore and **Anglo American**, which we feel have the best commodity mixes (i.e. heavy on copper, cobalt,

nickel etc, metals used in the energy transition). We materially reduced our position in **Rio Tinto**, which is focused on iron ore and where we continue to have some residual ESG concerns. These issues remain under close monitor. We also reduced our Drax position to 165bp following its strong performance.

A number of other stocks hit our 300bp active limit and we top sliced accordingly. At the end of the month a few holdings were just above this level, which was driven by imminent ex-dividend dates which will bring them back to < 300bp. We also reduced **Tesco** (where we are now 100bp overweight, about half where we were at the beginning of the year). The stock has held up (as it is deemed to be defensive) but forecasts have and will likely continue to come under pressure from cost increases (e.g. wage inflation). There is less ability to pass this on to end prices than in other sectors.

The market fall in the first half of the month and indiscriminate selling, particularly in financials and small caps, created the opportunity to add to a number of positions. We continued to add to **Ibstock** (a new position in the previous month), which had very strong results. Management laid out a new strategy for the next 3-4 years which will see earnings move to the levels on which we based our initial assessment, and indicated that, over the forecast period, they would have excess cash of around a third of the current market capitalisation. This suggests, in our view, that they are likely to start a share buyback soon. Currently 47% of the Fund is under buyback, which highlights the strong balance sheet we have running through the portfolio.

ITV was weak as described above. We added materially to our position. The valuation, as highlighted in the blog linked above, does not make sense to us. We also added to banks (Barclays) and **DS Smith.**

One of the weakest parts of the Fund was our two housebuilders – the narrative on cost of living, rising rates and cladding remediation costs all having a negative impact. We added to **Vistry** and **Bellway**. The former has seen a material acceleration in trading year on year since the start of 2022 and, following a 40p dividend due in early April, will be priced at around 900p. Our target price is 2,300p, based on what we believe are prudent valuation assumptions (15x PE for the partnerships business and 1.5x book value for the housebuilding side). The stock currently trades on a PER of 6.5x and yields 7.5%. There is a high likelihood of private equity interest in this sector given the ratings.

Dividends

At the start of the year we forecast dividend growth of 20-25% for 2022. Coupled with the 62% growth delivered in 2021 this would return us to a similar level of dividend as the Fund delivered in 2019, the year before Covid.

Results, with the odd exception (e.g. TP ICAP), have been strong year-to-date, which has meant dividends have been either in line with or ahead of our forecasts. We are currently running above the top end of the range noted above and are therefore able to upgrade guidance to 25-30% growth for 2022. This would leave us above the pre – Covid dividend level. We expect growth to continue into 2023, more in line with historic trends (5-10% pa).

For the discrete Q1 dividend we expect very strong growth, as the comparator (Q1 last year) still bore the scars of Covid. The Q1 Fund dividend growth will be just under 80%.

Based on the current guidance the Fund yields c. 5% at the end of March on a 2022 prospective basis.

Outlook

Much of the discussion around economic outlook revolves around the debate on the impact of rising inflationary pressures, particularly on consumer behaviour. As we highlighted in the first section, we believe that the elevated levels of saving in recent years in the UK and globally will provide a meaningful counterbalance to the short-term squeeze on living standards. Furthermore, some historical context is also required on the extent of this squeeze. Looking at the proportion of UK households' post-tax income that will be absorbed by non-discretionary spending (mortgages, council tax, food, fuel, domestic energy, other utilities etc), this year's increases are likely to move this measure from 54.5% of post-tax income in 2021 to 57% in 2022 and possibly slightly higher in 2023. However, for all of the period form 2011-2014, non-discretionary spending was running above 60% of post-tax income and in fact the 54.2% in 2020 was the lowest for over a decade. In many respects, this relationship will only be moving back to around the mid-point of its historical range rather than to a higher level. This leaves ample scope for another year of very strong discretionary spending in 2022, as consumers begin to travel and to eat out once again.

We feel that most commentators and investors are simply not looking at the actual facts or the maths on this dynamic and as such that has, once again, left vast swathes of the UK stock market looking unloved and undervalued. This is particularly the case in areas such as financials and domestic consumer cyclicals. Furthermore, at the aggregate level, our portfolio is in fine shape, with balance sheets stronger than they were pre-pandemic. This is reflected in the continued healthy rate of dividend growth as well as the supplementary share buybacks. The fund's prospective yield to December 2022 now stands at 5% with the very real prospect of a return to our historical dividend growth rate of c. 10% in following years. We make no apology for still being optimistic about the prospects for our fund's absolute and relative performance. The terrible conflict in Ukraine has created a fog that has somewhat obscured these attractive characteristics from investors' line of sight, but as and when the fog clears, we are confident that they will positively re-assess strategies such as ours, as they were beginning to do earlier this year.

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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Please refer to the fund prospectus and to the KIID before making any final investment decisions. These documents are available in English at www.johcm.com, and available from JOHCML at the address set out above.

Information on the rights of investors can be found here.

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Investments include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.

The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

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