Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: January 2021

Active sector bets for the month ending 31 December 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.19	3.15	+7.04
Mining	14.43	7.83	+6.60
Media	8.34	3.25	+5.09
Food & Drug Retailers	5.98	1.97	+4.01
Banks	10.92	7.06	+3.86

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.05	-8.05
Equity Investment Instruments	0.00	6.90	-6.90
Personal Goods	0.00	5.57	-5.57
Tobacco	0.00	3.54	-3.54
Beverages	0.00	3.50	-3.50

Active stock bets for the month ending 31 December 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Vistry Group	3.16	0.09	+3.07
Legal & General	3.76	0.72	+3.04
Barclays	4.18	1.17	+3.01
Glencore	4.11	1.16	+2.95
Anglo American	4.29	1.36	+2.93
ITV	3.10	0.18	+2.92
WPP	3.32	0.43	+2.89
Phoenix Group	3.05	0.17	+2.88
DS Smith	3.05	0.22	+2.83
Tesco	3.87	1.03	+2.84

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Unilever	0.00	5.17	-5.17
AstraZeneca	0.00	4.41	-4.41
HSBC	0.00	3.54	-3.54
Diageo	0.00	3.11	-3.11
GlaxoSmithKline	0.00	3.04	-3.04

Performance to 31 December 2020 (%):

	1 month	Year to date	Since inception	Fund size (m)	Strategy size (m)
Fund – A Acc GBP	**5.04**	**-15.72**	**244.10**	**£1,911mn**	**£2,289mn**
Lipper UK Equity Income mean*	3.70	-11.31	160.17		
FTSE All-Share TR Index (12pm adjusted)	2.85	-9.52	177.64		

Discrete 12-month performance (%) to:

	31.12.20	31.12.19	31.12.18	31.12.17	31.12.16
JOHCM UK Equity Income Fund – A Acc GBP	**-15.72**	**20.02**	**-13.19**	**18.11**	**16.79**
FTSE All-Share TR Index (12pm adjusted)	-9.52	19.29	-9.06	13.10	16.05

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

So, four and a half years after the referendum result, a Brexit trade deal was finally agreed. Although it fails to cover large parts of the key services sectors, it has removed a large degree of uncertainty, reflected in sterling/dollar ending the year at c. $1.36, a 30-month high. However, UK government bond yields barely moved as the positive of the removal of the Brexit tail risk was offset, in the short term, by rapidly rising Covid-19 cases, with the emergence of a more virulent new strain. This will clearly lead to a more subdued economic performance in the first quarter of 2021 before vaccinations progressively remove the need for social distancing measures. Prior to the latest rise in infections, PMI surveys in the UK and Europe were close to 50 in both regions, suggesting a fairly flat economic performance due to the gradual increase of restrictions during the second wave.

UK GDP officially rose by only 0.4% in October and will likely be lower in November and December. However, as we stated last month, we believe that the way in which the UK calculates GDP is much more conservative than other developed nations due to the way that public sector output is measured. Commensurately this should mean the 2021 recovery should be mathematically higher than elsewhere. Other economic statistics continue to reflect an economy which has actually proven more resilient than many expected. Unemployment has only reached 5% so far, clearly helped by the furlough scheme, but in October the number of vacancies rose by 110,000 to 537,000 and average earnings grew by 2.8%, partly helped by the fact that over one third of the jobs lost in the prior three months were from the lowly paid hospitality sector. The UK housing sector has continued to perform extremely strongly despite the November / December restrictions, with Nationwide reporting that house prices rose by 3% during Q4 and by over 7% for the whole of 2020.

The UK's spending review for 2020 at the end of November is worth reflecting upon as we consider how fiscal policy will evolve in 2021. The budget deficit for fiscal year 2020/1 is now forecast to reach £394bn, an increase of £340bn on 2019/20, equating to around 20% of GDP. It is then forecast to fall by over £200bn in the following year and to settle at around 4% of GDP in the medium term. It is difficult to see how widespread tax rises will either be palatable or indeed big enough to seriously reduce these deficit numbers in the short term, and it is more likely that the UK (and other Western administrations) will try to gradually deflate the number down over time. Meanwhile, it is worth noting that at present the debt interest payment bill is equivalent to around 2% of annual tax receipts, compared to 6-7% after the 2008-9 recession.

Most commodity prices, including copper and iron ore, were higher again in December and, in the case of most metals, sit at multi-year highs. As well as their role in the medium term for accelerating the energy transition to renewables, this also reflects continued strong demand from China, in particular, which reported annual industrial production 7% higher in November. Elsewhere, the ECB extended its support package and expanded its bond purchase programme by €500m. In the US, the Fed left most of its policy measures unchanged but implied that it would be prepared to let inflation overshoot in the short term before taking any action.

Performance

Market dynamics were volatile in December. Rising Covid-19 infection rates globally created pressure, particularly in the UK where border closures and the persistent yo-yo of newsflow around Brexit negotiations ahead of the deal being announced weighed on sentiment. Underneath the surface of that volatility there was a continued rotation away from growth stocks towards certain value sectors.

The Fund performed well, rising 5.04% compared to an index return of 2.85%, representing outperformance of 2.13%. Whilst this is a positive and continues the better performance that has existed since the start of the fourth quarter, we were behind the market for the year as a whole, with a return of -15.72% versus a -9.52% return by the FTSE All-Share Total Return index (12pm adjusted).

In 16 years at J O Hambro Capital Management we have only underperformed in four years, with 2020 being the fourth year. This is disappointing. Most of the underperformance came in February and March in the immediate weeks after Covid-19 took hold. In the outlook section we show how small the recovery has actually been since the lows versus the valuation disparities that have been growing for years, and why we are confident we will fully close our performance gap, as we did in other major performance drawdowns (the bursting of the TMT bubble whilst at Newton Investment Management and more latterly the Global Financial Crisis (GFC) at JOHCM).

Looking at the peer group, the Fund ranked third decile within the IA UK Equity Income sector for December and ninth decile for 2020. On a longer-term basis, the Fund is ranked fourth quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

The mining sector was one of the strongest performers across the month driven by the continued strength of commodity prices. Our five stocks, which in aggregate are c. 15% of the Fund, all outperformed, with **Glencore** (up 7% relative) and **Rio Tinto** (up 10% relative) the best performers. This sector remains very cheap, in our view, and as highlighted above is at the centre of two positive trends: the global economic recovery led by China, which will spread as the vaccine is rolled out in 2021; and the acceleration of the green agenda and decarbonisation, which is metal intensive. The oil sector was flattish, with **Petrofac** down on the back of a weak update.

With the odd exception (such as Petrofac), the majority of the trading updates were strong and either in line or above expectations. This partly reflects cautious expectations but also the robust recovery in sectors where we have material exposure. Stocks with strong results, trading updates or capital markets events performed well. Good examples include **Tyman** (up 5% relative), **DS Smith** (up 9% relative), **WPP** (up 6% relative), **Drax** (up 10% relative) and **Morses Group** (up 25% relative).

Financials were sluggish for most of the month. **Barclays** ended up only marginally underperforming the market across the year, which is remarkable given the nature of events.

It is also noticeable that small caps have continued to strengthen – a number of our stocks in this bucket are making decisive new relative highs, such as **Central Asia Metals**, Tyman, **Kenmare** and **Polar Capital**. Small caps remain c. 17% of the Fund and, in our view, material value remains in this segment, which we think will be a major driver of the Fund's relative performance in 2021.

Domestic stocks also picked up after the Brexit deal was announced. Some, such as **ITV,** have recovered well whilst others, such as the food retailers, which were hurt by the decision to repay the rates relief (see below), were relative laggards.

Portfolio activity

We added insurance sector IPO **Conduit** (mentioned in last month's update) to the Fund. The reinsurance market is seeing a material increase in prices due to a series of loss events before Covid-19, which were then compounded by the pandemic. This 'hard market' will lead to a high return environment over the next 2-5 years. Conduit came to the market at book value, in comparison to its sector peers which trade on 1.5x book value (the premium due to the hardening market). In this sector it may be better to be a start-up as there are no legacy issues. The management team at this new company have a good track record and are well known in the London market. The stock is trading in line with the issue price. Elsewhere, we also continued to gently add to our other recent addition, **Forterra**.

Countryside has led the recovery in domestic cyclicals since the low point in March / April. It announced that it planned to split its business in two (traditional housebuilding and Partnership Homes) in line with demands from a US activist shareholder. This is a positive development as it will place additional focus on Partnership Homes, which is, in our view, a high quality business with a good market position, a long pipeline of contracts and solid growth prospects. As well as the strong share price, the company has also raised money to strengthen its balance sheet, which has placed some pressure on near-term valuation metrics due to the higher number of shares in issue. We reduced our position, reinvesting the proceeds in our other housebuilder, **Vistry**, which has not recovered as much. Our position here remains close to a 300bp active position. Vistry has had a number of positive profit warnings in the last couple of months on earnings and lower-than-expected net debt. Management also announced they would restart the dividend earlier than expected.

Tesco and **WM Morrison** were weak as they announced they would repay business rate relief, which, in aggregate, we view as the right thing to do. It is a 'PE of 1' event as it will not impact profitability in future years. As we have discussed in previous updates, we think some of the longer-term trends associated with Covid-19 should underpin profitability in this sector in the medium term. Trends such as the shift to online shopping (which improves the competitive dynamic versus the discounters as well as improving drop densities and hence online profit dynamics), increased numbers of people working at home (which shifts spending from the likes of Pret a Manger to the supermarkets) and the shift towards larger basket sizes and the desire to go to larger stores should all help Tesco and WM Morrison. Our weighting in this sector remains c. 6% across these two stocks.

We continued to reduce **Lloyds Banking Group** in the early part of the month. We have indicated before that there are a few stocks in the Fund (less than 5% of total capital) that have significant upside but do not have the same multi-pronged fundamental dynamics as the majority of the Fund. One of these stocks is Lloyds. Where we have found better ideas, we have gradually reduced Lloyds as it recovers. We used some of the proceeds to add Conduit to the Fund and increase the position in **Standard Chartered**. Elsewhere in the wider financials sector **Phoenix** was weak and we added to that position.

TP ICAP has been weak for 3-4 months following the announcement of its acquisition of Liquidnet. Whilst the acquisition is strategically sound, the method of financing, a delayed rights issue, has caused weakness in the share price. We added to our position which is now c. 1.5%.

A few other stocks that performed very well were also marked back towards 300bp – ITV and **WPP** being notable examples.

Whilst **Drax** has been strong we continue to modestly add to our position as Boris Johnson's accelerated ten-point green plan includes carbon capture, announced in November, an area where Drax is well positioned. In December Drax announced the sale of its gas power station fleet, which means the stock is now a pure ESG play focused on biomass, hydro-electric and carbon capture. It is a bite-size, strategic asset given the fast-evolving energy transition policy developments and associated corporate strategy changes.

Fund dividend

2020 Fund dividend

During the initial months of the pandemic we estimated that the 2020 Fund dividend would fall by between 45-55%. That guidance remained unchanged with some modest deterioration towards the lower end of the range in the summer months before strengthening to finish at -49.9%, slightly better than our mid-point estimate. The more recent strengthening has been driven by a number of companies coming back to the dividend list sooner than we had expected (e.g. WPP, **Aviva**) and certain dividends being better than expected (e.g. Central Asia Metals, Polar Capital).

Many of the 2020 dividend reductions across the Fund were Covid-19-related and were undertaken to protect liquidity in the early days of the crisis, to allow companies to take advantage of government support and to reflect the lockdown which reduced profitability towards zero. In all these cases dividends will flow back in 2021 and beyond as profitability improves.

Some companies, such as **BP** and **Aviva,** decided to use the pandemic as an opportunity to reconsider the longer-term appropriateness of their dividend policy. Companies that would have cut their dividend in the period 2020-2024 are likely to have made the adjustment during 2020. As all material cuts have already taken place the structural downside risk to dividends is less than at any other stage in the last 40-50 years. This means the yield of the market and the Fund should be seen as (a) more solid and (b) having greater growth potential. Therefore, there is a powerful argument that dividend cashflow should be valued more highly.

Following the strong recovery in the Fund in the last quarter, the trough dividend yield based on the end of year unit price was 3.0%.

2021 Fund dividend – heavily affected by the calendar effect

The trajectory of the recovery in the Fund 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 will be declaring their 2020 fiscal year final dividends in Q1 2021, during what should be the last material phase of the pandemic before vaccinations take effect. Furthermore, they will be reporting on a year which was significantly disrupted economically and, as such, many final dividends will either be zero or very low given the wider stakeholder issues. 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 will be abnormally large. This is particularly the case because the tone around dividends has improved in recent months and in almost all of our engagements with management teams we are seeing the ‘dividend restart’ discussion close to the top of the agenda (both theirs and ours). We believe there is a visible enthusiasm from most boards to restart their dividend, in many cases with a modest 2020 final dividend and then back to normal thereafter.

Looking at our fiscal year 2021 forecast dividends versus fiscal year 2020, we currently expect around c. 60% growth.[*] However, looking at cash dividends paid in 2021 versus cash dividends paid in 2020, the forecast growth is 37%. So, we see a much more pronounced calendar effect than normal because of the Covid-19-related disruption to 2020 final dividends (declared and paid in early 2021).

Within the year, we expect the calendar Q1 dividend to fall year-on-year before growing strongly from Q2 onwards (including a more than doubling of the Q2 dividend year-on-year). Based upon the growth of 37%, the Fund dividend yield for 2021 is projected to be 4.1% and using the 60% growth, including the full calendar effect, it would be 4.8%.

[*] The main reasons for the decline in our forecast from 69% growth (stated in our July dividend paper) to 60% growth now are: (a) a strengthening of sterling (versus the US dollar) – this has moved from c. 1.27c, to 1.36c, reducing growth by c. 2-3%; and (b) the decision by all food retail companies to repay rate relief, which in the case of WM Morrison meant no special dividends (which have been an annual feature for the last few years) in 2021; this has a 2% impact, albeit a one-year impact as this should flow back in 2022.

Post 2021, we expect continued strong growth in dividends in 2022 and beyond as our forecasts for 2021 still include the effects of Covid-19, as a large number of our stocks in certain sectors rebuild their profits. We will provide a further update on the 2021 Fund dividend position and growth prospects into 2022 at the end of the first quarter.

Outlook

A couple of months ago, we highlighted that we expected resolutions on the US presidential election, Brexit and vaccine approvals to result in a change of leadership of global stock markets away from defensive, stay-at-home and growth stocks towards the recovery/value stocks where the Fund is largely positioned. The first vaccine approval in November gave this shift an impetus during November. But despite further progress on these issues in December, the leadership change has been somewhat held back by the resurgence of the virus in the UK, Europe and North America. We firmly believe that investors should look through what should be the last Covid economic pothole and concentrate on which stocks will pick up from an economic resurgence after Q1 2021. With very loose monetary policy, expansionist fiscal approaches, resilient employment levels, abnormally high savings ratios and very tangible pent-up demand, we expect a strong recovery once social distancing restrictions are loosened. This is particularly pertinent because valuations still remain very low in many parts of the recovery/value universe. The chart below shows the (relatively limited) extent of the switch back to 'value' versus the outperformance of growth both in 2020 but also in the decade preceding that.

As the likely economic recovery takes hold, we expect to see inflation expectations and government bond yields rise further, which will incrementally add to the attractions of value over growth.

MSCI Europe Growth Index relative to MSCI Europe Value Index

Source: Bloomberg

However, our Fund is far more than just a binary bet on the value/growth style axis. Across the portfolio we have a diverse range of well-managed, conservatively funded, modestly valued companies, many of which have strong structural following winds behind their strategies. These include our mining holdings, with their high exposure to copper and the accelerating demand from renewable power; our holdings in construction and housebuilding groups focused on affordable and undersupplied segments of the housing sector; and companies in the packaging and building materials sectors with leading positions in recycling. All of these, and many more, offer both growth and value as well as healthy and growing dividend yields at attractive prices. Furthermore, now that the Brexit cloud has been lifted, we would expect both international investors and corporates to focus upon the UK market, where valuations are very low, both in absolute terms and relative to other developed markets.

We appreciate that we have delivered a disappointing and unusually volatile outcome for 2020 and that we have tested your patience and resolve. Hopefully the last few months have shown you that stock market leadership can change quickly, and we expect this to accelerate during 2021, even if Q1 is a difficult economic quarter. We are fully focused upon regaining the lost relative and absolute performance from 2020 and then to move further beyond that. Hopefully this bulletin will

have given you a sense of the valuation support and building blocks which will drive that move. As such, we look forward to a much brighter 2021, both for the Fund and, most importantly, society as a whole.

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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