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Mind the gap: five valuation arguments for the JOHCM UK Equity Income Fund

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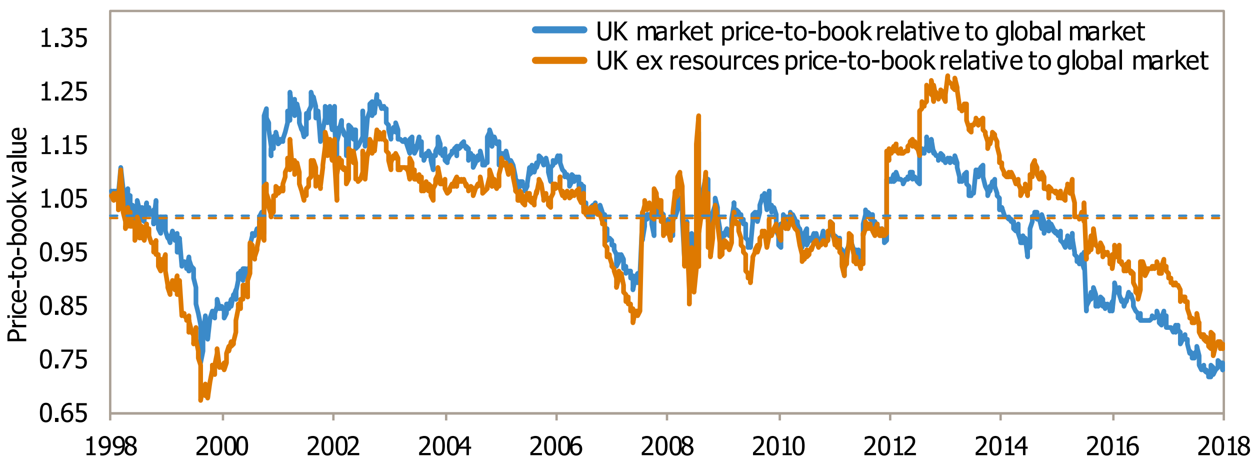
Last year was a tough one for the Fund, both in absolute and relative performance terms. However, we strongly believe that the Fund's performance has created a material valuation anomaly that we expect to correct at some point in the near future. Without exaggeration, such is the extent of this anomaly it arguably represents an investment opportunity second only to the market lows around the 2008-9 financial crisis in the context of the Fund's 14-year history. Below are five powerful valuation-based observations that lie behind this bold statement:

1 The price-to-book ratio for the UK stock market vs. world stock markets is close to multi-decade lows

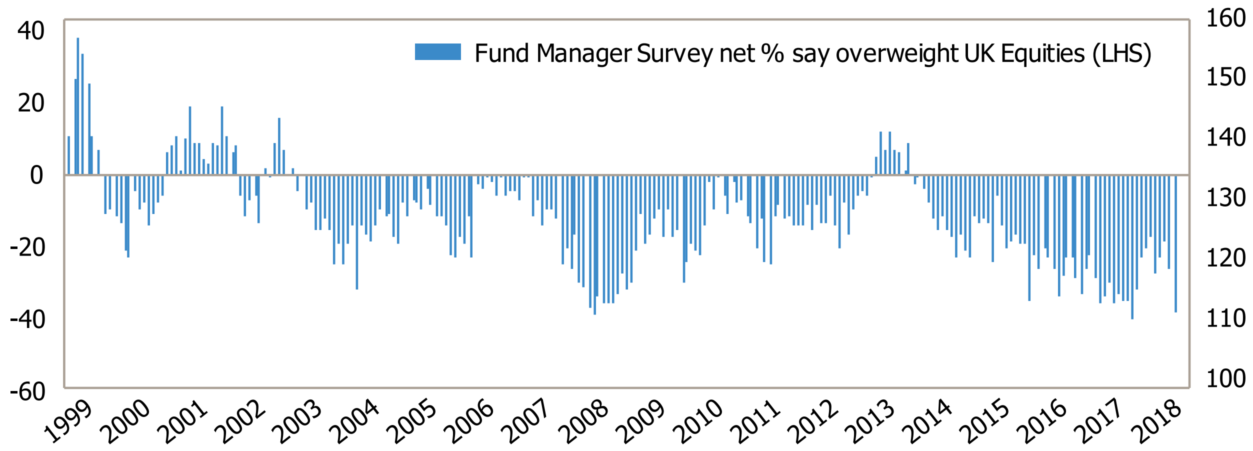
The unloved UK stock market



Source: Credit Suisse as at 17 December 2018.

The chart above highlights that the UK stock market is trading close to 20-year lows versus world stock markets. This dislocation is backed up by fund flow data, anecdotal commentary from overseas investors scared off by Brexit uncertainty and survey data, such as the BAML Fund Manager Survey (chart below), which shows record lows for UK equity allocations. The UK stock market and UK assets are not just currently unloved by investors; they are loathed. Revulsion is normally a good starting point for any investment.

Record lows for UK equities allocations



Source: BofA Merrill Lynch Global Fund Manager Survey.

Two markets in one: UK domestic versus overseas-earnings stocks +12m price-to-book

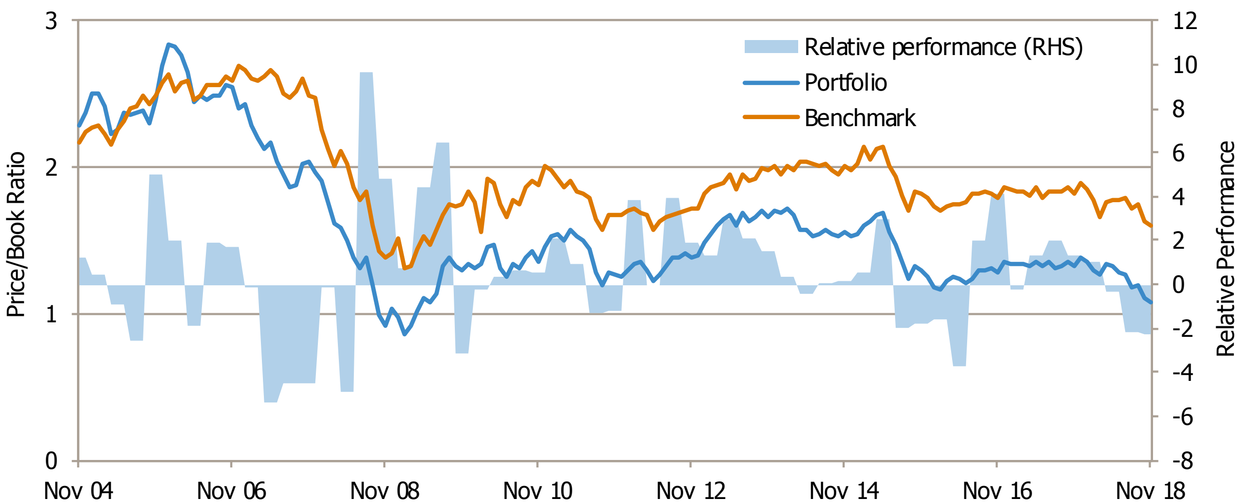
Source: Exane as at 17 December 2018.

But the argument is more nuanced than that. There are currently two markets within one in the UK equity market. On one side, the expensive side, sit the overseas-earners, the bond proxies, the growth stocks, typically trading on c. 20+ earnings multiples. On the other side, the cheap side, we have lowly-rated cyclicals, domestics, financials and commodities, all trading on 5-12x earnings. The Fund is very overweight the second group and significantly underweight the first group.

The first chart on page 1 shows the average of the two sides, so hides an even greater undervaluation of the second group of stocks. The chart above shows that the valuation mismatch between UK-quoted overseas-earners and UK domestics is back at post-Brexit vote lows. In summary, the overall UK stock market is at multi-year lows, whilst the area of the market to which the Fund is predominantly exposed, UK domestics (along with commodities, financials and small-caps), is trading at a substantial discount to that wider market average.

2 The Fund's price-to-book valuation is close to its lowest ever level

JOHCM UK Equity Income price-to-book history vs. FTSE All-Share



Source: JOHCM/Style Analytics

The Fund's aggregate price-to-book value is currently hovering at just over 1.0x, its lowest level in the Fund's history with the exception of the short period from the end of 2008 till early 2009 i.e. the middle of the financial crisis. With the usual caveat of past performance being no guarantee of future returns, it is worth remembering that the market troughed in March 2009 before rising more than 50% in the following 12 months - the Fund also performed very strongly in a relative sense at that time. Indeed, as the superimposed relative performance of the Fund shows in the chart above, a low price-to-book valuation can be a powerful signal of strong relative performance in the near term.

The chart also shows the gap between the portfolio and market's price-to-book valuation is currently at around its widest level since the Fund launched in November 2004.

3 Robust Fund dividend growth

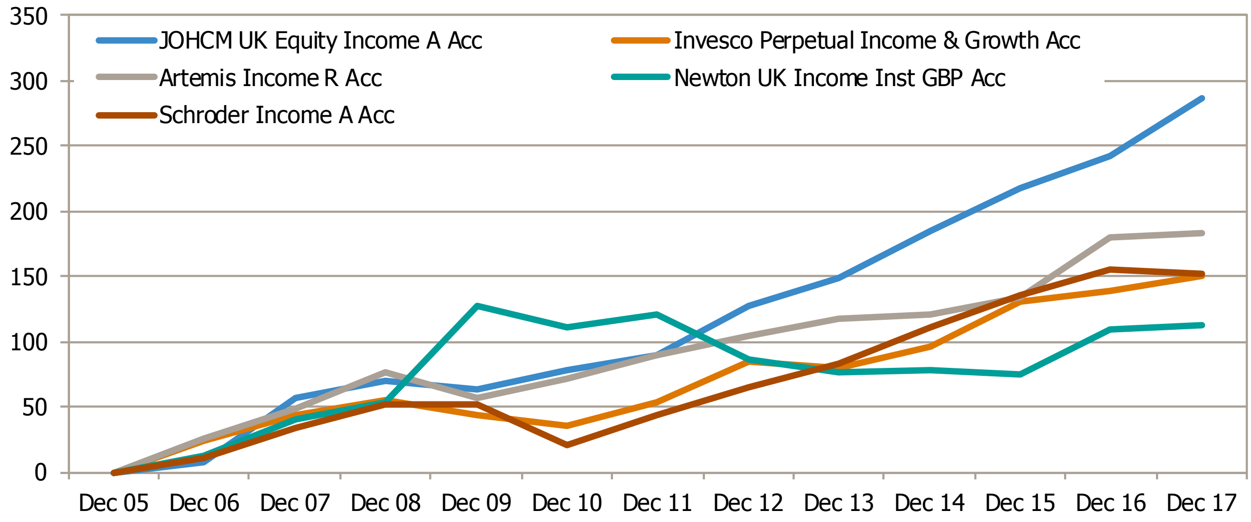
We recently upgraded our guidance for 2018 Fund dividend growth to c. 18% (based on the 'A' accumulation share class). With the Fund going ex-dividend on 31 December 2018, the exact growth was 18.2%. This is one of the fastest rates of dividend growth we have generated since the Fund's launch. The dividend per unit for 2018 was 19.2p, which means the historic yield on the Fund is 5.6%.

The outlook for 2019 is also positive when we prudently model dividends on a stock by stock basis. Nevertheless, there are a number of binary political and macroeconomic events to resolve. Coupled with our view that sterling will strengthen, which will pressure the $/€ denominated elements of the dividend base, this means we have built a buffer into our guidance. Our initial formal guidance for Fund dividend growth for 2019 is low to mid-single-digits percentage growth.

The Fund yields 5.8% on a prospective basis. Looking back over the life of the Fund, there have only been 14 months (during the global financial crisis) when the Fund has yielded more than this (out of 156 monthly data points).

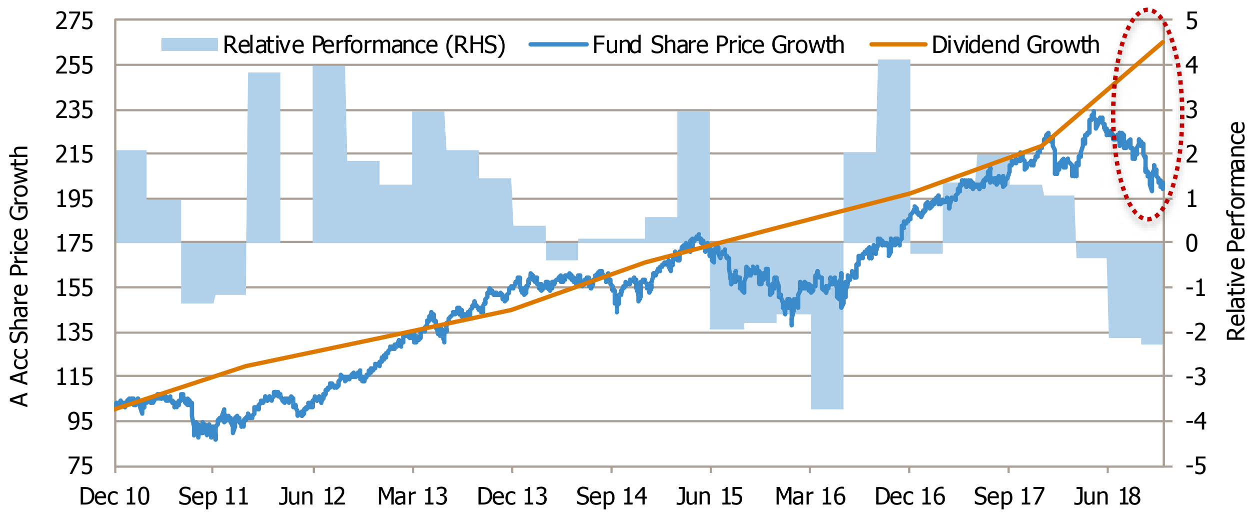
The graph below shows the growth of the Fund dividend versus other high profile UK Equity Income funds from our launch date through to the end of 2017. (The 2018 data is not included here because it is not yet available for the competitor funds.) The strength and consistency of our Fund dividend growth has been one of the key drivers of our relative performance versus the index since our launch and also versus our UK Equity Income peer group.

JOHCM UK Equity Income Fund: Fund dividend growth versus select peer funds



Source: JOHCM/Lipper as at 31 December 2017.

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



Source: JOHCM as at 17 December 2018.

Just like any single stock, the Fund's unit price should, over time, rise in line with the Fund dividend. In 2018, with the Fund dividend growing c. 18% and the unit price falling c. 13%, a material gap has opened up (circled above).

The shaded columns in the above chart represent the Fund's relative performance. It is noticeable from that periods of outperformance tend to follow periods like the one we are in, where the unit price has become detached from the Fund's dividend trajectory.

The unit price would have to rise by a third to return to the dividend line. The widening of the gap during 2018 represents a material de-rating of the Fund. This should close.

5 Valuation measures are flashing green

Part 1 – the overall portfolio

As we have been commenting in our monthly bulletins for some time, the progressive withdrawal of monetary stimulus across the major developed economies was always likely to introduce more volatility in financial markets and generally make it harder for stock markets to make meaningful progress. However, the impact of this tightening should predominantly be on the highly rated parts of the market (FAANGS, consumer staples, compounders). For years these areas have dined out on an effectively zero cost of capital. We have been cautiously positioned here for a long time. The valuation agenda in the parts of the market where we are invested is very different, as evidenced by the following data in Q4 2018:

- 63% of the Fund (by value) has a dividend yield of >6% to December 2019
- 65% of the Fund (by value) has a free cash flow yield of >10% to December 2019
- Only 10% of the Fund has net debt/EBITDA of >2x (excluding financials)
- Almost 50% of the Fund (by value) has committed to buy back equity over the next 12 months

We believe this combination of valuation characteristics for a diversified portfolio of approximately 60 stocks invested across the market cap spectrum is extremely attractive, particularly when combined with the strong dividend growth that the Fund currently exhibits.

Part 2 – individual stocks

We have thus far looked at valuation data for the Fund in aggregate. To drill down to an individual stock level, we have highlighted five stocks and their current valuation dynamics. Together they represent 13% of the Fund, with three – **Glencore**, **Barclays** and **DS Smith** – being top 10 active positions.

	Share price vs. 2017/18 high	Valuation metrics (all for 2019 unless stated)	Prudent, reasonable target valuation
BARCLAYS	-34%	• 0.55x price to tangible book • P/E of 6.9x • Yield of 5% (on a low 33% pay-out ratio)	• A P/E of 10x / 0.8x price to tangible book value = 50% upside potential
GLENCORE	-26%	• 16% free cash flow yield on current spot commodity prices • P/E of 7.7x	• 10% free cash flow yield = 50-60% upside potential
GallifordTry	-45%	• P/E of 4.2x • Yield of 12% on 50% pay-out ratio	• 6% yield / P/E of 8x = 100% upside potential
DS Smith	-42%	• P/E of 8x • Dividend yield of 5.9%	• P/E of 12x / yield of 4% = 50% upside potential
FORTERRA	-34%	• 2021 pro-forma EPS adjusting for new brick plant = 37p = P/E of 5.8x, yield of 5+%	• P/E of 10x = 60+% upside potential

The current valuations are all clearly very low, with the most expensive (DS Smith) on a P/E ratio of just 8x. On the basis of some very prudent assumptions, which would in each case still leave the stocks as 'buys', we estimate upside potential of 50+% in each of the stocks above.

Summary – the best opportunities will always arise when risks and uncertainties abound

As highlighted by the various valuation measures looked at in this paper, we believe the Fund's current valuation is very cheap, both compared to its history and in an absolute sense. With slowing global growth and an extended economic cycle, markets might continue to struggle in 2019, but we expect to make strong absolute and relative returns from here.

The biggest driver of future returns is the price you pay for any asset. The best opportunities will always arise when risks and uncertainties abound, as is the case today. Right now, we see a valuation opportunity almost unprecedented in the life of this fund.