JOHCM UK EQUITY INCOME FUND

MIND THE GAP 3

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Coronavirus, oil, Fund dividend and value vs. growth redux

- We are not complacent about the short-term economic impact of the pandemic, but we believe the effects will be finite – assuming a peak in new cases in April, recent and future stimulatory policy moves should bring about a v-shaped recovery in H2 2020.
- We strongly believe that the valuations in the stocks and sectors that make up the majority of the Fund provide ample downside protection, even if our economic assumptions prove to be too optimistic.
- In periods of extreme economic stress when earnings forecasts cannot be relied upon, price-to-book values are the most useful valuation measure – the Fund's price-to-book currently stands at under one for only the second time in its 15-year history.

These are truly remarkable times in global financial markets. Over the past three weeks we have seen the fastest ever drop in global stock markets, the biggest fall in the oil price since the 1970s, and the sharpest ever rise in the VIX index. Normal conventions around share price formation have been temporarily discarded, with limited focus on valuation, which normally protects the degree of downside, and scant evidence of marginal buyers.

The purpose of this paper is threefold: one, to highlight the Fund's compelling valuation base after these dramatic market moves and significant Fund underperformance during the sell-off; two, to provide an update on the portfolio's oil exposure in the wake of the collapse in the oil price; and, three, to give an update on the outlook for the Fund's dividend.

Coronavirus – the likely economic impact and market reaction

The arrival and rapid spread of covid-19 in Western Europe and North America has understandably caused much concern and, in some cases, outright panic in both societies and financial markets. Economic forecasting of the impact is difficult, particularly around the duration of the crisis, not least because even the scientists do not know whether the virus will become less virulent as and when temperatures in the northern hemisphere start to rise over the spring and summer.

The implementation of travel restrictions and social distancing measures will produce an economic contraction of some magnitude in the next few months. This will lead to a drop in global corporate earnings in 2020 versus 2019. At this stage, a c.10-15% fall in earnings seems, to us, a reasonable assumption, given that prior to the outbreak most analysts were assuming growth of high single-digits. Clearly there is a risk that it could be more severe than that. However, what is as important is the debate around whether the impact will be seen as a one-off, with a strong rebound towards the end of the year and into 2021 stimulated by loose economic policy, or whether it will be the precursor to a longer and more sustained economic contraction.

The market's reaction has suggested that many investors fear that central banks' lack of monetary policy firepower, particularly in terms of conventional interest rates, makes a global recession a very real possibility. We have some sympathy with this view. Regular readers will know that we have long cautioned on the impotency of further monetary policy easing from the starting point of such low absolute rates. However, if Western policymakers move actively to embrace the need for fiscal expansion for the next decade, there is a good probability that economic growth can resume towards the end of 2020 and beyond. In that regard, the powerful policy shift witnessed in the UK's expansionary budget last week was highly encouraging, and it is hoped that it will be followed by other governments including Germany and the US. The Federal Reserve's package of measures announced on Sunday evening are clearly designed to boost liquidity, in particular in fixed income markets, but will need to be complemented by fiscal support. The sense of crisis in many societies will make this more likely than before.

It is also clear from our engagement with our companies that China and supply chains linked to it are rapidly returning to normal. It is a similar story in countries like South Korea and Singapore, where the virus started earlier and governments took quicker actions. For markets to stabilise we may need to see a peak in the virus in Europe and the US, which is likely to be some weeks off and, as mentioned above, a significant fiscal response.

Clearly the loss of lives and suffering that the virus will bring makes this a human tragedy first and foremost. Here we can only consider the economic perspective, and we are not complacent about the short-term economic impact of the pandemic. However, at this stage, we believe the effects will be finite and that the stimulatory policy moves that have already occurred and are likely to accelerate in the coming weeks will bring about an improvement in activity in the second half of the year. We could obviously be wrong, but we strongly believe that the valuations in the stocks and sectors that make up the majority of the Fund provide ample downside protection, even if our economic assumptions prove to be too optimistic.

Oil price drop – thoughts on BP and Shell

The collapse in talks at the OPEC+ meeting, public disagreement between Saudi Arabia and Russia and the subsequent decision by both countries to ramp up oil production led to a c.30% fall in the spot oil price to the low US$30s – although it should be noted that the three-year forward oil price fell much less significantly and is currently sitting at around $50. Conspiracy theories abound as to the motivations of Russia, in particular, but it seems highly likely that it is targeting the US shale industry and expects a period of weaker prices to lower US shale production given the highly indebted nature of some shale operators. It seems very unlikely that the spot oil price will remain in the low US$30s for a significant period of time. But with the fall in demand from the Coronavirus, it may well stay there over the summer months, unless Russia has a change of strategy.

The financial implications for the major UK-listed oil companies, BP and Royal Dutch Shell, depend upon for how long you assume oil prices stay depressed, but the cost structure of the global industry suggests a return to US$45-55/bbl at some stage in the medium term. However, in the short term, the companies will have to pull some levers to mitigate against the price drop, particularly their capex budgets. Compared to the 2015-16 period of oil price weakness, pulling the capex lever is likely to be less effective this time around, as the companies have structurally and permanently removed some costs during the last five years, particularly via the greater use of technology. Nevertheless, it is likely that capex budgets could be cut by 10-20% if prices remain depressed. Furthermore, the businesses' downstream operations and exposure to natural gas (natural gas prices rose in the US after OPEC+'s move due to the likely cuts in shale production) do provide some offset. But, in the short term, these measures are likely to leave dividends uncovered by free cash flow in 2020 and close to balanced in 2021, assuming US$40 oil.

What does the oil price fall mean for BP?

Let's look at what this means for BP, one of our largest absolute and active position in the portfolio. Here the maths were broadly as follows in 2019:

	US$(bn)
Cash flow from operations	26.0
Capex	15.0
Lease/interest expenses	2.5
Dividend cost	8.5

Source: JOHCM.

The above numbers are broadly in balance, historically, but the recent fall in the oil price means that 2020 cash flow is likely to fall by c.US$4-5bn and capex reductions are only likely to offset by around US$1bn, resulting in a short-term deficit of US$3-4bn. Whether BP chooses to pay a flat dividend will depend upon a number of factors, including its view on the duration of the oil price downturn and the likelihood of the company receiving further cash receipts from its disposal programme to strengthen the balance sheet.

In 2021, assuming no recovery in the oil price, the shortfall would close further from another US$1-1.5bn of lower capex and an improvement in the underlying margin per barrel from the portfolio. This would leave the capital framework at or very close to being balanced. In the recent past, BP has taken a longer-term view on oil prices and provided a stable dividend. This remains our central assumption. However, if we were to assume a 30% cut in the full-year dividend by both BP and Royal Dutch Shell, starting in Q2 2020, the effect on the portfolio would be to reduce the Fund's dividend by around 5%.

Lessons on leverage

A key issue during periods of intense economic and market stress such as this is to avoid highly indebted stocks. As long-term holders of the Fund will know, one of the lessons we took from the financial crisis was the need to reduce the Fund's exposure to financial leverage. We did this in 2008/9 and avoiding highly leveraged companies continues to be an important feature of our approach. This is meaningful because it ensures companies can continue to operate through periods of material revenue pressure without the need to raise fresh capital. In contrast, highly indebted companies can be forced to raise equity, which is very dilutive to existing shareholders. With the market scenting blood in the form of rights issues, some of the worst performing shares in the last few weeks have been companies with large amounts of debt: Cineworld (-88% YTD), Capita (-85% YTD) and G4S (-60% YTD) – all three have net debt to EBITDA ratios of > 3x.

The Fund's balance sheet profile:

The Fund has very safe underlying balance sheet exposure, in our view. Our stocks fall into the following buckets from a balance sheet perspective:

Net cash on balance sheet:	5.6%
Net debt to EBITDA 0-1x:	32.5%
Net debt to EBITDA 1-2x:	19.2%
Net debt to EBITDA > 2x:	6.4%
Financials:	36.3%

Source: JOHCM.

For financials, net debt to EBITDA is not the relevant metric. We have the same focus on safe balance sheets in this sector, with high capital ratios in banks and strong solvency / liquidity across our insurance names. Actions after the financial crisis and resultant regulatory changes have strengthened most of the financial sector.

The stocks in the highest leverage bucket make up just 6% of the Fund. The main holdings in this bucket are:

Vodafone (nearly half of the total) – deleveraging through announced asset sales and the monetisation of its tower assets.

Diversified Gas and Oil – deleveraging quickly as its FCF yield is > 40%; this is mainly a gas asset.

SSE – as a utility, it will always have higher leverage given its networks / offshore wind / infrastructure-type exposure.

DFS – slightly over 2x, but with a very clear plan to maximise cash and liquidity over the next few months.

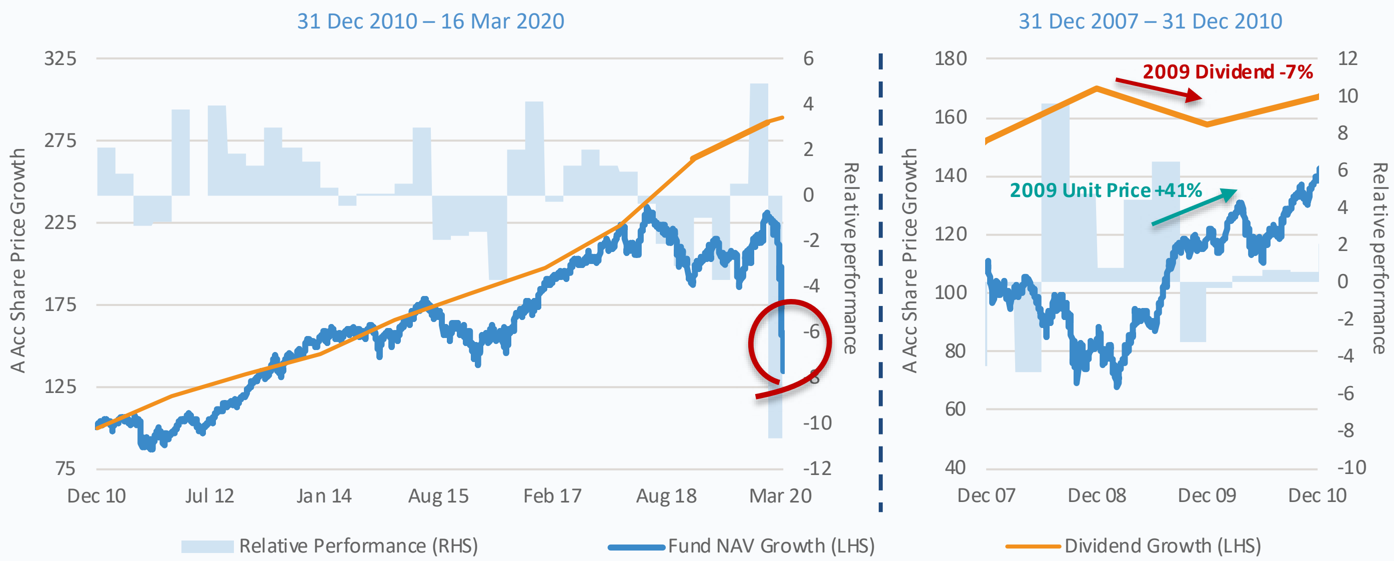
We will continue to ensure low levels of leverage in the Fund. Healthy, unstrained balance sheets are also a useful short-term protector of dividends.

Fund dividend – too early to make any changes to our 2020 guidance

Our previous guidance for Fund dividend growth for 2020 was for low single-digit growth. This was a prudent view at the time and, as always, included a buffer to reflect known and unknown risks. Our live model (unadjusted for the future risks associated with the oil price fall and Coronavirus) shows growth of close to 9%. This is the Fund dividend's starting position prior to the inevitable downward adjustment associated with these risk events.

The chart below, which we have highlighted before, shows the Fund dividend trajectory compared to the Fund's unit price. There was already a large gap between the two – as we have highlighted in our previous **'Mind the gap'** papers, the main driver being the significant outperformance of growth versus value over the last few years, and which we cover again below. As the chart shows, this gap has widened significantly due to the market sell-off. In order to recouple with the Fund dividend line, the Fund would either have to rise by > 100% or the Fund dividend would have to fall >50%.

The gap between the Fund's unit price to its dividend remains wide



Source: JOHCM/Fund analytics/StatPro as at 16 March 2020.

Clearly the dual market shocks of covid-19 and the oil price drop will have a significant impact on corporate cash flows and dividends. Above we have estimated the potential effect on dividends for our major oil holdings, where 30% dividend cuts by both BP and Shell would lead to a 5% drop in the Fund dividend. This adjustment, were it to happen, would occur over 2020 and 2021 given we are already part way through the former.

The potential impact of Coronavirus is harder to forecast. It will depend on the extent and duration of the economic fallout and the policy response. The latter, as laid out above, is likely to be considerable, global and coordinated. This should create a v-shaped recovery. For these reasons, we have not forecast the exact sensitivity of the Fund dividend to the Coronavirus, as we have done for its sensitivity to the oil price.

We know, as detailed above, that the clear majority of our holdings have robust balance sheets. And we knew before any earnings adjustments associated with these events that our dividend cover was strong in an absolute sense (c. 55%) and better than the market average. We also know that the Fund's dividend has only ever fallen once: in 2009, during the financial crisis, when it fell by only 7% despite the severe nature of that crisis. It may be that recent events create a situation where the Fund dividend is flattish in both 2020 (i.e. the buffer of c. 9% growth is eroded away) and 2021. Clearly the situation could be worse than this if some companies choose to prioritise preserving cash in the short term. Indeed, we have already seen some highly leveraged companies, such as William Hill (not owned in the portfolio), cancel dividends that had already been announced. It would be wrong to assume we will not see some dividend suspensions amongst our holdings. The extent of the dividend pressure will depend on how quickly the virus peaks and how fiscal policy is enacted. But irrespective of the outcome, as the chart above shows, the gap between the Fund dividend and the unit price suggests the Fund is materially undervalued.

We will provide an update to our Fund dividend guidance at the end of May when we hope the picture may be clearer. The Fund dividend for Q1 will be down c. 5% due to portfolio mix changes. The Q2 dividend, where much of the growth is for this year (again driven by portfolio changes), is currently forecast to be materially up.

On an assumption of flat dividend growth for 2020, the Fund currently yields 8.4%.

Market – value vs. growth: at historic extremes

The circumstances discussed above have created an even greater skew between value and growth stocks. In August 2019, this reached the same extremes as it did during the peak of the TMT bubble in 2001. Value then rallied slightly last autumn (and so did the Fund's performance), but much of this relative outperformance was given up in the first six weeks of the year as issues such as the US/Iranian tensions shaped the market narrative. Since then, as Coronavirus fears and the oil price war have reverberated, the gap between value and growth has expanded it to its widest ever level. The graph below shows how extreme the positioning has become.

MSCI Europe Growth relative to MSCI Europe Value (price performance) – now beyond the TMT bubble

Source: Credit Suisse as at 12 March 2020.

The resultant value differential growth to value is stark

Europe factor performance	Aug 19 PE valuation percentile vs. history[1]	12 Mar 20 PE valuation percentile vs. history
Value	5	5
P/E	5	7
P/B	2	4
DY	2	4
FCF/EV	1	1
Quality	98	100
ROE	99	100
Low leverage	56	68
EPS stability	100	100
Growth (eps)	94	88
Growth (sales)	93	92
EPS mmt.	89	99
Price mmt.	94	97
Low vol.	96	98
Nifty 50	99	97

Source: Exane as at 12 March 2020.

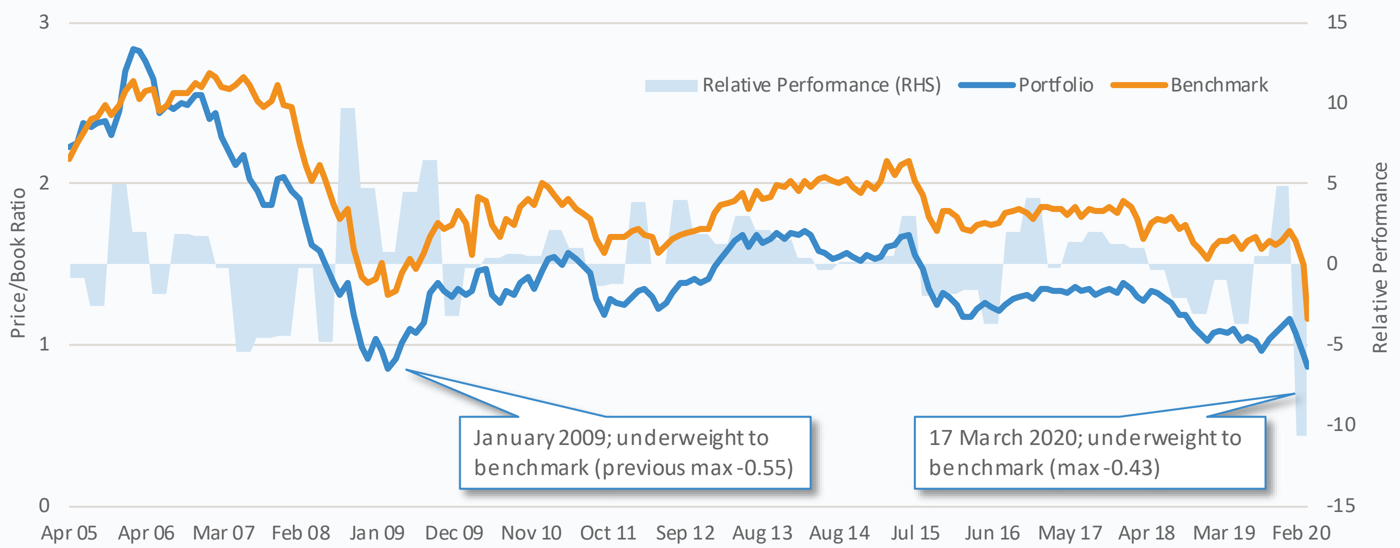
This extreme outperformance of growth stocks versus value stocks over the last 2-3 weeks has been a material headwind to Fund performance. The table above shows where recent market moves have left value, quality and growth factors versus their history. Value has rarely been cheaper; certain quality and growth factors have never been more expensive. This has been driven by the panic created around covid-19 and its associated uncertainty. This stretch in valuation within the market cannot continue indefinitely. We believe the greatest danger to investors is the high valuations of the parts of the market that we do not own. These are viewed as 'safe' by certain investors, rather than our own positioning, which, as all the evidence in this paper suggests, is close to the cheapest it has ever been.

The Fund – unprecedented value on a book value basis

When we have major market dislocations, when uncertainty is high and when market participants find it hard to gain a proper handle on earnings forecasts, valuation metrics become less of a driver of share prices. Panic sets in and risk is rebuffed at any price. Yet history tells us that these moments represent the best long-term investment opportunities.

The graph below shows the Fund's price-to-book value versus the wider market.

The Fund's price-to-book valuation (vs. market) is close to its lowest ever level



Source: JOHCM/Fund Analytics/StatPro as at 16 March 2020.

In our view, this is the best metric to look at in times like this because it is independent of earnings. As the graph shows, the gap between the Fund and the market remains wide, but in an absolute sense the Fund's price-to-book value ratio is at its lowest ever level. It is also below 1x for only the second time in the Fund's 15-year history, the only other occasion being the six months leading up to March 2009, when we were in the eye of the storm that was the financial crisis.

Our stock smorgasbord – real world value?

How distressed have valuations become in this sell-off? All fund managers will have their own collection of favourite names that they feel have been disproportionately punished in this savage sell-off. Here are some examples of the valuations amongst some of our holdings:

Barclays now trades on 0.3x book value despite repairing its capital base, whilst Standard Chartered's Asian growth franchise is rated at 6x earnings.

Both **WPP** and **Standard Life** sit on dividend yields of over 10%. This is despite both companies having unfinished share buyback programmes that will shrink their share counts by 10-20% at current prices.

Diversified Gas and **Oil** has a 45% free cash flow yield and has hedged 90% of its 2020 gas production at prices 40% above spot. Gas prices, as we highlight above, have risen in the US, not fallen, since the OPEC+ breakdown.

Rio Tinto and **Glencore** are on dividend yields of well over 10% but have critical roles to play in the electric vehicle transition.

ITV trades on 6.0x earnings despite having one of the world's leading studio production businesses at a time when demand for content continues to rise.

Legal & General sits on a yield of 10.5% yet has grown its eps by 58% in the last four years and has a compelling growth pipeline.

Norcros is on 5x earnings, **Vistry** on 6x earnings…the low valuation picture is very clear…

Stay calm and focus on the long term and the valuation agenda

Fund performance has been extremely challenging from both an absolute (-41.0%) and relative (-10.7%) standpoint (YTD to 16 March 2020). Unfortunately, the compelling valuation base across the Fund has been rendered largely irrelevant in the face of indiscriminate selling by market participants and as share prices have almost completely decoupled from underlying stock fundamentals.

The nature of this crisis makes precise forecasting prone to substantial error and in many respects the uncertainty explains the remarkable speed of the fall in markets. However, whilst the possibility of a prolonged global recession cannot be ignored, a more likely outcome is a deep but short-lived economic contraction followed by a recovery in the second half of 2020. In this context, we believe investors should focus upon the longer-term outlook and valuation agenda. As we have hopefully highlighted in this paper, this should be highly supportive for the Fund in due course, but we would stress the need for calm and patience in coming weeks.

On an assumption of flat dividend growth for 2020, the Fund currently yields 8.6%. However, the sharp and deep nature of this event could mean that our aggregate dividend payments fall somewhat this year for the reasons outlined above. At this stage, economically, this event does not feel to us to be more severe than the financial crisis of 2008/9. In that regard, the 7% fall in the dividend distribution but 40+% rise in the unit price in 2009, as the recovery began, may prove useful to reflect upon.

JOHCM UK Equity Income Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	29.02.20	28.02.19	28.02.18	28.02.17	29.02.16
A GBP Class	-4.77	-3.73	10.67	25.69	-8.60
Benchmark	-1.20	0.93	4.96	23.09	-7.53
Relative return	-3.62	-4.61	5.44	2.11	-1.16

Past performance is no guarantee of future performance.

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.