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J O Hambro Capital Management Group

THREE YEARS ON, FIVE LESSONS LEARNT

Rachel Reutter
Senior Fund Manager

Michael Ulrich
Senior Fund Manager

Three years on from assuming co-leadership of the fund, we reflect on five lessons learnt:

1. Give yourself options
2. Don't be lured by large dividends
3. Structural growth is essential
4. Why 'Management behaving better' matters
5. Co-management confers benefits

JOHCM UK Opportunities Fund

Three years ago we took over the running of the **JOHCM UK Opportunities Fund** when John Wood, who founded the fund in 2005, decided the time was right to handover the reins and step into retirement.

It seems an appropriate moment to reflect on the journey the fund has been on and how we've been adapting to the new circumstances we face.

For any equity investor who is disciplined about valuation, recent years have been hard. Structuring a portfolio for capital growth when assets are expensive and capital misallocation is rife has been far from easy.

The Covid-19 pandemic has posed a fresh set of challenges and some new opportunities. Today we have a portfolio of well-positioned companies which we believe are likely to emerge stronger than before.

Our investment process has adapted well to these changing circumstances. The fund has delivered first quartile performance over 1, 3 and 5 years, driven by its focus on well-positioned large-cap UK companies and disciplined execution.

While we're encouraged by the numbers, we've only just begun. More interesting than the scores on the board so far are the lessons we've learnt on the way:

1. Give yourself options

"Having one option is being trapped. Two options is a dilemma. Three options marks the beginnings of freedom." This mantra underpins the way we have evolved and expanded our watchlist of stocks.

Throughout 2016 and 2017 stretched valuations and weak balance sheets triggered our sell discipline.

We sold British American Tobacco when an acquisition took its debt to 4.5x earnings. We sold Experian on valuation grounds. Nationalisation risk forced us to reduce positions in utilities which had previously been core holdings. In short, we found ourselves with very few options and an elevated cash balance.

JOHCM UK Opportunities Fund
Periodic performance (%) to 30.09.20

	3 m	6 m	1 y	3 y	5 y	SI p.a.[1]
JOHCM UK Opportunities Fund	-0.42	12.93	-7.24	0.86	23.74	7.26
FTSE All-Share TR Index	-3.21	8.21	-16.51	-9.23	19.01	4.88
UK All Companies Sector	-1.02	13.05	-12.97	-7.98	17.34	5.40
Quartile*	2	2	1	1	1	1

Past performance is no guarantee of future performance.

Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as at 30 September 2020. Benchmark: FTSE All-Share TR Index (12pm adjusted). Performance of other share classes may vary and is available upon request. Inception date: 30 November 2005. *Lipper Hindsight, IA UK All Companies Sector Rankings to 30 September 2020. Note: The current managers took over the fund on 1 October 2017. [1]Annualised.

In 2017 we set to work on building a more extensive watchlist, exploring a wider range of ideas and formalising the circumstances under which we would buy them. These circumstances include changes in structural growth tailwinds, valuation, management, debt, competitors and regulation.

Our research process has evolved to include greater use of industry contacts, management engagement and independent analysis providers. We rely far less on investment bank research, which is increasingly short term and of variable quality. Both the effort expended and the quality of the inputs have given us a larger watchlist of well researched potential investments where we are prepared to move quickly.

We demonstrated this both in Q4 2018, when we used our cash balance to deploy 10% new capital into the short market sell-off, and in Q1/Q2 2020, when we invested roughly 30% of new capital into watchlist ideas. Being better prepared enabled us to act decisively in the short windows of valuation upside with which we were presented.

With our cash balance being an output of the opportunities we face, widening our list of well researched stocks has given us more options to deploy capital. Today we have a portfolio which we feel is the best positioned for capital growth, diversity of risks and optionality than any time in the last three years. With a current cash balance of 9.5%, we also have plenty of flexibility to buy new names when opportunities such as capital raises occur and the all-important ability to sell if we need to.

2. Don't be lured by large dividends

For a fund that prizes stability of cashflows, a large dividend yield can seem attractive. As well as income, high yielders often have attractive low short-term earnings-based valuations.

Over the last three years, our biggest capital losses have come from stocks with these compelling characteristics. As valuations continued to rise in the 2017-19 period, our mistake was to put too much emphasis on short-term cashflows and not enough on the prospects for long-term growth.

Three of our worst performers over the period, Imperial Brands, Royal Dutch Shell and Centrica, offered an attractive income return that was soon dwarfed by capital losses. All three subsequently cut their unsustainable dividends.

Overdistribution also has the effect of starving a business of capital for growth. These three businesses faced structural and regulatory headwinds that required a radical reshaping of their businesses. They were unable to make the necessary investment because they were paying out too much to their shareholders.

Few companies manage to stand still. In a competitive market place, growth is an essential defensive characteristic. Companies that merely aim to hold sales and profits soon find themselves in decline and we have learnt the hard way about investing in companies with the sole hope that their dividend can be maintained.

3. Structural growth is essential

Put simply, it is far easier for a company to grow in a growing market. Whilst factors such as management, balance sheet and valuation remain important parts of our process, our work on identifying structural tailwinds has proved critical to the success of the fund.

We don't seek speculative or explosive growth from a particular product or service. Our quest is for meaningful and sustainable growth over the long term driven by a structural change. Changes in global demographic spending patterns benefit companies such as Unilever, GlaxoSmithKline and Smith & Nephew. Changes in the way we use data have driven positive results from Experian and Relx. The trend to tighter health and safety regulation has helped Intertek, whilst Ashtead continues to win as its core US market moves to outsourcing. Our decision to buy Next, having sold the stock some years earlier, was based on its successful investment in online retail, distribution capabilities and its position as the go-to platform for smaller retailers who struggle with the cost and complexity of online operations.

A focus on structural growth has also helped us spot when a trend is broken or a new one emerges. The pandemic may have accelerated some structural changes and reversed others. We see increased emphasis on renewable energy and have positioned the fund to benefit from Johnson Matthey's battery and hydrogen technology, SSE's leading position in windfarms and National Grid's ability to connect both new electricity and gas networks. As the pandemic commenced, we sold our position in oil stocks, as well as AB Foods, where the accelerated shift to online retail is a challenge for its Primark business, which has no online offering.

The role of our work on structural growth tailwinds and recognising when the facts have changed has never been more important. In a world where the facts are changing almost on a daily basis, we believe that a lot of the value we can add will be where detailed bottom-up company analysis meets our work on big picture changes. This will be a vital combination to help us spot the winners and, even more crucially, weed out the losers.

4. Why 'Management behaving better' matters

In 2015 we presented a fund update with the title 'Management behaving badly'. In it we detailed our engagement with companies on the perils of capital misallocation, short-term cost-cutting exercises and earnings growth-based incentive structures. Our view is unchanged: good governance, which sits at the heart of our quality control, sets a culture within the business of 'doing the right thing' for all stakeholders and the environment, thereby creating sustainable growth.

Using all of the important principles of our quality control, we have developed a scorecard based on three key principles:

1. financial propriety;
2. appropriate boards and remuneration; and
3. a social contract between the company, its wider stakeholders and the environment.

We have engaged heavily with the boards and managements teams of companies who have been under pressure to grow dividends via debt-fuelled acquisitions, increase pay-outs and ultimately take on more debt. We used these red flags to weed out Capita, Cobham and Ultra Electronics, Centrica and BT. We have recently sold out of DCC, because we couldn't obtain sufficient information on its organic growth or gross debt position.

Our engagement with companies has delivered some meaningful improvements. In the case of PZ Cussons, we engaged with its remuneration committee and chairwoman for over a year to

encourage the company to move away from bonuses based on short-term earnings growth and instead put more emphasis on organic growth and environmental measures.

We feel that the Covid-19 pandemic has given management teams an opportunity to re-set their capital allocation priorities. It has been encouraging to see the number of companies who have permanently re-set their distributions to lower levels and accelerated investment. The wider industry shift towards investing in companies with strong ESG credentials is also a positive force for change.

5. Co-management confers benefits

One of the criticisms we faced after John retired was our newly established co-portfolio manager structure. Navigating the market over the last three years, we believe we have benefited from the debate and challenge that comes from having a co-fund manager structure with equal skin in the game. At times when the world has seemed mad, we have been able to draw strength from each other in order to maintain our discipline. Having a co-portfolio manager set up also means there is no hierarchical deference that can stifle debate, such as when a bank of junior analysts has to present to an established fund manager. We believe it increases the chances that a decision made in the heat of the market turmoil is subject to the right amount of scrutiny.

In February the UK Opportunities team analyst, Roshni Bolton, will also have completed three years with us. We have no plans to increase the size of the team and agree with Pythagoras's view: three is the perfect number, representing “harmony, wisdom and understanding”.

JOHCM UK Opportunities Fund

5 year discrete performance (%)

	30.09.20	30.09.19	30.09.18	30.09.17	30.09.16
A GBP Class	-7.24	5.68	2.89	4.16	17.80
FTSE All-Share TR Index	-16.51	2.72	5.84	12.62	16.43
Relative return	11.10	2.89	-2.79	-7.51	1.17

Past performance is no guarantee of future performance.

Source: JOHCM/FTSE International/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees as at 30 September 2020. The A Acc GBP class was launched on 30 November 2005. Benchmark: FTSE All-Share TR (12pm adjusted). Performance of other share classes may vary and is available on request.

Share class details

	ISIN	SEDOL	Bloomberg	WKN	Initial charge	Annual charge	Ongoing charge	Minimum investment*
A Acc GBP	GB00B0LLB641	B0LLB64	JOHUOIA LN	A0H1DL	Up to 5%	0.75%	0.88%	£1,000
A Dis GBP	GB00B3K76Q93	B3K76Q9	JOHUOII LN	A0RGE1	Up to 5%	0.75%	0.88%	£1,000
Y Acc GBP	GB00B95HP811	B95HP81	JOHUOYA LN	A1XCAZ	Up to 5%	0.63%	0.75%	£50,000,000
Y Dis GBP	GB00B95J5C19	B95J5C1	JOHUOYI LN	A1XCAY	Up to 5%	0.63%	0.75%	£50,000,000

Performance fee: 15% on excess if Fund outperforms benchmark, calculated daily. Any underperformance carried forward. Ongoing Charge is as at 30 September 2020. *Other currency equivalents apply. Further details on additional share classes are available on request.

The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. 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. We recommend that you read the Prospectus and Key Investor Information Document available from the address overleaf or from our website. Information on how JOHCM handles personal data which it receives can be found in the JOHCM Privacy Statement on our website: www.johcm.com. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Ltd. Registered in England and Wales under No:2176004. Registered office: Level 3, 1 St James’s Market, London SW1Y 4AH.