Under the Bonnet

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Investment background

March saw concerns over slowing global economic growth weigh on the recovery in global equities that had characterised the quarter. Central banks responded with a globally synchronised easing of monetary policy, which resulted in marked gains in bonds, bond-like equities and growth stocks. The FTSE World (total return) index rose 1.7% over the month whilst the more growth focused NASDAQ 100 (total return) rose 4.0%, nearing its August 2018 all-time high.

The global manufacturing sector continued to be the main source of growth concerns. The global manufacturing PMI reached a 32-month low as the rate of expansion in new orders stayed close to stagnation. Although China's Caixin manufacturing PMI registered only fractionally below the neutral mark at 49.9, the US PMI signalled operating conditions improving at their slowest pace since August 2017, whilst both Japan and the eurozone slipped in to contraction for the first time in 32 months and five-and-a-half years respectively. In Europe, declining orders outstripped output at the fastest rate in seven years implying production would need to be pared back. The ECB, acknowledging that the slowdown would be longer and deeper than previously thought, reducing its growth forecasts for 2019 (from 1.7% to 1.1%), 2020 and 2021 whilst also launching a third iteration of the Targeted Longer-Term Refinancing Operation (TLTRO III). The severity of the slowdown was subsequently confirmed by the eurozone flash manufacturing PMI falling to a 71-month low.

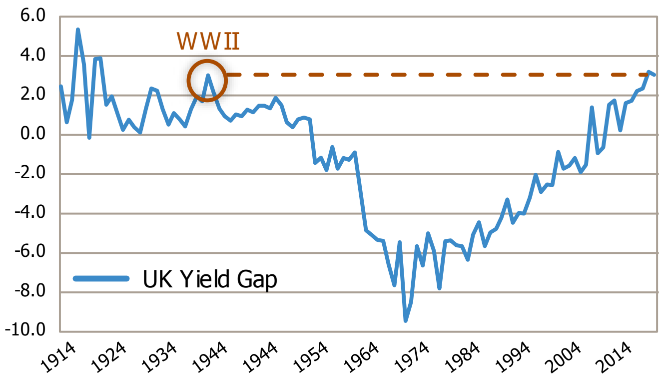
Monetary policy also softened in the US and China, with the latter even implementing fiscal measures. The National People's Congress of China announced it would continue to carry out prudent monetary policy alongside tax cuts and increased government spending in order to achieve a new 2019 GDP growth target of 6.0-6.5%, down from 6.5% in 2018. In light of the slowdown in global economic activity, the US Federal Reserve announced it would likely delay any further rate rises this year, thereby reversing its guidance issued at the end of 2018.

The combined impact of all this central bank activity had a marked impact on bond yields. The yield on the generic 10-year US Treasury fell to a 15-month low whilst the yield on the generic 10-year German bund fell into negative territory for the first time in nearly three years. Moves were exacerbated by a flight to safety from investors looking to buy assets with perceived defensive qualities in the face of slowing global growth. The market value of the Bloomberg Barclays Global aggregate negative-yielding debt index rose to over $10 trillion, its highest level in a year-and-a-half, and 63% higher than its total just six months before.

Although there was no change to monetary policy in the UK, Brexit-related uncertainty continued to weigh on economic growth and investor sentiment. The Office for Budget Responsibility cut its 2019 growth outlook from 1.6% to 1.2% to reflect its belief that the sharp slowdown at the end of last year had continued in to the first quarter of 2019. This rationale looks justified given the likely impact on corporate confidence of Parliament failing to find a majority for any outcome to Brexit in March despite a second meaningful vote on Prime Minister Theresa May's deal and a round of indicative voting on eight alternatives. With Parliament yet to reject fully a no-deal at any point and the 29th March Brexit deadline a clear impossibility, UK assets came under pressure over the month. The more domestically focused FTSE 250 (total return) index fell 0.1% compared to a 2.7% gain in the FTSE All-Share (total return) index. Sterling, whilst volatile, recovered much of its losses following the announcement that the European Council would grant an extension to Article 50 and ended the month only slightly down against the euro (-0.4%) and the US dollar (-1.7%). This news did little to avert the yield on the UK generic 10-year gilt from following global bond yields lower, falling 30bps to 1.0%, an 18-month low.

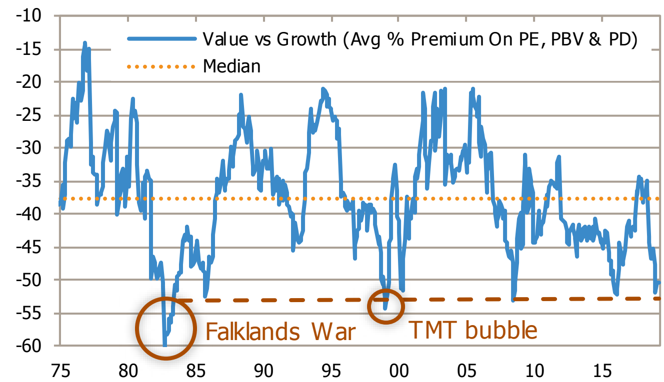
These moves capped what has been an extraordinary quarter for valuations in UK equities. The discount of UK equities to gilts implied by the dividend yield gap remains at levels only seen in the last 100 years during World War II (first mentioned in 'Under the Bonnet', October 2016). Further to this, analysis by Morgan Stanley shows that the current discount of UK value stocks to UK growth stocks using a blended valuation approach (P/E, price to book and price to dividend) has only been markedly lower once in the last 45 years: the 12 months after the UK engaged in the Falklands War. The disparity in UK valuations is marked.

UK dividend and bond yield gap



Source: Global Financial Data, DataStream, Citi Research.

UK value vs. growth average valuation premium



Sources: MSCI, Morgan Stanley Research. Note: Average relative valuations use 12M forward data where available (forward P/E data starts in 2003) and trailing data where forward P/E not available.

Strategy update

The Fund underperformed in March, rising 1.17% versus a 2.67% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing (geometric) underperformance of 146bps. Over the first quarter of 2019, the Fund rose 7.87% versus a 9.15% rise by the index, underperformance of 117bps.

Whilst it is disappointing to report any underperformance, it must be noted that all the underperformance over the quarter can be attributed to market allocation effects rather than stock selection. In March alone the Fund experienced a headwind of 85bps from not holding positions in British American Tobacco, Diageo, Unilever and Reckitt Benckiser. Share prices increased in these perceived defensive, bond-like equities as investors clamoured for safety in response to the economic and political factors detailed above. We have seen these conditions before (see "Under the Bonnet – 2016: A Year to Remember", January 2017) and know how quickly extreme disparities in valuation can revert to the norm. However, we are cognisant that UK assets could well remain volatile, particularly given the potential for a general election in the coming months, which may affect the Fund's short-term performance. Despite this the Fund will continue to focus on allocating capital to those opportunities that provide sufficient margin of safety through a combination of valuation and management self-help, not by buying quality at any price.

In this context it is pleasing to report that the Fund's industrials holdings delivered 53bps of outperformance in March, despite a 12bp allocation headwind. This performance more than offset the 39bps headwind the Fund's industrial holdings contributed last month (see 'Under the Bonnet', March 2019) and is evidence that their operational performance is not reliant on macro tailwinds. Full-year results from **TT Electronics** saw some analysts upgrading numbers as increasing synergies from the Stadium acquisition and improving operating performance increased group margins. Operating margins are 7.8% having been just 4.3% three years ago and despite R&D increasing as a percentage of sales. The share price increased 22% over the month, suggesting that the technical overhang from the stock placing in January has now cleared, yet the shares remained inexpensive at just 12x consensus FY19 EPS.

There were also clear signs of progress at **Essentra**, one of the Fund's industrial holdings we have written about at length. Full-year results showed operating profits in the company's healthcare packaging business improving from a £1.8m loss to a £5.4m profit and H2 sales like-for-likes increasing to 7.7% from -1.0% in H1 (-9.2% in H2 2018) as all geographic regions returned to growth. Growth was driven by increased demand from existing blue-chip pharma clients as increased service levels rebuilt trust which had been severely damaged under previous management. As we detailed in October last year ('Under the Bonnet', October 2018), Essentra's packaging business is one of only two multi-continental suppliers to the healthcare industry in the world and yet, despite accounting for 33% of 2018 revenues, it only contributed to 5% of 2018 group operating profit (pre-central costs). A turnaround in this division has the potential to drive significant shareholder value and, importantly, in a non-cyclical end market. There was also margin improvement and encouraging commentary on new growth initiatives in Essentra's filters division, another non-cyclical division which accounts for 31% of operating profit (pre-central costs). In addition, Essentra announced it would buy out the remaining minority interest in its filters joint venture in Dubai. An earnings-enhancing transaction that will also enable management to transform the operation into a regional hub, thereby expanding Essentra's world leading position.

The turnaround at **SIG** showed its first real signs of progress. Despite strong headwinds in the end markets of UK and French construction, full-year numbers were in line with consensus as management actions led to a significant step up in both gross margins and operating margins in H2. Management also announced they would be reviewing strategic options for the Air Handling division in what is a consolidating market. If Air Handling was to achieve 10-12x EBITDA on disposal, in line with comparable transactions, then this would create significant value for shareholders given the group currently trades on close to 8x EV/EBITDA and the proceeds would be sufficient to pay off all outstanding debt facilities including the factoring facility. Shares increased 13% over the month.

Full-year results at **Melrose** were also better than many commentators feared, with profits and cash ahead of expectations and so too the guidance on automotive. But it was not all good news for the Fund's industrials holdings. Shares in **Elementis** (technically in chemicals rather than industrials) fell 9% despite meeting consensus numbers as analysts put through c. 3% downgrades to 2019-20, reflecting lower revenue growth in the cyclically exposed coatings business. Whilst it is disappointing to see further downgrades, the share price reaction seems harsh given the shares already trade at a seven-year low in terms of relative price to benchmark, EV/EBITDA and P/E. It would appear that the Mondo acquisition may have created a technical overhang at a cyclically tricky time and, as a result, clear value is now emerging.

Sadly, it was a similar story at **The Restaurant Group**. Despite preliminary results delivering profit before tax in line with consensus and the share price closing up 10% on the day, the shares lost their gains to be down 7% on the month, thereby costing the Fund 31bps of performance. Although there was a slight trimming of estimates by analysts to account for the launch costs associated with the new Mamago food to go brand and the delivery kitchen business, share price weakness is more likely to have been a combination of continued investor concerns over the CEO's recently announced departure plus ongoing Brexit uncertainty. As detailed last month ('Under the Bonnet', February 2019), there is more than enough raw material at The Restaurant Group to attract a new high calibre CEO and therefore scope for the existing market narrative to change. In the meantime, extreme value has emerged with the current market cap of the group now equal to the total amount paid for Wagamama less than six months ago.

Good management teams are essential to unlocking value in companies, and there is no better example of this than **Morrisons**. Full-year results were accompanied by a further special dividend, meaning that total dividends were up 25% year-on-year as management continue to deliver on their cash focused, capital-light strategy. However, maybe of more interest was the announcement of a trial to convert ten McColl's stores to Morrisons Daily convenience stores, with a full Morrisons convenience offer. These are ex Co-Op stores and therefore lend themselves to a full supermarket offering and, as part of this, will be managed within the full Morrisons estate. With 300 ex Co-Op stores potentially up for conversion, this could provide another meaningful capital-light leg to this management's strategy.

Further value was also unlocked by new management at **Daily Mail & General Trust** (DMGT) with the announcement that it would distribute its 49% stake in **Euromoney** to its own shareholders. Shares were directly distributed to shareholders plus an additional cash return of £200m being the cash on DMGT's balance sheet that had been realised from the sale of its remaining stake in Zoopla. As DMGT shareholders, this is a positive outcome as it reduces the complexity of the group and increases the balance sheet efficiency, thus enabling investors to more clearly see how undervalued the group is on a sum-of-the-parts valuation (see 'Under the Bonnet', December 2018). As Euromoney shareholders, we are pleased to see this overhang removed and believe Euromoney's management will now have the freedom to pursue their own strategy unencumbered.

Finally, the Fund exited its residual positons in **Marks & Spencer** and **Majestic Wine**. In both cases the strategies have taken a different direction to our own thinking and, in doing so, removed our margin of safety. As we wrote last month, whilst Marks & Spencer's joint venture with Ocado is a bold move that will likely prove to be a success in time, the JV will not be operational until at least 18 months from now. In the meantime, the deal has introduced both valuation and execution risk.

We have written previously of our concerns over the direction of strategy at Majestic Wine ('Under the Bonnet', January 2019) and had been reducing our position. The remaining 28bps was sold on the news that management would be looking to close stores and cut the dividend in order to fund further investment in Naked Wines. We see the uncertainty these plans bring to the future of the core Majestic brands (Retail, Commercial and Lay & Wheeler) as immediately value destructive whilst the potential cutting of the dividend and full reliance on the high growth but low profitability Naked Wines as removing any remaining margin of safety.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12-month performance to:

	31.03.2019	31.03.2018	31.03.2017	31.03.2016	31.03.2015
A GBP class	1.99	4.24	29.40	-5.98	6.54
Benchmark	5.93	1.36	21.88	-4.42	6.87
Relative return	-3.72	2.84	6.17	-1.64	-0.31

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 31 March 2019. Inception date: 16 June 2008. Note: Performance data for the period 16 June 2008 to 22 October 2009 is for Ryder Court UK Dynamic Fund. From 23 October 2009 onwards, the Fund converted to JOHCM UK Dynamic Fund. All fund performance is shown against the FTSE All-Share TR Index (12pm adjusted). Performance of other share classes may vary and is available upon request.