Under the Bonnet

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Investment background

Global equity markets rose in July as the global services PMI survey enjoyed its best quarter in over two years and the continued devaluation of the US dollar sent the S&P 500, NASDAQ and Dow Jones Industrial Average to new all-time highs. Having fallen 2.9% in July, the trade-weighted US dollar has now endured its greatest six-month decline in six years following the US Federal Reserve's weakening view on the outlook for inflation and ongoing political turmoil in Washington. Strength in the euro has been marked, especially against the dollar, increasing 3.6% in July and 12.6% since the beginning of the year. Eurozone PMIs have continued to be robust, led mainly by manufacturing – the composite had its best quarter for over six years – but challenges may come if currency headwinds ensue.

In the UK, the FTSE All-Share Total Return rose 1.2%, regaining some of its losses after June's general election. The uncertainty that accompanied the Conservative party losing its parliamentary majority and media coverage of initial Brexit negotiations weighed on June's PMI numbers, with all showing an unsurprising slowdown in activity driven by weaker new business growth. Despite this slowdown, all PMIs remained in expansionary territory, and both the services and manufacturing sectors continued to show increases in employment. More marked was the decrease in consumer confidence, with GfK's index showing a return to the low point experienced immediately after last year's Brexit vote, driven by a decline in expectations for the general economic situation. Likewise the IHS Markit Household Finance Index (HFI) recorded the fastest deterioration in financial wellbeing for exactly three years, with the survey's measure of inflation perceptions remaining among the highest recorded since the start of 2014.

Whilst we are cognisant of the implications of a weaker consumer environment, we have written previously ('Under the Bonnet', May & June 2017) that we believe many of these headwinds on consumer spending to be transient in nature. Accordingly, it was pleasing to note that the Consumer Prices Index (CPI) 12-month rate was 2.6% in June, down from 2.9% in May, mainly because of a fall in petrol prices, a dynamic we had previously identified. Similarly, there are signs that with the unemployment rate at a record low of 4.5% (the lowest since 1975), wage inflation is beginning to occur, with permanent starting salaries rising at their fastest pace in 19 months, according to the Markit/REC Report on Jobs. With the full annualisation of the devaluation in sterling meaning a further rolling over in headline inflation is likely in July, it is maybe no surprise that July's Household Finance Index of expectations for finances in the next 12 month has already recorded an uplift from the lows seen in June.

Strategy update

The Fund outperformed its benchmark in July in returning 0.95%, net of fees, versus a 0.62% return for its benchmark, the FTSE All-Share Total Return Index (12pm adjusted). Positive returns were generated through stock selection and sector exposure, with the Fund benefiting in the latter case from not holding tobacco stocks, the worst-performing category (-10%) over the month following the news that the US Food and Drug Administration (FDA) wants to lower nicotine in cigarettes to non-addictive levels.

It was an extremely busy month for news flow on the Fund's positions, with updates and strategic actions coming from holdings representing over 50% of the Fund's capital. It is pleasing to report that this news flow was nearly all positive, with the only exception being the negative outcome of **AstraZeneca's** MYSTIC trial, where the Fund had only a minor active position (more details below).

News that **TT Electronics** had entered into a conditional agreement to sell its Transportation Sensing and Control division (TS&C) to AVX Corporation for a cash consideration of £118.8 million (equivalent to c.33% of the group's enterprise value) was arguably the most significant development for the Fund in the month. Although the deal is earnings dilutive in the short term, critically it is accretive at the free cash flow level, and it removes TT's subscale position in the global internal combustion engine market (the source of historic profit warnings and increasing investor concern in the face of growth in electric vehicles). The deal also provides the business with a net cash position and c. £150m of acquisition firepower to accelerate management's pivot towards higher margin, higher return, structural growth markets where there is increasing requirement for electric content. This is an exciting development for the equity story. Whilst it is in line with our own views on how this strategy might develop ('Under the Bonnet', April 2017), it has come significantly sooner than we would have expected, which is testimony to the quality of this management team and the momentum in this turnaround. The Fund continues to hold a full active position.

Elsewhere, the Fund benefited from a wide range of positive statements: the Fund's largest active position, **Electrocomponents**, issued another positive trading update as the Q1 revenue growth rate accelerated from mid-single-digit to double-digit across all regions globally, whilst the Americas division sustained its quarterly growth rate of 16%; top five position, **3i Group** saw its NAV grow 4.1% in Q1, driven by earnings increasing across the portfolio; continued volume growth in GB Stills at **Britvic** underpinned stronger-than-expected organic sales growth in Q3, leading many analysts to upgrade their full-year expectations; an in-line H1 update at **National Express** was accompanied by management commentary that changes to the concessions bidding methodology in Spain (c.36% of group profits) has changed such that the business is now worth "materially more" to the group; **Anglo American's** H1 numbers demonstrated further success in cash generation and balance sheet management, with net debt now significantly below the full-year target at US$6.2bn (vs US$7.0bn) and at less than 1x net debt/EBITDA; looking through the one-offs associated with the wind-up of the non-core bank, **Barclays'** H1 numbers showed Common Equity Tier 1 capital ahead of consensus forecasts and the introduction of a new 10% ROTE target "in time"; H1 at **Lloyds Banking Group** saw continued net interest margin (NIM) growth and improved 2017 NIM and asset quality guidance; **McBride's** full-year trading statement confirmed operating profits were to be in line with expectations despite competitive pressures and raw material price inflation; **Numis** reported a strong trading update for the year, with marked increases in the Corporate Broking & Advisory fee generation; and **Chemring** confirmed that its Countermeasures USA business had been awarded a multi-year contract for flares worth US$28m by the US Army.

Despite re-affirming its guidance outlined in May of expectations for steady progress in FY18, **QinetiQ's** Q1 trading statement had the undesired effect of worsening the already weak share price, leading to a 40bp headwind to the Fund's performance in July. This came on top of the previous month's 38bp headwind. As detailed last month ('Under the Bonnet', July 2017), we remain puzzled by the significant decline in the share price (c.25% in two months) on seemingly no news. Management seem just as bemused, as denoted by the CEO, CFO, Chairman and three non-executive directors all buying stock totalling £244k during the recent share price weakness. We continue to back management's new growth strategy and have been carefully rebuilding our position in this top five active holding.

We previously detailed ('Under the Bonnet', June 2017) that we still had a 100bp active position in the long-running turnaround story at **AstraZeneca**. We believed that despite the strong share price performance following the PACIFIC trial success in May, the share price still undervalued the probability-weighted outcome of the forthcoming blockbuster MYSTIC trial – a potential US$15bn market opportunity in immuno-oncology. With the share price strengthening further since we last wrote, the active position in the Fund was reduced to reflect the corresponding reduction in the risk weighted pay-off, resulting in a small active position of less than 50bps at the beginning of July. On 27 July it was announced that the MYSTIC trial had failed to reach its primary end point of progression free survival, and the shares fell 15% to 4287p. We wrote that our working assumption was that the share price could fall close to 3600p if the trial failed to meet its primary end point. However, the announcement was accompanied by news that AstraZeneca's FLAURA trial in Tagrisso was a success (a c. US$2bn market opportunity) and, additionally, that it had entered into a strategic oncology collaboration with Merck to co-commercialise AstraZeneca's PARP inhibitor (Lynparza) in exchange for a total contingent consideration of up to US$8.5bn. These announcements are testimony to the value in the AstraZeneca portfolio beyond the MYSTIC trial. Nonetheless, with the shares now reflecting this information and trading at a premium to our fair value, the Fund's active position was cut to neutral immediately. The total impact on the Fund was a negative 8bps of relative return in the month. The remaining absolute position is under consideration.

GlaxoSmithKline (GSK) announced its Q2 results and new CEO, Emma Walmsley, presented her first Investor Day. Our active position in GSK has long been predicated on the market underappreciating (only 38% analyst 'Buy' recommendations) the operational improvements that have been undertaken by ex-CEO Andrew Witty and hence undervaluing the cash generating potential of the individual businesses. Q2 numbers illustrated that this was still the case, with strong margin growth continuing to come through in Vaccines and Consumer, which pushed EPS ahead of consensus forecasts, albeit the acquisition of a priority review voucher (which had been previously announced) led to a lower 2017 Core EPS guidance. Whilst the headlines will say Walmsley's new strategy is more evolution than revolution, with no immediate changes to group structure, we have been impressed by the speed and depth of change that is being outlined within the organisation, particularly with regards to a focusing of capital allocation within Pharmaceuticals. Notable actions announced so far include: a focus on four therapeutic areas (respiratory, HIV, oncology, immuno-inflammation); termination of other initiatives including 30 clinical and preclinical R&D programmes; potential sale of the "rare diseases" business (maybe worth £2-3bn); termination of the sirukumab programme with Johnson & Johnson; potential divestment of 130 non-core brands totalling £500m; and extension of the cost-reduction programme to target £1bn by 2020. In addition, GSK has committed to an 80p dividend for 2018 and is aiming to build free cash flow cover to a target of 1.25x-1.5x. Whilst it is still early days in this the new strategy, we see this strict cash focus as an encouraging starting point, and so too the current 5.3% dividend yield.

Finally, we sold the Fund's small positon in **Pearson**. This followed the announcement that the company had disposed of only 22% of Penguin Random House (PRH), compared to our (and the market's) expectation of the full 47%, plus the news that the dividend policy would change to earnings cover in excess of 2x, implying a larger cut than expected despite the extra cash flows implied by retaining the stake in PRH. As we previously wrote ('Under the Bonnet', June 2017), the margin of safety was particularly important in this story given the structural issues that surrounded the investment case. Although we are still working to fully assess these issues, the larger reduction in the dividend reduced the margin of safety to an insufficient level whilst also maybe indicating that that management's own view of the speed of the turnaround had also softened. We will continue to monitor this dynamic situation.