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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro
Capital Management Group

Under the Bonnet

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Investment background

Further strong economic data in July pushed global equity markets to three-month highs whilst in the US the NASDAQ 100 reached a new all-time high. J P Morgan's global services PMI registered business activity rising at one of the fastest rates in over three years in June. The US remained the main driver of global services growth – output growth was the second fastest since April 2015 – but significant contributions also came from the eurozone (a four-month high) and, notably, the UK (an eight-month high). Global growth in manufacturing was more muted as the effects of tariffs put pressure on input prices, whilst the prospect of further trade tensions weighed on business optimism. In the eurozone, this has led to a reversal of the positive momentum experienced throughout 2017, with June's manufacturing PMI posting an 18-month low of 54.9, down from 55.5 in May, as business optimism slumped to its lowest level in over two-and-a-half years. By the end of the month there were signs that these trade tensions might be peaking with US President Trump and EU Commission President Juncker agreeing to commence talks on freer trade.

In the UK, July was marked by political turmoil. The news on 7th July that Theresa May's cabinet had reached a "collective" agreement on the proposals for the UK's future relationship with the EU proved to be short lived. A string of resignations followed, including Brexit Secretary David Davis and Foreign Secretary Boris Johnson, in objection to the softer negotiating stance that the agreement had outlined. Despite accompanying fears of a party leadership challenge, markets remained broadly unchanged, suggesting that investors continue to welcome a softer EU exit, regardless of the political cost. Following Theresa May's subsequent victories in passing the amended customs and trade bills, tabled by Brexiteer Tories, thereby fighting off the Remainer rebellion (albeit with a small majority), sterling depreciated 1.7% against the US dollar and 1.3% against the euro, whilst also temporarily pushing the UK 10-year Gilt yield down to a low of 1.17% - its lowest level this year bar the Italian political crisis in May. Further Conservative ministers resigned, this time in objection to the harder negotiating stance, leaving the total resignations related to the Brexit negotiations at eight in the month. We wrote in the Fund's year-end review that the forthcoming UK and EU trade negotiations would "no doubt cause plenty of volatility" ('Under the Bonnet', January 2018). As we draw closer to the October negotiation deadline, it seems sensible to believe this volatility will only intensify.

The prolonged uncertainty surrounding Brexit continued to shroud a strengthening underlying UK economy. July's ONS data showed the jobs market breaking new records, with the employment rate reaching its highest level since records began in 1971 and the unemployment rate being the joint lowest since 1975. Correspondingly, growth in real wages continued, with latest estimates showing an increase of 0.4% excluding bonuses and 0.2% including bonuses. At a household level, there is much to be cheerful about. IHS Markit's Household Finance index (HFI) registered its second highest level since December 2016, an improvement in job security for the first time since the survey began in 2009, the strongest improvement in incomes in the survey's history and one of the fastest rises in spending since early-2015. Despite all of this, the warm weather and World Cup fever, GfK's confidence index fell by a further point in July to -10, as improvements in consumer views of their personal financial situation were more than offset by increasing concerns over the wider economic situation, combined with a declining propensity to make major purchases. As we have written many times before, certainty remains the missing link for the UK economy.

Strategy update

The Fund underperformed in July returning -0.04% against a showing of 1.09% by its the benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing total underperformance of 111bps. This marks the worst month of performance for the Fund since June 2016, the month of the EU referendum. Whilst clearly a disappointing outcome, there were clear macro and technical effects at play, leading share prices to not accurately reflect the underlying operating improvements in many of the Fund's holdings.

Allocation effects accounted for a third of the underperformance. Not owning British American Tobacco, AstraZeneca and Reckitt Benckiser provided a 70bp headwind, as all three experienced marked share price increases post their updates. The size of these share price moves were as much a reflection of the corresponding sector performances as they were of positive changes in the fundamental stories – in the case of British American Tobacco, volumes actually came in below analysts' expectations. Consumer goods and healthcare (sectors where the Fund has its largest underweights) had the biggest positive contribution to overall market performance in the month, as investors sought defensive, overseas-earning stocks to hedge against increasing fears of a hard Brexit outcome. Offsetting this, the Fund benefited from not owning Glencore (+15bps), where the shares fell following news of a subpoena from the US Department of Justice in relation to a money laundering probe.

It is disappointing that two thirds of underperformance came from stock selection, not least because it was a busy month for the Fund, with half of its positions providing updates. Contrary to the Fund's overall performance, there were no notable negative updates to report. The largest contributor to underperformance in the month was **Urban & Civic** (-29bps), where shares came under pressure following the placing of a 27.9% stake in the company that was previously owned by private equity. It is likely the resulting technical weakness could last a couple of months given the scale of the placing. However, the ease at which it was executed (the

book build took just a day) illustrates the investor support for this management team, whilst the resulting increased liquidity in the shares is a welcome development. Urban & Civic remains a full conviction position for the Fund.

Morrisons and **3i Group** were the top two performers for the Fund. The former benefited from a recommendation and earnings upgrade at UBS, taking the number of 'buy' recommendations to four, still representing just 22% of all analyst recommendations. This contrarian position remains a top three position for the Fund.

3i Group's share price rallied following an impressive quarter-on-quarter NAV increase of 5%, driven predominantly by strong portfolio earnings growth. The value of the largest holding, discount retailer Action, increased 7%. Encouragingly, there were also strong levels of investment and realisations in what is typically a quiet quarter, suggesting a good pipeline of opportunities to generate future returns. 3i also remains a top three position in the Fund.

The Fund's largest position, **Electrocomponents**, also reported a strong Q1, with analysts having to upgrade earnings estimates as organic growth continued at the previous quarter's rate of 10%. This was an impressive performance given the company had previously guided to there being "tough trading comparators" in the quarter. Despite this marked sequential momentum, the shares underperformed the FTSE All-Share by 6.5% (a 27bp headwind for the Fund), as the market became fixated on the implications of rising global trade tensions for industrial stocks.

Shares at **SIG**, the speciality building products distributor, also underperformed (-19bps). Whilst an interim trading update confirmed management's underlying profitability expectations for the year, this failed to allay investor concerns of a cyclical slowdown, especially in light of the political turmoil in the UK. Profit warnings from construction materials peers Travis Perkins and Ibstock (neither owned by the Fund) no doubt weighed on sector sentiment. However, it must be noted that Travis Perkins's warning was related to competitor issues with its DIY chain Wickes, rather than its trade- focused businesses, which experienced good trading momentum. At Ibstock, meanwhile, the warning resulted from production issues caused by operating at full capacity for several years. Both statements suggest good underlying demand for building products in the UK, which is encouraging in light of the H2 weighting to SIG's full-year numbers resulting from poor weather in Q1, the usual seasonality of the business and the timing of management's transformational plans for the business. Management continue to highlight the scope for delivering "meaningful cost benefits" at this market-leading distributor. This should, in turn, lead to good earnings growth and a path to increasing returns over time. It is still very early days in this turnaround story.

There were a number of notable updates which went unrewarded in share price terms despite clear underlying improvements. **QinetiQ**'s Q1 trading update, whilst only confirming trading as in line with expectations at this stage, reported organic revenue growth in both EMEA Services and Global Products. It continued to win campaigns-based business on major government-funded programmes in the former, whilst demand for its robots and survivability products drove the latter. Although earnings continue to face headwinds from lower margin single-source UK revenues in the short term, evidence that growth is being delivered despite this and through building out exposures to structural growth markets outside the UK is encouraging. As outlined previously ('Under the Bonnet', June 2018), the shares remain an enticing proposition, in our view, at just 8x EV/EBITDA for a business with a net cash balance sheet and significant revenue visibility as a result of its long-term contract work. QinetiQ remains the Fund's fourth largest position.

Similarly, headlines for **DMGT**'s Q3 results of flat nine-month organic growth in line with market expectations may have looked uninteresting. Nevertheless, within this there was a reacceleration in MailOnline's advertising revenues despite GDPR and, for the third quarter in a row, RMS delivered faster than expected revenue growth. As we wrote two months ago ('Under the Bonnet', June 2018), DMGT possess a number of under-earning assets with the largest of these being RMS, thus evidence that revenue growth accelerated to high-single-digit levels in Q3 is particularly encouraging in terms of value creation. This is another business with net cash providing management with powerful optionality over how to generate future returns.

Finally, there were encouraging interim results from **Moneysupermarket**, a new position in the Fund. The Fund initially built its position at the end of February after the share price collapsed by over 20% following the announcement that EBITDA growth for FY18 would be flat (9% below consensus estimates), as the relatively new CEO took on further operating costs (50 additional programmers based in Manchester) in order to invest in the mobile offering and optimise customer journeys. This provided a rare valuation opportunity to buy into a management change situation in a highly cash generative (c. 7% free cash flow yield at the time), market-leading business with high growth end markets. The Fund rarely finds sufficient margin of safety in such high growth stories, but the current harsh environment for UK stocks is throwing up an array of new opportunities.

Moneysupermarket's management are confident they can return the revenue growth run rate back to market levels of 6-7% by the end of this year through redeveloping the user interface, yet the share price at the time implied the market believed they would only achieve c. 3% growth to perpetuity. This was a significant expectations gap that seemed unjustified given the company had spent the last four years replatforming its entire IT infrastructure to create market-leading functionalities. Since then revenue growth was 4% in Q1 and 6% for Q2 (5% for the H1 as a whole). Importantly, management divulged at the interims that customer experience optimisation in their Energy offering has already delivered 50% improvements in customer conversion in just six months. Energy is part of Home Services, which itself represents less than 13% of total group revenues. Therefore, just by focusing on customer experience optimisation in the rest of the business over the next 6-12 months, there are clear levers to drive significant growth without any further capital required. This is merely the beginning of what looks to be a very interesting story, with further growth optionality in forming new partnerships, creating electronic mortgage services and rolling out new APIs (application programming interfaces), so as to leverage the existing price comparison skill set and database of 13.2 million active customers. The shares rallied up 6% on the day of the interims but, in a similar vein to the examples above, subsequently reversed their gains to underperform the FTSE All-Share index over the month.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance to

	31.07.2018	31.07.2017	31.07.2016	31.07.2015	31.07.2014
JOHCM UK Dynamic Fund	10.31	23.86	0.97	7.27	10.91
Benchmark	9.17	15.33	4.06	4.42	6.31
Relative return	1.04	7.40	-2.97	2.72	4.32

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 31 July 2018. 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.

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