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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

# Under the Bonnet


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### Investment background

When we come to reflect on 2019, July will likely be seen as decisive. It was a month in which geopolitical brinkmanship came to a head, leading government and central bank policies to be reappraised globally and which ultimately may lead to a new market narrative.

It is always darkest before dawn. Global bond yields collapsed in July to all-time lows as investors crowded further into defensive positions following continued weak economic data, particularly from the eurozone, and clear signs that US-China trade tensions were escalating following the collapse of negotiations and the imposition of additional tariffs on Chinese goods by US President Trump. Markets were alarmed by the severity of Trump's new tariffs, which included, for the first time, items that would directly affect prices paid by US consumers.

The escalation of the trade war just a day after President Trump publically expressed his disappointment with the Federal Reserve for cutting rates by only 25bps is the clearest signal yet that US international trade policy is as much, if not more so, about domestic policy. But evidence is building that Trump's strategy may not be translating as effectively as hoped: employment growth in important vote swing states has stagnated[1] and Trump's own poll ratings are showing some recent signs of weakness[2]. With the US yield curve subsequently inverting and increasing headlines of recessionary fears, there are signs that uncertainty may be beginning to build in the US domestic economy. One wonders how much further President Trump can afford to push his existing strategy as he approaches an election year.

A retraction of some of the most recent Chinese tariffs has already begun and, separately, President Trump has openly suggested a humane solution from China to the Hong Kong protests as a pre-requisite to a trade deal. Has policy already begun to pivot? If so, one should not underestimate the economic potency of the Federal Reserve cutting rates for the first time since the Global Financial Crisis in an economy which is experiencing growth in employment, wages, and currently already has expansionary PMI surveys.

Eurozone manufacturing has continued to bear the brunt of the global economic slowdown, now in its fifth consecutive month of contraction, with reductions in employment now being felt in Germany, Italy and Spain. The continued resilience of the services sector is also increasingly looking uncertain, with business sentiment at a 4.5 year low. This has led the ECB's outgoing head, Mario Draghi, to state the ECB must "stand ready to adjust all of its instruments" if the economic situation worsens further.

With negative interest rates across the eurozone, TLTRO III (Targeted Long-Term Refinancing Operations) already beginning in September and suggestions now of a negative tiering system for deposits, one wonders how much further monetary policy can be pushed. The real world effects are already being felt, particularly in the eurozone's heartland, Germany. Germany's constitutional court is hearing a long-running case on whether the ECB's asset purchase programme is potentially prohibited by EU law, a local German bank has had to close 20,000 savings accounts due to prolonged low interest rates and the Financial Times recently reported that German media is "habitually referring to negative interest rates as penalty rates — a fine levied by the ECB to punish German savers".

It would appear that the European electorate may already be losing patience with existing policy. We wonder, further still, what implications this backdrop may have for the EU's continued stance of no renegotiation of the withdrawal agreement with the UK. Can the EU currently afford a disorderly Brexit?

In the UK, policy has already been forced to change. The new Prime Minister, Boris Johnson, and his cabinet are now all arch Leave voters, with a clear ambition to exit the EU by 31 October 2019. The most recent YouGov voting intentions survey has the Brexit Party as the fourth largest party, with still 14% share of vote, whilst a recent ComRes survey showed 44% of respondents believed Boris Johnson needed to deliver Brexit by whatever means (this rose to 54% if the 19% who declined to offer an opinion were excluded). There appears to be a clear electoral mandate to end the uncertainty that has weighed on the UK economy over the last three years.

With Boris Johnson already touting an end to austerity, tax breaks and increased investment, consumer confidence has begun to stabilise, aided by the continued resilience of the UK jobs market. GfK's consumer survey showed expectations of future finances rose to a one-year high, IHS/Markit's Household Finance index rose for the second month in a row – the first time since 2016 – and real wage growth of 1.7% reached its highest level for a number of years. Whilst corporate confidence remains under pressure, with Deloitte's Q2 CFO survey registering an all-time high of 83% of respondents believing Brexit will worsen the business environment, one wonders how much worse those expectations can get and how much longer Parliament can afford to delay Brexit. Despite corporate objections, with the same ComRes poll showing that 88% of respondents feel Parliament is "out of touch" with the British public, it feels this new Brexit narrative shift is here to stay.

[1]BofAML The Flow Show 8th August 2019, "Unemployment claims in 2020 US election battleground sates.."

[2]news.gallup.com/poll/203207/trump-job-approval-weekly.aspx.

### Strategy update

The Fund underperformed in July, rising by 0.57% against the FTSE All-Share TR index (12 pm adjusted), which rose by 2.28%. This underperformance was driven in the main by the asset allocation preferences of a deeply defensive and mildly hysterical stock market that has resulted in fairly indiscriminate selling of any company which has UK and/or global trade exposures.

UK economy-exposed companies were prominent on the list of the Fund's top 10 underperforming investments over the month, with **Moneysupermarket, Urban & Civic, St Modwen, Morrisons** and **Lloyds Banking Group** in combination costing the Fund c. 93bps of relative performance. This was despite strong news flow from many of these names, some of which we review below.

**Moneysupermarket** results for H1 were in line with or slightly ahead of expectations, although the shares fell, reversing the prior month's strong performance, with the market perhaps disappointed that there was not an upgrade to full-year numbers accompanying the release. Much of the H1 outperformance was due to a very strong performance from the energy-switching market, driven by both a strong underlying market (caused by the increase in the default tariff cap in the first half) but also by underlying market share gains from Moneysupermarket. There was also a strong performance from the company's B2B division and specifically from Decision Tech, a business acquired in 2018 and which grew revenues by 30% in the first half. Whilst the short-term performance was encouraging, progress on some of the longer-term initiatives was of more interest to us. We believe there is a good opportunity for Moneysupermarket to develop a deeper and more relevant mortgage proposition. To that end, it was interesting to note that the company signed an agreement with Nationwide in the first half to integrate directly with the lender and offer specific rates for re-mortgage customers. This initial pilot has now been followed by a similar agreement with Santander.

**St. Modwen's** half-year results were good, although NAV growth, at 1.3%, was slightly held back by valuation markdowns across the company's remaining retail portfolio (which now represents a very small c.5% of its overall portfolio). This is a legacy issue and takes nothing away from the extraordinary progress that has been made over the last two years to de-risk this balance sheet (LTV now c. 20% and portfolio quality much improved) and create a strong growth platform. The business is endowed with an extremely strong landbank, which provides the opportunity for many years of internally led growth and in turn the possibility for double-digit annual total returns. The current committed development pipeline of 1.6m sq ft in the industrial & logistics division is comparable in scale, if not larger, than Segro's current committed UK pipeline. (Segro is a business ten times larger than St. Modwen.) The total industrial and logistics pipeline is in excess of 15m sq ft. The housebuilding business delivered volume growth of 36% in H1 (against a target of 25%) and an increase in operating margins. The landbank for this part of the business supports substantial growth for the next 10 years and as a standalone business could potentially be valued at c. £400m. But with the regeneration business alongside, with which it is relatively integrated, perhaps as much as £800m - £1bn. With the whole group currently trading at a market capitalisation of £800m and with no requirement for new capital, there is real, intrinsic value in the shares, in our view.

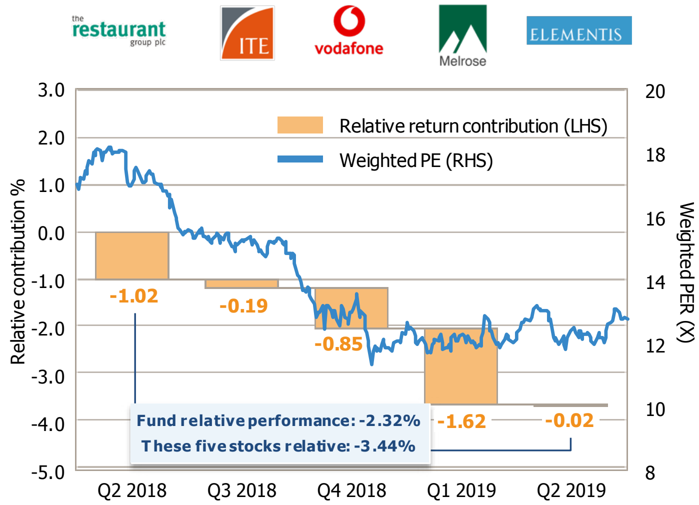
**Lloyds Banking Group** was affected by a larger than expected increase in PPI provisions, with interim results and a word of caution about the current market conditions in the UK that perhaps shouldn't have been a major surprise to the stock market. Competition in the mortgage market at the moment and the current interest rate environment is a slight drag on net interest margins and, of course, with the obvious UK exposures it is an easy decision for fast money to sell or short the shares. Whilst we do not expect the shares to perform well in the short term, the strong core tier 1 ratio of 14.6% (against a target of 13.5%), the 7% dividend and the ongoing capital generation of c. 170-200bps / year supporting steady growth in that dividend, the healthy underlying return on tangible equity of c. 13-14%, but now at a 10% discount to tangible NAV / share of 54p all suggest to us that the shares are very undervalued.

Elsewhere, the Fund was affected by a decline in **Anglo American** shares as Vulcan investments decided to unwind and cash in a structured product put in place in 2017. The accompanying share placement deflated the share price that had been strong in response to the recent rise in some commodity prices and excellent half-year results. We remain high conviction owners of this business transformation story that now has the balance sheet and growth prospects to continue delivering for shareholders.

Despite some shorter-term share price pressures, more broadly the Fund continued to experience positive news flow across the majority of its holdings, a consistent, but as yet largely unrewarded, theme this year.

Whilst not making excuses we have tried to emphasise that performance has suffered from, in particular, five M&A transactions in 2018 that had a damaging effect on the share prices of the companies making the acquisitions. The five stocks are **The Restaurant Group, Elementis, ITE, Melrose** and **Vodafone.** In the 15 months to 30 June 2019, these stocks cost the Fund 344 bps of relative performance. The Fund's total underperformance (i.e. versus the FTSE All-Share Total return index) over that period was 232bps, and so we see that they more than accounted for any underperformance.

### Idiosyncratic – negatives starting to abate




Source: JOHCM. Note: The above shows quarter by quarter discrete contribution to relative performance of five individual stocks (The Restaurant Group, ITE, Melrose, Vodafone, Elementis) from 1 April 2018 – 30 June 2019. PE line of those five stocks over the same time period is weighted by current position size as at 30 June 2019.

The question we pose ourselves is whether and when we will get some performance back from these self-inflicted issues. Interestingly, these stocks started to stabilise in July and recover for the right reasons – results and news flow. All five made a positive contribution to relative performance, in total amounting to 114bps, but all of this was offset elsewhere, not by bad news from the Fund's stocks but from market mix and de-ratings.

It was particularly pleasing to see better than expected Q1 results from **Vodafone**, which highlighted an improvement in underlying conditions in a number of core markets, confirmation of full-year forecasts and the highly encouraging decision to monetise a substantial part of its valuable European Tower infrastructure assets over the next 18 months. The combination of these pieces of news served to change the debate on the stock and the shares closed the month up 16%. With the Liberty Global transaction now complete, the dividend cut, a de-leveraging story in place and the promise of continued and value-accretive portfolio restructuring, we look forward to a better period of performance from the shares.

**The Restaurant Group** shares also had a strong month, rising by 15%, in part due to its concessions business winning multiple sites at the new Manchester Terminal 2, including a Wagamama. This reaffirmed to us the undoubted synergies available by bringing the Wagamama brand into the group and proved that the debate on the stock should not just be about the struggling Leisure estate. We await half-year results, which should confirm similar recent trends, although we would caution that the recent sterling move may have a slight inflationary effect on the cost base given a number of euro purchasing costs.

**Elementis** released its interim results, which although confirming a tough six months of trading, also broadly confirmed the full-year outlook and delivered a better than expected cash performance that helped allay some concerns around the balance sheet. The shares partially recovered in response, although after a torrid 12 months which has broadly seen the shares halve, there is a long way to go to recover value here. Nonetheless, this was a pleasing stabilisation in trends and important in re-establishing some board credibility.

**Aggreko** is a newer idea worthy of mention. Its first-half results were ahead of expectations and continued to show improved capital discipline under the current management team. Whilst market conditions are tough, there is a real ability for this business to help itself through driving asset utilisation whilst also broadening the scope and relevance of its offer through integrating more energy efficient technology. Having bought a battery storage business, Younicos, in 2017, with these results the company announced the launch of Y.Cube, a mobile and modular energy storage system that integrates with existing thermal power systems. This is a key development playing to the heart of energy efficiency and has already attracted considerable client interest across multiple sectors. With the focus on return on invested capital (targeting mid-teens by 2020), improving cash generation and with a substantial legacy debtor book that is being methodically managed lower by new CFO Heath Drewett, the combination offers the real opportunity for better-than-expected debt paydown in the short run. There is a real chance that this might lead to an underleveraged balance sheet in the next 12-18 months, which will release capital for growth or for higher shareholder distributions. Ongoing analyst scepticism of this company and strategy looks a little misplaced.

Fund performance over the 18 months to end of June could have been better but was broadly in line with the UK market over that period of time and, in fact, when measured against some peers, particularly the more value-oriented, compares reasonably well. It is worth noting that the Fund's since inception Lipper ranking climbed from 11th to 9th (in the UK All Companies sector) between Q2 18 and Q2 19. Having said that, our standards are high, and we are disappointed that the Fund has not done better.

So, whilst July was tougher for performance, and this has carried through into the start of August (as we write this), we hope we have been clear about why this is the case. As a reminder, we do carry some UK exposure (c. 30% of the Fund's assets) due to the extraordinary valuation disparity available in this market coupled with high conviction transformation opportunities. We also do have some short-cycle industrial exposure (c.10% of the Fund) through a few stocks that happen to manufacture or distribute components to industrial or electronics customers across the globe. These are also high conviction business transformation stories including **Electrocomponents, Essentra, Melrose, TT Electronics** and **Elementis**.

In a tough external environment and in combination with some idiosyncratic issues and general apathy towards 'value' and valuation in the stock market, we are confident about where we are and where we are going. We do not control the external environment, but we do back situations where, through self-help, there is the ability for management to control at least some of their financial outcomes. History has shown that when conditions normalise and headwinds die down or become tailwinds, this drives substantial Fund outperformance.

With regards to the Fund's ability to outperform at this scale – a question it is now common for us to be asked – we have absolutely no concerns. The Fund has rarely allocated a large amount to smaller capitalisation companies (since inception c. 10% allocation to smaller cap stocks) and has never invested in companies with a free float market cap below £100m. In 2015, when the Fund was much smaller, we decided to vacate the smallest and most illiquid end of the market below £250m market capitalisation. The majority of returns from this Fund have always been delivered from FTSE 350 companies. We also run a low turnover strategy where returns are not dependent on being able to quickly trade in and out of companies. We believe we are employed to think and allocate capital for the long term, within an OEIC structure.

This Fund's strategy of focusing on long-term business transformation remains a highly relevant, differentiated and competitive value proposition within the UK All Companies Funds sector.

## JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

| | 31.07.19 | 31.07.18 | 31.07.17 | 31.07.16 | 31.07.15 |
|---|---|---|---|---|---|
| A GBP Class | -2.81 | 10.31 | 23.86 | 0.97 | 7.27 |
| Benchmark | 1.33 | 9.17 | 15.33 | 4.06 | 4.42 |
| Relative return | -4.08 | 1.04 | 7.40 | -2.97 | 2.72 |

**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 July 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). Relative return caculated on a geometric basis. Performance of other share classes may vary and is available upon request.