February 2019
FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

Alex Savvides & Tom Matthews, JOHCM UK Dynamic Fund

Investment background

A confluence of factors led global equity markets to rally in January. Market sentiment, initially negative following the sharp price declines at the end of 2018, changed course following the People's Bank of China announcement of a 100 basis point cut to the banking reserve ratio accompanied by the Chinese premier Li Keqiang urging banks to increase lending into the private sector. Markets became further assured by rumoured progress in the ongoing US-China trade dispute and a strong US non-farm payroll for December – 312,000 jobs added represented the largest increase since February, beating estimates of 180,000, while there were upward revisions to the previous two months' job numbers. Remarks from Federal Reserve Chairman Powell added to the market optimism. He softened his previous month's hawkish tone, commenting that there was now no "pre-set path" for monetary policy and the Fed would be "patient" in deciding whether to press ahead with additional interest rate rises. Markets rallied further, with the S&P 500 (total return) and NASDAQ 100 (total return) surging 8.0% and 9.2% over the month, respectively, in US dollar terms, to be up over three months.

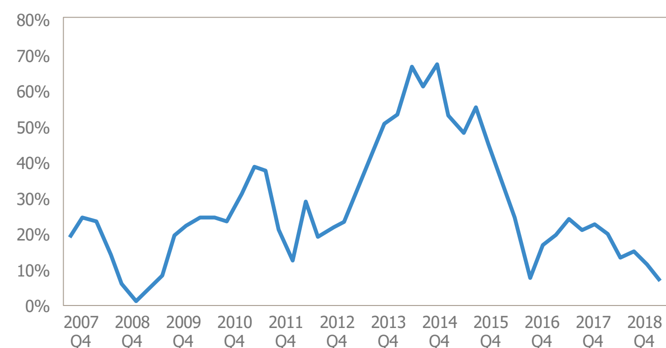
Outside of the US, there was little economic data to cheer. The J P Morgan global services PMI average reading for Q4 was the weakest since Q4 2016, whilst the global manufacturing PMI for December fell to a 27-month low, dragging the quarterly reading down to the lowest level since Q3 2016. Economic data from Europe was once again the source of much of this slowdown. Headwinds from international trade wars were exacerbated by disruption from the 'gilets jaunes' movement in France and ongoing challenges within the continent's autos industry. In manufacturing, the eurozone's 'big four' economies posted the lowest PMI readings in the region; Italy remained in contraction at 49.2; France fell into contraction for the first time in 27 months at 49.7; and Germany (51.5) and Spain (51.1) fell to 33-month and 28-month lows respectively. There was a similarly marked slowdown in services. The subsequent Eurozone flash composite PMI reading of just 50.7 for January showed a further deterioration in conditions, with growth close to stalling at a five-and-a-half year low.

In the UK, the focus was once again on parliament. First, the House of Commons rejected Prime Minister Theresa May's negotiated EU Withdrawal Treaty by a margin of 432-202 (the largest defeat for a sitting government in history), which subsequently led to a vote of no confidence. Conversely, sterling rose to a near two-month high against the euro and back to the two-month high level it had begun the day at against the US dollar. With Theresa May surviving the vote and growing signs of parliamentary factions looking for a softer Brexit, sterling strengthened further to reach a three-month high against the US dollar and 9-month high against the euro. These gains partially reversed when MPs rallied behind Theresa May to pass the Brady amendment, mandating the prime minister to re-open talks with the EU in order to find 'alternative arrangements' for the Irish backstop, thereby taking negotiations to the brink. Sterling's strength aided the rally in the FTSE 250 total return index, which rose 7.1% to be just short of its starting point three months before, whilst the FTSE All-Share Total Return index rose 4.2%, its best start to the year since 2013.

Despite the ongoing political uncertainty, UK jobs data continued to strengthen and real wages continued to increase (1.1% year-on-year excluding bonuses). Confidence again, though, remained the missing link. The UK services PMI rose only slightly from its 28-month low in November, with Brexit related concerns weighing on business spending and a number of firms noting subdued consumer demand. The survey also recorded the degree of confidence towards the coming year as the second weakest since March 2009 - the same month that the FTSE All-Share reached its lowest point post the financial crisis. A similar message was echoed by the Q4 Deloitte UK CFO survey in which only 7% of respondents agreed with the statement that "this was a good time to be taking greater risk on your balance sheet" – its lowest reading since Q1 2009 (see chart below). However, while the Deloitte survey still ranked the effects of Brexit as the greatest concern amongst UK CFOs, the percentage of CFOs citing this fell quarter-on-quarter whilst it was concerns over the effects of an escalating US trade war that saw the largest increase over the period.

Corporate risk appetite

% of CFOs who think this is a good time to take greater risk onto their balance sheets



Source: The Deloitte CFO Survey, Q4 2018.

Strategy update

The Fund outperformed in January, returning 6.11% against a 4.59% showing for its benchmark, the FTSE All-Share TR (12pm adjusted) index, representing a total (geometric) outperformance of 145bps. It is pleasing to report that over three quarters of this outperformance came from stock selection, not least because the Fund had updates from positions representing over 40% of absolute capital but also following what had been a tough period for stock selection in the second half of last year.

The largest contribution to outperformance came from the Fund's active positions in financials. **3i Group** led the way here after it regained all its previous month's price losses (in relative and absolute terms) following its Q3 trading update. Elsewhere in the sector, there were share price gains for **Lloyds Banking Group** and **Aviva** as investor appetite for UK domestic assets showed signs of improving in the New Year.

Of note in 3i's trading update, the Fund's second largest active

position, was continued NAV progression ahead of analyst expectations, driven by valuation increases in all of the top six private equity assets. 3i's largest asset, Action, saw the greatest quarterly NAV increase (+6.7%) following a strong December which contributed to a 23% revenue growth number for the full year. Importantly, December's sales performance came as a result of significantly improved like-for-likes in France, as supply chain issues, which had hindered performance in the previous quarter, were resolved. Action looks well placed to continue its impressive growth trajectory, with a new distribution centre having just opened near Lyon, France, and a further one scheduled to open in Germany in late February, thereby taking the total footprint from five to seven in just two months.

It is most pleasing to report that outperformance also came from the Fund's consumer services holdings, currently its largest sector overweight and at its highest levels since the Fund's launch in June 2008. Outperformance came not just from allocation effects as the sector responded well to sterling's strength, but also from stock selection led by active positions in **Tesco** and **Morrison**.

Tesco was the stand out winner amongst the listed supermarket players over Christmas, posting like-for-like sales growth in the UK of +2.2%, outperforming the market in both volume and value terms despite continuing to invest in price via the relaunch of its 'Exclusively at Tesco' ranges (95% complete at the end of the period). Whilst the relaunch had caused some disruption in Q3, leading to LFL sales growth of just +0.7%, overall UK sales volumes were already outperforming the market by the end of the quarter. In an increasingly competitive environment, there are clear signs that Tesco is effectively using its scale to drive sustainable efficiencies and re-invest these in the customer proposition to attract further volume, ultimately leading to higher returns and cash flows for shareholders in time.

Tesco's strategy very much echoes that laid out three years ago by Morrisons' management, which in turn has led to the increased cash returns to shareholder which began in earnest last year ('Under the Bonnet', April 2018). Morrisons' Christmas retail like-for-like sales figures came in slightly ahead of analyst expectations, although looked meagre in comparison to Tesco at just +0.6%, in part due to a strong comparator which benefited from competitor supply chain disruption following the distributor Palmer & Harvey going into administration last year. Progress in the wholesale growth channel was more muted than expected at just +3.0%, albeit this is a lumpy revenue line reliant on the phasing of the McColls supply agreement and the winning of new contracts. Wholesale is an important part of the Morrisons' growth story as it provides a key lever for driving volume through the vertically integrated business. Progress here will be keenly watched. While the timing and size of any new contracts is difficult to predict, further opportunities to build scale may come from the forthcoming Competition and Markets Authority (CMA) ruling on the Sainsburys/Asda merger. If approved, remedial action could lead to a large number of new store acquisition opportunities for Morrisons and, to a much lesser extent, Tesco.

Other consumers service holding updates included retailers **Marks & Spencer**, **Majestic Wine** and, in leisure, **The Restaurant Group**. All reported trading broadly in line with analyst estimates, which led to relief rallies in all having suffered significant share price declines in the proceeding months as market fears of a worsening consumer environment had mounted. The market was also positively surprised by **Daily Mail & General Trust's** (DMGT) Q1 trading statement. We have written at length about the significant valuation mismatch at DMGT. To briefly recap, a sum-of-the-parts valuation suggests one is getting the Consumer Media, Energy, Education Technology and the entire venture portfolio for free at the current share price ('Under the Bonnet', December 2018). Consequently, it was pleasing to see Q1 trading come ahead of analyst expectations, driven mainly by the Consumer Media division, where Mail Online's revenue growth accelerated and print advertising declines moderated, and strong revenues in Education Technology, albeit analysts were quick to point out that the latter was due to one-time software sales. Analyst commentary and valuation continues to focus on trading within the Insurance Risk division, where revenue growth remains muted at 1% as management undertakes a re-architecture of the technology platform. Whilst Insurance Risk is an important part of the current valuation, potentially accounting for a third of the implied Enterprise Value at the current share price, it is unlikely to be the main value driver in the short term given the repositioning planned by management. Progress elsewhere in the portfolio where the market is wrongly ascribing little to no value is therefore a welcome development and an important driver of shareholder value.

An H1 trading update from **McBride** showed underlying revenues continuing to grow (+6%) and, importantly, confirmed that full-year earnings were on track to be in line with expectations. Higher sales volumes have helped mitigate much of the previously experienced logistics cost inflation, and management commentary suggests that the pricing outlook for many of the company's key raw materials has improved. As we detailed last month ('Under the Bonnet', January 2019), these were the last remaining operational headwinds on the businesses following what was a tough 2018 for the shares, so this is encouraging progress if sustained. Likewise **SDL**, a detractor to this Fund's performance in 2017 ('Under the Bonnet', January 2017) , issued a short pre-close statement that not only showed revenues and profit a touch ahead of analyst forecasts but cash materially ahead as new financial controls helped deliver improvements in working capital. Having continued to back management through a turnaround that has had a number of false starts, it is pleasing to see revenue growth now accompanied by profit and cash growth.

Finally, **Anglo American** was the Fund's best performing holding in the month. Its share price responded to a 12% rise in the iron ore price following the tragic news of the collapse of Vale's tailings dam near Brumadinho in Brazil and the company's subsequent decision to decommission all of its 10 upstream tailing dams over a three-year period, leading to a 40Mt per year production cut. The Fund also benefited significantly from not holding AstraZeneca. Its previous three months of relative share price gains unwound as currency pressures combined with concerns over a number of high profile management departures and the CEO's messaging on margins.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12-month performance to:

	31.01.2019	31.01.2018	31.01.2017	31.01.2016	31.01.2015
JOHCM UK Dynamic Fund	-4.31	13.87	29.30	-6.96	6.63
Benchmark	-4.03	11.12	22.46	-6.33	8.50
Relative return	-0.29	2.48	5.59	-0.68	-1.72

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 January 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.

Source: JOHCM/Bloomberg unless otherwise stated. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. Past performance is no guarantee of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. 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. The Fund's investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. Source: JOHCM/Bloomberg/FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE" ® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.