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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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Investment background: a remarkable year

Global stock markets closed the year on a high, buoyed by continued synchronised economic strength across the world led by manufacturing and typified by the near-record readings in the eurozone. The eurozone November manufacturing PMI reached its highest reading since April 2000 following broad-based growth across the continent. With surveys recording the steepest backlogs of work since records began, it seemed likely there would be a continuation in strength. The subsequent flash eurozone PMI print of 62 confirmed this picture. The eurozone composite PMI for November rose to 57.5 to become the 53rd successive month of expansion and the flash composite PMI for December rose further again to 58. Surveys noted that inflation reached a 6.5-year high, which perhaps calls into question the ECB's recent decision to go very slowly on its QE tapering programme.

Benefiting from this rosy global picture and from the ongoing relative weakness of sterling, the UK manufacturing PMI for November continued its recent run of strength, hitting its highest level since August 2013, with output, new orders and employment all rising at faster rates. Interestingly, investment goods orders grew at the fastest rate since August 1994, driven by export strength but also by solid domestic demand. This is an interesting development in light of recent general survey evidence of CFO reluctance to make new investment decisions after the EU referendum (Deloitte CFO surveys Q2 and Q3 2017) and given the Bank of England raised interest rates for the first time in ten years in November.

The robust manufacturing picture in the UK was not matched by the service sector. The November services PMI reduced to 53.8 from 55.6 due to uncertainties over consumer demand and the Brexit outcome. Prices charged rose at the fastest rate since 2008, a response to the inflated cost environment. News on ongoing Brexit negotiations was better, however, with the Government announcing a breakthrough in mid-December with a deal to settle the so-called 'divorce bill' and a commitment to find a solution to the Irish border issue. This will allow a move to trade negotiations as we move through 2018, a set of negotiations which will no doubt cause plenty of volatility.

Surprisingly, given the Brexit breakthrough and continued economic resilience, UK bond yields closed the year on a weak note, with the 10-year gilt yield falling 14bps in December and closing near the year's low at 1.19% (down 5bps over the year). This is perhaps all the more surprising given the Consumer Prices Index (CPI) 12-month rate was 3.1% in November, up from 3.0% in October and slightly higher than expected. Whilst wage inflation remains subdued, trends are slowly improving. Employment surveys suggest tightness in the labour market, with further steep drops in permanent candidate availability (IHS Markit/REC Report on Jobs), a situation exacerbated by net migration from the EU falling to just 9,000 in Q2, the lowest quarterly recording since records began in 2015, as many EU workers chose to move home. This is likely to have contributed to the minor fall in the employment rate for August to October, but this does not signify anything particularly sinister about the labour market as the unemployment rate fell to its joint lowest level since 1975.

Sterling finished near the year's high against the US dollar in closing at US$1.351/£1, flat for the month of December but up 9.4% for the year. The weakness of the trade-weighted US dollar over the year is perhaps somewhat surprising given the strength of the US economy, the accompanying interest rate rises and, in December, the passing of the legislation of President Trump's landmark Tax Cuts and Jobs Act by Congress. The tax reforms, whilst complex, will provide a markedly lower forward corporate tax rate and a further fillip to the US economy, albeit claims by Treasury secretary Steven Mnuchin that the cuts will more than pay for themselves have been widely lambasted by economists.

It was an excellent year for global stock markets by almost any measure.[1] In the US, the Dow Jones index closed the year up a fairly remarkable 25.1%, the Nasdaq rose by 28.2% and the S&P 500 returned 19.4%. Taking a global view, the FTSE World index rose by 1.5% in December and closed the year up 21.1%. Emerging market equities fared particularly well, reflected in a 25.4% return for the MSCI Emerging Markets index. In Europe, despite the strong economic conditions, the German Dax returned a slightly more sober 12.5% while the French CAC 40 was up by 9.3% and the Spanish IBEX a more subdued 7.4%. In the UK, the FTSE All-Share index closed the year up 9%, with the FTSE 100 being the laggard, rising by just 7.6%. In comparison, the mid-cap FTSE 250 index rose by 14.7%, the FTSE Small Cap index finished up 14.9% while AIM returned a bumper 24.3%.

[1] All index returns quoted in local currency terms.

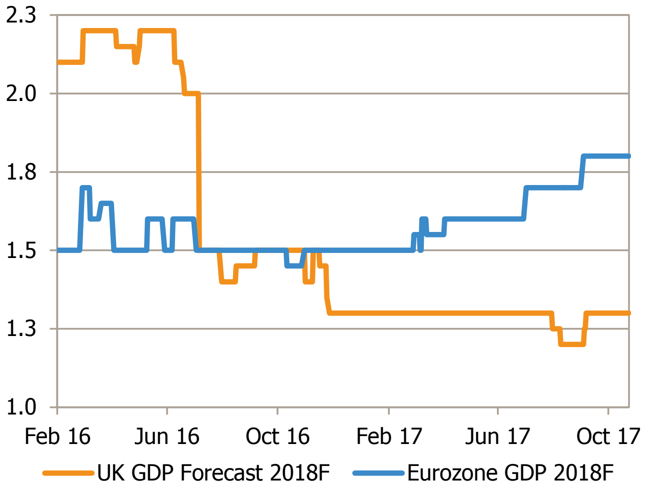
A new narrative begins to play out

As we look back on 2017 and into 2018, it is worth recalling what we wrote of the momentous events that occurred in 2016 ('Under the Bonnet – A Year to Remember', January 2017). 2016 was a year which may have marked the end of a 35-year bond market bull run and, as we said at the time, would go on to have some profound sector performance repercussions. Although the US Federal Reserve made its first interest rate rise post the 2008 financial crisis in December 2015, 2016 was a year of little further action due to it being an election year. The next rate rise did not come until December 2016 after a surprisingly strong Q3 GDP print and the shock election of the pro-business Donald Trump. 2017 was thus the year of the US interest rate rise, with three in total in response to Trump's re-energised US economy. We will have to see what the Q4 figure brings, but after strong Q2 and Q3 GDP prints the US looks set to record c.2.5% growth in 2017 and a similar number in 2018, supported further no doubt by the recent passing into law of the Tax Cuts and Jobs Act. In light of this, it is perhaps surprising to note that the US 10-year treasury yield finished the year virtually flat at 2.4%.

UK left in the wings...again

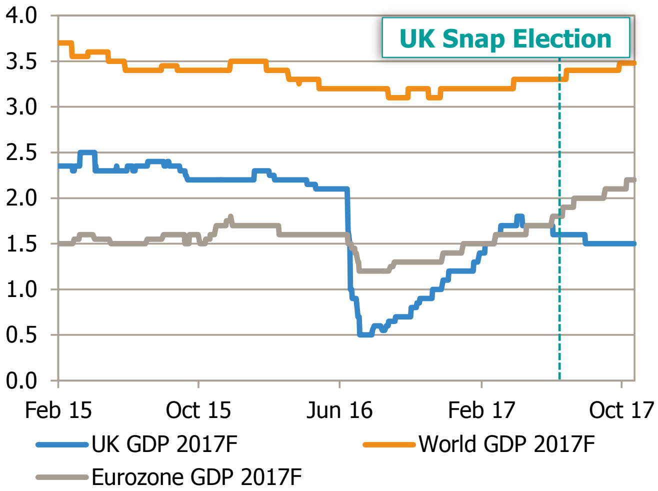
2016 was also the year that set in train a process of Brexit, but it was not until 2017 that the true implications of this would start to be felt, both economically and politically. The UK services and construction sectors, much more sentiment-driven components of the economy, suffered a tougher year while the more export-led manufacturing sector fared much better. Politically everything seemingly changed (again) after the badly misjudged snap general election in June, which returned the Conservative Party with fewer seats and softened the UK Government's Brexit position. This single event was perhaps the defining moment for the UK in 2017 (see Portfolio review below). Nowhere is this seen more clearly than in the subsequent divergence in UK GDP expectations relative to the eurozone, an economic area that the UK had been soundly growing faster than until the EU referendum.

UK 2018 GDP expectations lagging the Eurozone



Source: Bloomberg as at November 2017.

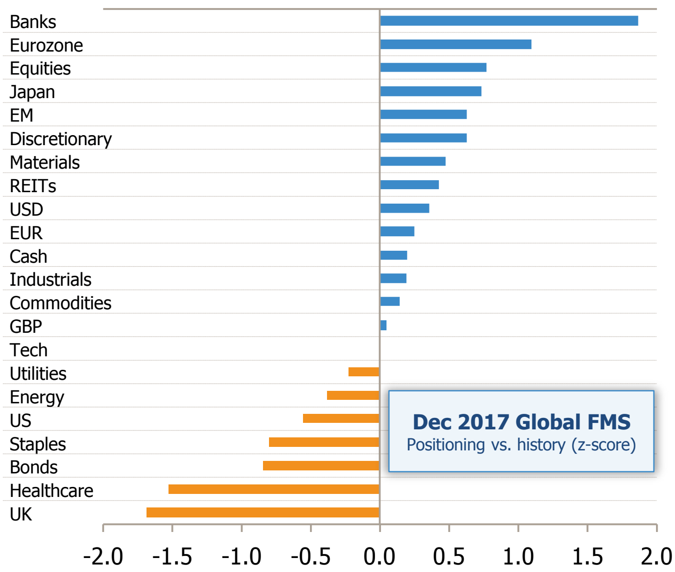
Despite the UK having previously been growing ahead



Source: Bloomberg as at November 2017.

As a result we go into 2018 with the UK at the bottom of the list of desirability for international investors for a second year running (see 'Under the Bonnet – 2016: A Year to Remember'), according to Bank of America Merrill Lynch's Fund Manager Survey, and, in the case of UK domestic stocks, price-to-earnings (P/E) discounts to the market last seen in the depths of the financial crisis (see 'Under the Bonnet – December 2017').

The Longs & Shorts, relative to Global FMS History*

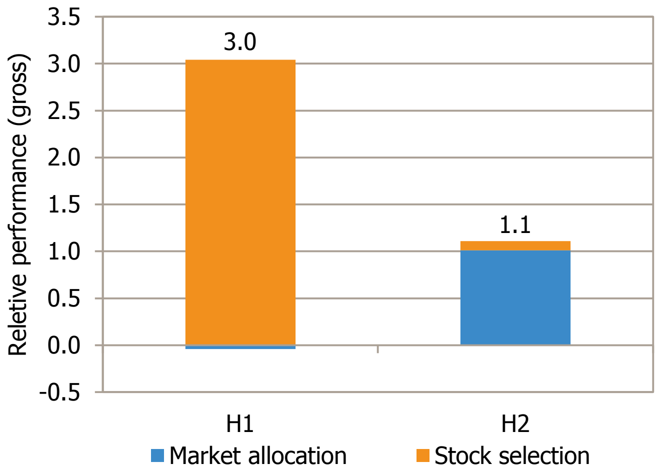


Source: BofA Merrill Lynch Global Fund Manager Survey. *data since 2006 for commodities & real estate; since 2001 for everything else.

Portfolio review: a year of two halves

The Fund rose by 2.53% in December, net of fees, representing underperformance of 63bps against its benchmark, the FTSE All-Share Total Return index (12pm adjusted), which rose by 3.18%. This closed off a tougher quarter for the Fund which saw it underperform by 49bps, its first quarter of relative underperformance since Q2 2016.

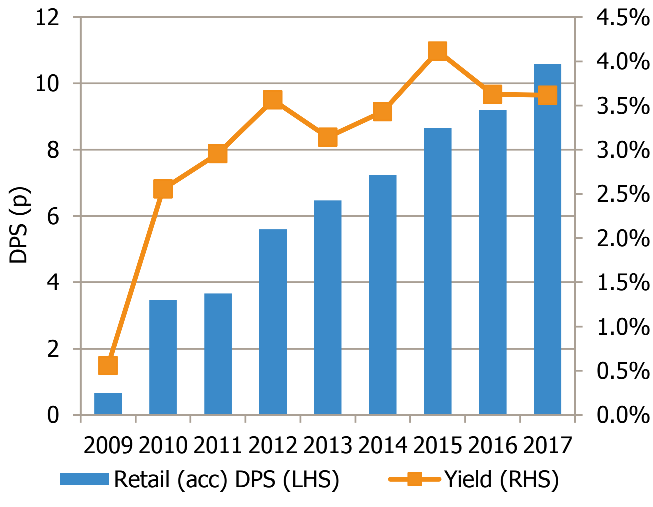
Looking at 2017 as a whole, however, the Fund fared reasonably well in returning 16.03%, net of fees, representing 259bps outperformance when compared with its benchmark, which rose by 13.10%. But the story of the year was most definitely a tale of two halves, with the first being considerably better than the second, as illustrated in the chart below.



Source: JOHCM. Based on end of day returns.

The Fund grew its dividend for an eighth consecutive year, paying 10.6p per share ('A' accumulating share class), representing annual growth of 15.1% and a historic yield of 3.6%. While income generation will always remain an important component of the Fund and the investment process, we are unlikely to see such material growth in the Fund dividend in 2018 given the significant dividend-boosting benefits from sterling's depreciation enjoyed by UK companies in 2017.

Fund dividend growth



Source JOHCM/Bloomberg.

The few become the many

The Fund entered 2017 with strong momentum from a number of its larger active positions. When reflecting on the portfolio's showing in 2016, we noted that we would expect to see a broadening out of performance amongst the Fund's holdings and, by implication, a levelling off of returns from some of 2016's best performers. We also had high hopes for what was a relatively young portfolio of assets, a collective balance sheet position that was extremely strong and a set of management teams that we rate extremely highly.

Outcomes for the year on a stock and sector level were broadly as expected with one or two major exceptions. In terms of the better performers from 2016, we highlighted **Electrocomponents, 3i Group, Anglo American** and **WM Morrison Supermarkets**. Except for WM Morrison these stocks continued to fare extremely well in 2017 (perhaps even more so than expected), as a combination of positive external conditions (e.g. exposure to strong global manufacturing conditions) and sound strategic management of these businesses (particularly around cash generation and balance sheet management) continued throughout the year. All three of Electrocomponents, 3i and Anglo American were in the top 10 contributors for 2017 and in combination added a further c.200bps of positive relative contribution. Only in the last quarter of the year did any of these stocks suffer from some profit taking.

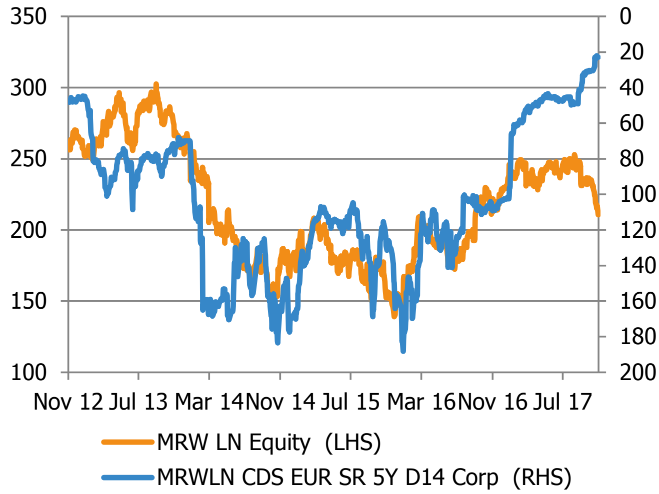
Pleasingly, there was a broadening out of performance across the portfolio, with over 50% of the performance from the top ten outperformers coming from stocks that were not top ten active positions at the beginning of the year. Patience was certainly a virtue in 2017. **Man Group** and **Britvic**, both long-standing positions in the Fund but not top ten actives, were the largest and third-largest positive contributors to the Fund's performance, respectively. Man Group was a major beneficiary of late-cycle economics, with strong fund flows throughout the year aided by new management's strategy of focusing on differentiated and diversified products in an ever competitive industry. Britvic, having had a tough 2016 in share price terms as the market looked dimly on the short-term cash impact of it investing in it UK supply chain, saw its shares re-rate in 2017. This followed earnings upgrades predominantly driven by the benefits derived from that very same UK supply chain investment plus greater than expected synergies from its acquisitions in Brazil.

Top ten performances also came from the global recruiter **Robert Walters**. Having been in the Fund for four years, it was sold in November after breaking through to new all-time relative highs as it benefited from the strong global economic environment. **Stock Spirits**, a position that was added at the beginning of 2016, also featured in the top ten performers, as did **SIG**, which was added at the beginning of 2017 but which this Fund has previously made money from having last held it in 2013 under different management. We look forward to updating you on further progress at Stock Spirits and SIG, both of which, under new management, have stabilised their leading market positions in their respective markets and show promise of returning to growth.

No summer of love for UK domestic stocks

WM Morrison was one of the Fund's top-performing positions last year, so it was more than surprising (to us, at least) that it cost 62bps of relative performance over the year, with much of this coming in the second half. It is hard to pinpoint what exactly happened to turn the share price performance as there was not any single event, but we can offer a few suggestions. Share price performance started to turn more negative around the time that Amazon announced the acquisition of Whole Foods in the US. All the UK supermarkets' share prices were hurt, but Morrisons, with its existing wholesale arrangement with Amazon, was initially affected the least. The half-year results then showed better than expected like-for-like sales (LfL) progression but did not show further margin growth, as management chose to invest further in price in a slightly more promotional market. This was used as a source of disappointment and negative commentary amongst a still negative analyst community. This fed through to a debate over the high price-to-earnings (P/E) relative to the sector, something we feel strongly is less relevant given the rapidly improving balance sheet (cash flow and net debt continued to surprise positively for the majority of the year). On a balance sheet-adjusted basis, Morrisons remains valued in line with the sector or lower, but it has a materially higher margin of safety given extensive asset ownership and a pension surplus. Indeed, it is interesting to see the recent divergence between the debt and equity markets' view of Morrisons.

Morrisons equity vs. 5 year CDS (inverted)



Source: Bloomberg as at November 2017.

With near 12% short interest, Morrisons is the sixth most-shorted stock in the UK and second most-shorted retailer after Debenhams. We cannot understand the logic. 2018 is likely to be a year of further LfL and balance sheet progression, particularly after the signing of the McColls wholesale deal, which begins in earnest in Q1 2018. Furthermore, we expect to see the introduction of a special dividend or share buyback. With such negatively skewed investor crowding and operational momentum, we would expect the shares to have a better year.

QinetiQ encapsulates the extremities of negative investor sentiment towards UK-centric stocks in 2017. Prior to the snap election on 8 June 2017, QinetiQ's share price had been up as much as 20% for the year. The market had begun to reappraise the investment case as new management shifted the strategy from restructuring to growth through the use of its net cash balance sheet to invest in core assets and bolt-on acquisitions, a strategic direction we have long advocated. However, post the snap UK election QinetiQ's share price collapsed 32%, from 299p to a low of 202p in November, as investors became concerned over UK defence budgets with a minority government in place and an emboldened Labour Party led by a self-declared pacifist. UK defence peer Ultra Electronics did go on to issue a profit warning in the period (its share price fell a total of 45% from 8 June to November), which led to a 10-14% cut to consensus EPS estimates for 2017-19 and the departure of the CEO. But QinetiQ suffered no such earnings downgrades; there were actually upgrades, albeit mainly one-off in nature. Furthermore, it indicated an improvement in its EMEA Services order book and management bought the equivalent of over £400k in shares at today's prices, indicating their own bemusement at the weakness of the share price. All these factors went on to be ignored by the market. As with Man Group and Britvic, hopefully patience will once again prove to be a virtue in 2018.

Capital allocation: good and bad

Fund performance benefited from some notable sell decisions throughout the year. **Acacia Mining** was sold in its entirety at the end of March at a share price close to 485p. In our view, the shares failed to reflect the implications of the news that the Tanzanian President had banned the export of gold and copper. We saw this as a precursor to far more populist anti-business measures being introduced – a risk we were not willing to take given Tanzania accounted for all of Acacia's revenues. The situation went on to significantly worsen and the shares trade at 193p today.

The Fund's holding in **Saga** was sold at 182p as our emerging concerns that the motor insurance broking panel was failing to deliver expected earnings upgrades and underlying cash flow growth were confirmed by a change in messaging from management at September's half-year. The shares now trade at 122p following a profit warning in December.

For those who listen to the Fund's quarterly calls, we outlined in Q4 2016 that the Fund sold its successful holding in New River Retail REIT and reallocated the capital to the relatively new position in **Urban & Civic**. We failed to understand why the latter traded at a 20% discount to net asset value (40% if fully adjusted for off-balance sheet assets and valuer adjustments) whilst the former traded at a 20% premium. It is pleasing to report that over the course of 2017 shares in Urban & Civic rose 30% whilst New River Retail REIT rose just 5%, once adjusted for capital returns. We continue to hold a maximum overweight position in Urban & Civic as its significant land bank in the south-east and leading master developer credentials mean it is particularly well placed to benefit from the UK's housing shortage.

Inevitably with active fund management not all of the Fund's positions played out successfully over the year. **Imagination Technologies** sold off heavily after announcing that Apple will no longer use the group's intellectual property in its new products. Whilst the Fund had only a small 75bp active position in this early stage restructuring story – largely because of our concerns of an overreliance on Apple as a customer – there proved to be an inadequate margin of safety in the valuation and the shares fell significantly. The Fund sold its position in full on the day of the Apple announcement, crystallising a 57bp negative contribution for the year. This was both a disappointing outcome and a costly reminder of the importance of revenue diversity.

Another early stage restructuring story, **Xaar**, was also exited in the year following a revenue miss. A sufficient margin of safety in valuation meant there was no negative impact on performance for the year, however.

With two profit warnings, **SDL**, the global language translation provider, was perhaps the most disappointing outcome for the Fund in the year. The first warning came as gross margins collapsed after the business was forced to use more outsourced translators in order to service its higher revenues – the opposite outcome to what new management was trying to achieve. These margin downgrades came at a time when additional operating cost investment was being made in order to build the automated project management system, Helix, which would enable better utilisation of in-house translators. Believing this margin compression to be transitory, the Fund maintained a reduced position. Unfortunately SDL warned again in December (albeit the share price has now regained much of these losses), citing the deferral of certain software deals into next year and cost phasing issues as well as announcing the need for further investment. We are currently reviewing the turnaround strategy in place.

A poor performer in the second half was **GlaxoSmithKline**. The market responded negatively to comments over margin investment and the risk of a dividend cut should it decide to bid and be successful in the forthcoming sale of Pfizer's consumer health assets (see 'Under the Bonnet – November 2017'). The stock cost the Fund 55bps in relative performance over the year, but, being a large component of the FTSE 100, the opportunity cost was far larger. Relative to not owning it, the opportunity cost was a far more material c. 140bps. 2018 will be an interesting year for this stock.

Barclays performed poorly, with the share price following earnings estimates lower throughout the year. Whilst management successfully completed the heavy lifting parts of the restructuring plan, including the unwind of the non-core bank and sell down and deconsolidation of Barclays Africa Group, there was little success in building any notable momentum in its key franchises, especially within Investment Banking.

Outlook: sticking to the knitting

As we look in to 2018 we are mindful that absolute value is becoming increasingly hard to find. Despite lagging most major stock market indices in 2017, the FTSE All-Share index is at an all-time high. Current global economic momentum may arguably look supportive of higher valuations, but if the events of the past two years are anything to go by, we should be cognisant of how quickly things can change and thus what assumptions we are being expected to make at these higher prices. As ever, a margin of safety is paramount.

This Fund has always built its margin of safety through investing in stocks that exhibit not solely traditional value characteristics but also exhibit idiosyncratic drivers of shareholder value in the form of management change and strategic change. It is perhaps of little surprise therefore that the newer ideas in the portfolio all have new management teams that are implementing significant portfolio asset changes, e.g. **St Modwen Properties, Essentra, Euromoney, Hunting, ITE Group** and **Daily Mail & General Trust.**

Additionally, given the currently extremely negative sentiment towards domestically-oriented UK stocks, we believe there are pockets of value, particularly in the consumer services sector. Many of these stocks come with negative earnings momentum and/or substantial investor short interest bases focused on structural issues – characteristics which bear similarities to those of the mining sector at the end of 2015. As with the mining sector before it, it is difficult to pinpoint what precise catalyst will lead this sector to outperform. But by focusing on those stocks with strong balance sheet and cash flow characteristics alongside management and strategic change, we believe the Fund holds a subset of stocks that have the potential to outperform without the need for a broader sector move, yet are buttressed by a sufficient margin of safety. The Fund's capital in consumer services totals c. 16.5% versus the benchmark weighting of c. 11.0% and includes UK-centric names such as **WM Morrison, Tesco, The Restaurant Group, Marks & Spencer** and **Majestic Wine.**

After what was a remarkable year, 2018 is unlikely to be dull either. Given the potential in the current portfolio, we remain confident that the Fund can continue to deliver outperformance, regardless of how the stock market or economic cycles unfold.

Performance highlights

Discrete 12 month performance (%) to

	31.12.2017	31.12.2016	31.12.2015	31.12.2014	31.12.2013
A Acc GBP	16.03	20.95	0.22	3.13	31.49

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 December 2017. Inception date: 16 June 2008. 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.