July 2019

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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Investment background

Global equity markets rallied in June regaining much of their previous month's losses. US equity markets led the rally, with the S&P 500 (total return) index reaching a new all-time high. Markets were buoyed by the expectations of looser central bank monetary policy in response to slowing economic data, which, in turn, pushed global government bond yields down to historical lows.

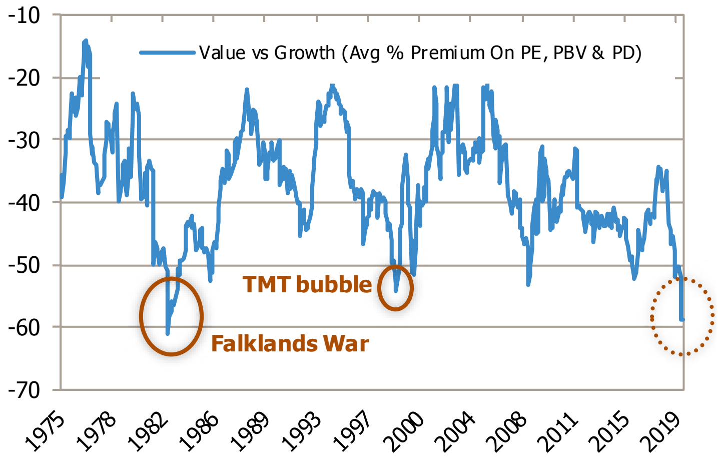
Expectations that the US Federal Reserve would cut interest rates in July became increasingly priced in as the month progressed. This followed a dovish speech by Fed chair Jay Powell, data releases showing a slowing US economy (weak manufacturing and services PMI surveys and lacklustre new jobs and wage growth) and the Fed stating it would "act as appropriate to maintain expansion". The yield on the Federal Fund 30-day active contract fell from 2.25% to 2.05%, implying the market now expects two rate cuts of 25bps by the end of August. The yield on the US generic 10-year Treasury dipped below 2.00% for the first time since the election of President Trump, signalling a complete unwind in the market's expectations of 'Trumpflation'.

Downward pressure on global bond yields was exacerbated by central bank actions in Europe. The Eurozone composite PMI showed growth remaining subdued as manufacturing output continued to contract, leading ECB President Mario Draghi to hint at a restart of the quantitative easing programme if inflation and growth failed to improve. The yield on the French generic 10-year government bond fell into negative territory for the first time in history, whilst the Greek generic 10-year government bond closed the month with a yield of just 2.45% - despite Greece remaining the world's second most indebted country and its debt yielding 44% in March 2012. (It is worth noting that 92% of this Fund's capital is invested in stocks with a dividend yield currently greater than the Greek yield.)

Investor fears of a global recession have become heightened. Over the year to date, US$136bn has flowed into investment grade corporate bonds and US$34bn into government bonds. Meanwhile, a total of US$112bn has flowed out of US and European equities as investors switch into perceived safe assets. Bank of America Merrill Lynch noted in its June Fund Manager Survey that investor confidence is now the most bearish it has been since the Global Financial Crisis despite, since the 1 July, the US enjoying the longest period of economic expansion without a recession since the America Civil War. So marked is the demand for perceived safe assets that the market value of the Bloomberg Barclays Global aggregate negative-yielding debt index rose to a new all-time high of US$12.9trn in June.

In the UK, fear has had a clear impact on asset prices. Fear of a 'no deal' Brexit rose back up the agenda, with the recently formed Brexit Party now polling ahead of all parties in a recent YouGov survey and the Conservative Party leadership race narrowing down to a choice between arch-Brexiteer Boris Johnson and Jeremy Hunt, who, despite voting remain, has been forced to try and 'out-Brexit' Johnson to appeal to the Conservative party membership. Sterling continued to weaken over the month such that the Bank of England's trade-weighted effective exchange rate has now unwound all its gains for the year. Two months ago ('Under the Bonnet', April 2019), we highlighted analysis by Morgan Stanley that showed that the current discount of UK value stocks to growth stocks had only been markedly lower once in the last 45 years: during the 1982 Falklands War. This same analysis (see below) now shows that the disparity in valuations has reached a level akin (-58.6 vs. -60.9) to this 45-year low and hence is more marked than even the TMT bubble or Global Financial Crisis. We live in extraordinary financial times.

UK value vs. growth average valuation premium



Sources: MSCI, Morgan Stanley Research. Note: Average relative valuations use 12M forward data where available (forward P/E data starts in 2003) and trailing data where forward P/E not available.

Strategy update

The Fund rose 2.59% in June versus a 3.65% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing (geometric) underperformance of 103bps. At the half-year point the Fund's performance was broadly flat: +12.56% versus a +12.96% return by its benchmark, representing (geometric) underperformance of 36bps.

Underperformance over six months was broadly equivalent to the Fund not owning Diageo (-30bps). However, performance was more characterised by marked individual positive stock performances offset by continued idiosyncratic stock headwinds. **3i Group** (the Fund's largest active position) and **Moneysupermarket** were the largest contributors to performance (+177bps in total) over the period. Both delivered earnings upgrades as management continued to successfully execute their strategies, thereby leading the shares to more than regain the declines they suffered in the broader market sell-off at the end of last year and re-rate to reach new absolute and relative share price highs since the Fund's ownership. Whilst cognisant that the speed of these share price moves will have in part been aided by the market's current appetite for growth stocks, we remain confident over the idiosyncratic drivers of future earnings growth yet to be delivered by both strategies. These will provide valuation support in the short to medium term and hence both positions remain high conviction.

In terms of negative performance contributors, the Fund continued to experience headwinds from those stocks that undertook acquisitions last year. **The Restaurant Group** (which also unexpectedly lost its CEO), **Elementis** and **Vodafone** broadly offset all the gains made by 3i and Moneysupermarket (-169bps). We see these factors as reversible and thus sources of latent upside as the respective management teams begin to execute their strategies, rebuild the earnings growth profiles and reduce leverage. There are already early signs of progress, with the appointment of a replacement CEO at The Restaurant Group and strong trading from Wagamama whilst at

Vodafone the recent dividend cut is a clear step forward in reducing leverage.

Turning to June, underperformance in the month can be attributed to two factors. First, the Fund's underweight position in the bond-like healthcare sector, where not owning Astrazeneca provided a 23bps headwind. Second, underperformance in **QinetiQ's** shares following two analysts downgrading their recommendations on valuation grounds (a 25bp headwind). We disagree with their conclusions and see the analysis as short-term earnings momentum-driven rather than based on fundamental valuation. The shares currently trade on 8.7x blended forward 12-month consensus EV/EBITDA, in line with their five-year average, despite the uncertainties of the last five years surrounding the level of the UK Government's Single Source margin and the terms of the Long Term Partnering Agreement (LTPA) having now been removed from the investment case. The signed LTPA contracts now provide revenue visibility over c. 35% of group revenues out to 2028, plus clear contracted returns on investment above the company's cost of capital. This provides a strong base (both in terms of future cash flows and reputation) for the company to build towards its ambitions of increasing share of revenues from international to over 50%. With recent contract wins including the US Common Robotics System and Canadian Unmanned Air System, there is clear evidence that this strategy is working.

June was a relatively quiet month for the Fund, with trading updates from some of the smaller positions. Interims from **Crest Nicholson** showed further encouraging progress in its turnaround, with profit before tax falling just 11% compared to the previous guidance of 25-30%, aided by bulk deals and land sales. Importantly, the interim dividend continued to be maintained at 11.2p (the shares currently yield c. 9%). We wait to hear from the new CEO on strategy, however we are becoming increasingly confident about the asset value of this business, both on and off the balance sheet, whilst we are only being asked to pay 1.0x FY19 P/NAV for shares. **Chemring's** interims also showed encouraging progress, with insurance recoveries from the incident at the UK Countermeasures site in August 2018 being received earlier than anticipated and its Australian subsidiary awarded its first F-35 countermeasures contract by the US Department of Defense. This award is sole source and provides credence not only to Chemring's market-leading position but also to the capex strategy put in place by outgoing management who upgraded the Australian facilities.

June was, however, a busy month for capital markets days. We attended a day at Tesco and two days with **Stock Spirits** in the Czech Republic. **Tesco's** capital markets day was possibly one of the best we have recently attended. The clarity of message, joined up thinking and strength of management solidified how dominant this business is and will continue to be in its chosen markets. Whilst management issued no new guidance, we were left under no illusion that there are still significant untapped cost-saving opportunities which, when channelled through the three pillared strategy (product, channels, customer), will generate continued trading momentum and cash generation. The breadth and depth of analysis and thinking exhibited at the Environmental, Social and Governance investor day the following week was equally impressive. There seems little doubt that Tesco is on track to regain its position as a leader in global retail in time. We added to the Fund's position.

Stock Spirits, whilst a much lesser known brand than Tesco in the UK, represents an equally exciting story. With new management having turned around the company's fortunes operationally in the last two years, ambitions are now set on internationalising the company's deep portfolio of brands. The group has already achieved its 2020 target of achieving 30% of revenues from premium brands, as defined by Nielsen, through brand innovation and re-launch successes in it its core markets of Poland and the Czech Republic (36% and 40% premiumised as at H1 2019, respectively). Management are looking to build on these successes to tackle Italy, Stock's third largest market and one of the largest international markets for bitters, a category in which Stock is a market leader. Success in Italy is important as, combined with a potential bolt-on brand acquisition in Germany or Scandinavia, this would provide the company with a platform akin to that created by Campari at the outset of its strategy to internationalise its brands. Whilst successful execution of the strategy is by no means certain, it is worth noting that in its 2013 IPO Stocks Spirits listed at the same blended forward 12-month EV/EBITDA as Campari at 11.8x. Today the same multiple for Stock Spirits is 8.0x while for Campari it is 21.5x.

JOHCM UK Dynamic Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.06.19	30.06.18	30.06.17	30.06.16	30.06.15
A GBP Class	-3.40	11.39	31.53	-6.09	8.90
Benchmark	0.14	8.66	21.37	-0.60	3.39
Relative return	-3.53	2.51	8.37	-5.53	5.33

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 30 June 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.