Under the Bonnet

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Investment background

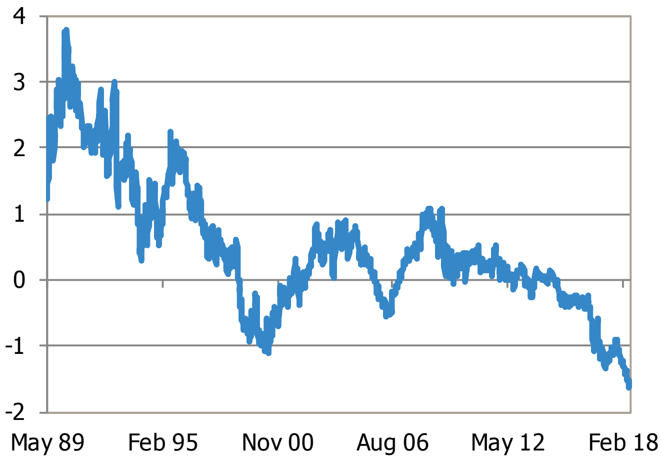
Equity markets continued to recover from their March lows in the UK and the US, whilst European stock markets struggled somewhat in the face of new political crises in both Italy and Spain and a continued moderation in various PMI data. Emerging markets continued their recent struggles due to continued US dollar strength and various headline idiosyncratic issues recently affecting Argentina, Brazil and Turkey, in particular. Further headline news regarding trade wars and the on-off US summit with North Korea did not help the general macro environment.

Economic data in the UK generally remained subdued, particularly the manufacturing PMI which continued to decline in April. The service sector recovered marginally from March's weak showing, and the construction sector bounced back particularly strongly, although the recovery was not broad based and was more focused on new housing, a part of the market that continues to see strong government support. The much-discussed real wage situation continued to improve, however, and remains one of the key pieces of the confidence malaise currently being suffered in the UK. Data released in May showed that nominal average weekly earnings (ex-bonuses) in the three months to the end of March grew by 2.9%, with the three-month average CPI over that period being 2.7%. More interestingly, wage settlements in the month of March were 3.0% up year-on-year, whilst CPI inflation data for April fell to 2.4%. That is a material widening of the gap between wages and prices and represents the strongest real wage position in the UK for a number of years.

Consumer confidence recovered slightly, according to the monthly GFK survey, although remains overall in negative territory for the 28th month in a row. The scores for personal finances, particularly for the year ahead, continued to improve somewhat, although thoughts over the general economic situation of the country remained downbeat (as noted in the GFK press release). Retail sales data therefore remained relatively subdued in April, rising by 0.1% (three-month on three-month), although bouncing back 1.6% from a weak, weather-affected March. It will be interesting to see how things develop from here, given the continued labour market strength and recent real wage improvements, although the recent rise in oil prices may have a partially dampening effect.

UK interest rates were kept on hold in May – as expected after the weaker Q1 GDP figures – as they also were in the United States. General economic conditions in the US continue to outperform the UK and helped drive a wide divergence in bond yields and currency movements over the month. UK 10-year gilt yields fell by 19bps, or 13%, over the month to 1.23% (moving more in line with eurozone yields) whilst 10-year US Treasury yields fell by just 9bps, or 3.4%, to 2.86%. The UK-US 10-year government bond spread is plumbing new lows and now stands at a historic -163bps, a reflection of many things of course but extremely noteworthy nonetheless, with sterling/dollar closing the month back at $1.33, down 3.4% for the month and well below the long-run average since 1970 of closer to $1.75.

UK-US 10 yr government bond spread



Source: Bloomberg as at June 2018.

Strategy update

The Fund performed broadly in line (+3bps) with its benchmark, the FTSE All-Share Total Return index (adjusted) in what was a tougher month for outperformance given declining bond yields and weakening sterling. Declining bond yields are not immediately supportive to this Fund, which remains underweight large-cap defensives. As an example the Fund's underweight position in British American Tobacco cost c. 23bps over the month. Interestingly, however, sector allocation effects were broadly positive for the month, with the relatively neutral positions in both oil & gas and basic materials helping defend the Fund from a further sharp upward move from those sectors and allowing the overweight positions in both industrials and consumer services to add value.

May was an important month for the Fund, with a number of the portfolio's largest active positions being March year-ends and therefore reporting full-year results. **Electrocomponents**, **QinetiQ** and **3i Group**, collectively c. 11% of the Fund, all reported excellent full-year numbers. These resulted in earnings or NAV upgrades in all cases and saw their share prices rise immediately following the earnings announcements.

The performance from **Electrocomponents** was particularly noteworthy, given a set of very strong results across the board, c. 7-10% earnings upgrades for the year ahead and the first bolt-on acquisition from this management team (and from this company for a generation).

Having raised expectations for the full-year results at both the Q3 and Q4 trading statements, driven by continuing strong revenue growth across all regions, 2018's results were delivered in line with these higher expectations.

The positive news for the future, however, was the strength in gross margins, which grew year-on-year and exited the period at the year's highs. This was caused by better pricing discipline, a positive mix towards higher margin own label products and better supplier rebate management. This bodes well for future gross margin development, particularly given the stronger growth (than group average) of the higher margin RS Pro own label products within the mix. The acquisition of IESA for £88m adds a high growth, high margin and differentiated corporate maintenance repair and operations (MRO) function to the group's business mix and looks a sensible bolt-on that offers clear revenue synergies. Even accounting for the acquisition cost, group leverage remains low at less than 0.5x net debt: ebitda. This remains a high conviction holding.

QinetiQ's results also beat expectations on both earnings and cash flow. This led the shares to recover their poise after a surprising period of weakness in the last nine months and about which we have previously commented (see 'Under the Bonnet', January 2018). This business suffered a major share price fall after the snap UK general election in June 2017, falling c. 40% peak to trough despite stable to growing earnings. Government defence spending, whilst pressured, has not yet fallen to the extent predicted by some commentators and the specific issue of SSRO (Single Source Regulations Office) re-pricing having a downward effect on group margins is being well navigated. The targeted strategy under this management team to grow the business both organically and via bolt-on acquisitions is starting to gain real traction. This offers the enticing prospect of the company potentially delivering c. 30p of earnings per share in three years' time. (JOHCM forecasts)

3i Group continued its strong run of results. It delivered a gross investment return of c. 30% year-on-year and announced a better-than-expected full-year dividend of c. 30p, accompanied by a new progressive dividend policy from this 30p base (including an interim dividend of c. 50% of the prior year's total dividend). This is a very powerful and confident new policy, backed by the continuing strong momentum across the invested portfolio. CEO Simon Borrows followed this with a further c. £32.5m investment into the shares.

DMGT management sold the group's 30% stake in Zoopla to Silverlake Partners as part of a full bid for Zoopla at a c. 30% premium. Whilst a good deal in itself, (c. 23x earnings and a huge return on investment for DMGT - c. 14x its original investment), this is yet another example of the radical rethinking and restructuring going on within the DMGT portfolio. In just the last 18 months, under a completely new management, this board has sanctioned the part disposal of Euromoney, has sold US property business EDR whilst closing another highly loss-making business Xceligent, sold part of the US education business and replaced management at two of the key underperforming information businesses, RMS and Genscape. These actions have taken the balance sheet from net debt of £679m in September 2016 to an expected net cash position of c. £400m post the Zoopla sale. These are radical moves indeed and surprisingly rapid for an organisation sometimes accused of being slow moving. The balance sheet gives powerful optionality to management (whom we feel will be disciplined) to recycle capital at the right time or return a portion of it. In the meantime, efforts to reinvigorate certain under-earning assets, (e.g. RMS) could deliver substantial value to the existing remaining earnings base. This is a very interesting situation indeed.

ITE traded poorly after announcing the proposed acquisition of Ascential's exhibitions business. The Fund also has a position in Ascential, which, with a sale price of £300m or c.4x sales (for a 25% ebitda margin business) seems to be, in the short-run at least, getting the better side of the deal. For ITE management – some of whom (including the CEO and COO) used to run these assets whilst previously at Ascential – the attraction is in adding a set of established, cash generative and market-leading shows which could benefit from more intensive management and investment, for example growth from geo-cloning, whilst also offering some simple cost synergies. The assets are undoubtedly high quality and offer more diverse revenue streams, but the price paid and therefore the margin of safety on the deal is questionable.

Vodafone also performed poorly after a set of in line to slightly weaker results, the announcement of a transaction to buy a set of European assets from Liberty Global, and a CEO succession. Again, whilst a good deal, in being complementary and offering synergies and growth optionality, the price paid, whilst not outlandish, is reasonably high and adds a level of gearing which has perhaps placed the dividend under a little more perceived pressure.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance to

	31.05.2018	31.05.2017	31.05.2016	31.05.2015	31.05.2014
JOHCM UK Dynamic Fund	9.66	30.71	-8.86	12.03	15.88
Benchmark	6.41	24.51	-6.80	8.23	8.97
Relative return	3.06	4.98	-2.22	3.52	6.34

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 May 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.