J O Hambro Capital Management Group

Under the Bonnet

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Investment background

After the explosive start to 2018 by global stock markets, particularly in the US, February was a poor and volatile month. The ongoing strength in economic conditions, hardening evidence of inflationary pressures and intensifying threats of faster interest rate increases finally spilled over to cause a short but intense sell-off in equities.

Although difficult to pinpoint the specific trigger for the market fall, it was most likely a reaction to US wage inflation pressures emanating from the ongoing strength in the US labour market, made worse by the recent rapid rises in the US equity indices. January non-farm payrolls, released on the 2nd February, grew by a further 200,000, ahead of the expected 180,000. More importantly, though, this was accompanied by data showing average hourly earnings growth of 2.9%. This number was not only ahead of expectations but was also the highest increase since the nadir of the financial crisis. Coupled with continuing survey evidence of inflationary pressures throughout the globe – the January global manufacturing PMI survey reported selling price inflation at the second-highest rate in 80 months – it was perhaps inevitable that the inflation fears in the bond markets might spill over to equity markets.

Whilst the strengthening data was not new news it poured fuel onto an already nervous US bond market, which was still trying to digest the implications of the Trump administration's successful passing of the Tax Cuts and Jobs Act in late 2017. Whilst positive to growth, hence strong equity markets, these reforms perhaps imply a faster rate of interest rate normalisation. The US 10-year Treasury yield started 2018 at 2.4%, but by 16th January had risen by 6% to 2.54%. Between the 16th January and 2nd February, it rose a further 12% to 2.84%, before peaking on the 21st February at 2.95%, a year-to-date rise of 23% in just seven weeks. In turn, after rising by 28% in 2017, between the 2nd and 26th January the Dow Jones Total Return Index rose by a further 7.8%. But as the 10-year yield continued its rise into February, the US equity market finally reacted, with the Dow Jones Index subsequently falling by 8.8% between 1st and 8th February. Although recovering its poise somewhat as the month progressed, the Dow still closed February down 4.0%. Other markets experienced similar falls: the Nikkei 225 index was down 4.4%; the DAX fell 5.7%; the FTSE World Index lost 3.5%; while the FTSE All-Share was a relative outperformer in falling by 3.3%.

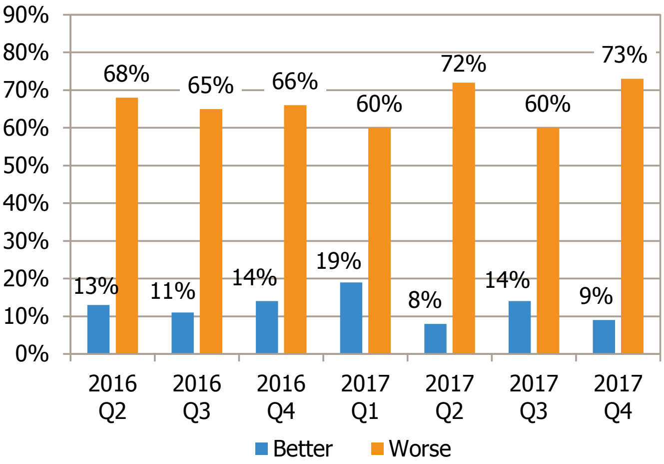
Conditions in the UK market remain governed by the overriding uncertainty created by Brexit. Where US 10-year Treasury yields have risen by 46bps since the start of the year to the end of February, in the UK the 10-year gilt yield is up by 31bps. The UK unemployment rate for the three months to December was 4.4% whilst in the US it was 4.1%. Wage inflation in the UK, judged by average weekly earnings, rose by 2.6% in December and by 2.5% for the final three months, compared to 2.9% wage growth in the US. UK inflation, driven higher by a weak pound sterling, remained at 2.7% (CPIH) in January (or 3% excluding housing costs), whilst in the US it is at 1.7%. Expectations in the US this year are for three interest rate rises, although noise around four increases is growing, particularly given hawkish comments in late February from Jerome Powell, the new Chair of the Federal Reserve. In the UK, expectations are for one rate rise, around mid-year.

Yet in many ways conditions might be tighter in the UK. Labour supply is falling in the UK post the Brexit vote and productivity remains low. The vacancy rate in the job market is rising rapidly and wage surveys continue to indicate further salary growth. Recent sterling strength has seen a stabilisation in inflation trends and expectations are for falls in the inflation rate this year. Notwithstanding a slow start to the year – UK construction, services and manufacturing PMI data have all been lower of late – which will no doubt be further affected by some extreme recent weather, GDP continues to remain resilient and was guided slightly higher over the forecast period at the Bank of England's February policy meeting. External demand continues to drive the UK economy, with eurozone manufacturing data continuing near all-time survey highs and the US economy, as discussed, still gathering momentum.

Confidence is the missing link in the UK. The most recent Deloitte CFO survey paints the picture very clearly. In Q4 2017, UK CFOs became as pessimistic about Brexit as they have been since the referendum (see chart below). UK economic growth is their second major fear. Nevertheless, whilst still acutely cost-focused, measures of overall uncertainty amongst CFOs remain acceptable and investment intentions to drive growth continue to be healthy. The potential rewards from executing a reasonable trade deal with the EU are abundantly clear and would unshackle the UK economy from the current drag of weak domestic demand. This would make current expectations of one or two interest rate rises over the next 12 months seem rather conservative. Whilst the short-term outlook is tough, the risks high and international sentiment towards the asset class extremely negative, UK equities are on sale and should therefore be of interest to any dispassionate investor.

Long-term impact of Brexit

% of CFOs who think the overall environment for business in the long term will be better/worse if the UK leaves the EU



Source: Deloitte CFO Survey.

Strategy update

The Fund fared relatively well in February, returning -2.29% versus a -3.34% showing by its benchmark, the FTSE All-Share Total Return index (12pm adjusted). A mix of both stock selection and asset allocation drove this outperformance. A low allocation to the consumer goods sector (particularly tobacco and household goods) was a positive for asset allocation. Stock selection was helped by a strong contribution from some of the Fund's larger holdings, including **Electrocomponents, Anglo American, 3i Group** and **Wm Morrison Supermarkets**. It was also pleasing to see a positive contribution in a tough month from some of the Fund's smaller and highly idiosyncratic media positions, including **Sky, Ascential, Daily Mail & General Trust** and **Euromoney**.

Despite the volatility February was a fascinating and highly active month in the UK stock market, witnessing extreme divergence in performances as the rate of profit warnings picked up, the market became more discerning about balance sheets and M&A activity seemed to rise.

Continuing the trend seen in the last few quarters of 2017 there has been a rapid increase in profit warnings, predominantly in the support services and general retail sectors, as uncertainty over UK consumer and government spending continues to bite at structurally and/or financially challenged businesses. According to EY, just under a quarter of listed companies in the support services sector issued a profit warning in 2017, as did a third of general retailers. The outlook for retail remains extremely tough in 2018, with the amount of profit warnings in the sector in the first two weeks of 2018 being higher than in the whole of Q1 2017. Capita, AA Group, Mothercare, Dignity and Carpetright (none of which we own) are just a few of the stocks that have suffered, down between 50-70% each year-to-date. There have also been dilutive fund raisings from various companies, including high profile rights issues by Capita, TalkTalk and Provident Financial (again none of which are held in the portfolio) whilst others will no doubt need to follow suit.

On the flipside, however, there has been abundant M&A activity in early 2018. **Sky** (held), **GKN** (now held – see below), Fidessa, Laird, Stadium Group (by **TT Electronics**) and GKN have all recently announced takeover approaches, some at material premiums to their undisturbed share prices. We expect a continuation of M&A activity given the blend of underperforming companies with attractive valuations, strategically challenged companies needing to diversify and technological shifts driving a search for both protection and growth. An active stock market means good conditions for investment banks, with both **Barclays** and **Numis** kicking off the year extremely well. Numis, in particular, has experienced a very solid start to the year. A trading statement in February confirmed that its revenues are considerably ahead of the comparable year, with a larger number of clients accessing the equity markets and greater M&A revenue.

In the B2B media space, **Euromoney, DMGT** and **Ascential** fared well in a tough month. The three stocks currently make up c. 3% of the Fund. All are changing at pace as they grapple with the transformative effects of technological and regulatory shifts on various parts of their businesses. Since DMGT took the historic step of reducing its stake in Euromoney to below 50% in December 2016, Euromoney management have moved quickly to transform their asset base, with a focus on embedded data providers. In March 2017, Euromoney bought RISI, a price reporting agency for the global forest products market, for US$125m. Since then the company has been in disposal mode, in particular recently selling a 15% stake in Dealogic for US$135m, representing an exit multiple of c. 30x pre-tax profits and thereby recouping over twice its investment in roughly two years. Last month, Euromoney announced the disposal of its Global Markets Intelligence Division for US$145m, a deal which whilst initially dilutive leaves the group balance sheet in an extremely strong net cash position as management consider their options to reshape the business. We are backing this management team to execute well and continue to support their strategy.

Similarly, **Ascential** management are systematically recycling capital away from some of the company's traditional events and journals businesses into faster-growing digital data and marketing services businesses. This includes, in the last 18 months, acquisitions of One Click Retail, an online retail information services provider, Medialink, a marketing services business, and Clavis Insight, an ecommerce analytics company that offers strong synergies with One Click Retail. Underlying results for 2017 were strong and slightly ahead of expectations, as the management team's strategy to invest in information services continues to pay off.

The approach for **Sky** by Comcast provided a modest performance boost at the end of the month. Sky is a small position in the Fund at c. 1% of the assets. We have always felt (and written) that 21st Century Fox's bid for Sky was set at an opportunistic level that underpriced both the actual and strategic value of the business. When Disney bid for certain Fox assets, including Sky, we felt this vindicated our opinion that there was strong strategic value in the broadcaster, particularly so given Sky's successful recent renewal of Premier League football rights at a substantial discount. Moreover, the fact that Fox was a willing seller of the asset to a third party was a new and very interesting piece of information. Since then we have been hopeful of another bid for Sky. Comcast may not be the last player to declare its interest, but even if it is, we believe there is further upside to the valuation here as Fox/Disney respond to Comcast's offer. We have maintained the Fund's position at the higher level.

The situation at **GKN** is similarly interesting. Whilst we were not involved at the time of the Melrose bid for GKN in January, we have since made a small investment. If the bid fails, we are happy to be exposed to the underlying restructuring story that has been kicked off within GKN at pace since the announcement of Melrose's unsolicited interest. The strategy to unlock value by the new GKN management team, under severe pressure, looks interesting at first sight and is exactly the type of situation that attracts us. That we are paying a higher price for the Fund's first investment does not worry us, as the Melrose interest is serving to accelerate change. When toying with the scenarios we feel that if Melrose were to walk away, we would happily increase the Fund's position in GKN, as the management team would be under pressure to deliver and have a clear plan to do so. If Melrose is successful in its bid on the current terms, we would be happy to take more of the bid as stock and recycle the cash component into Melrose, having had previous experience of the latter's turnaround capabilities when it bought FKI in 2008. Another scenario includes a higher offer from either Melrose or another party. This is an intriguing and ongoing situation.

There is currently strategic value in having balance sheet strength. We have been on record saying that the balance sheet metrics amongst the current portfolio of investments are near the best we have seen since the Fund's launch in 2008. This alone is not a reason to be excited, but it does give the management teams we back the option to grow inorganically. **TT Electronics**, having sold its auto sensors business for c. £120m in early Q4 2017, announced the acquisition of Stadium Group for an equity value of £46m and an enterprise value of £58m. The deal is immediately earnings-accretive, due to the use of excess cash to buy these earnings. More importantly, it makes strategic sense, taking TT higher up the electronics value chain and offering both revenue and cost synergies. Stadium has been run inefficiently and offers strong working capital and, in particular, cost efficiencies, as well as access to some fast-growing products. We feel confident that the deal will deliver extremely strong earnings accretion to TT Group, in the range of 30-50%, if the synergies are delivered as we expect. Although never without risk, these are the kind of deals we back management teams to make.

The biggest detractor in February was **Man Group**, which suffered heavy profit taking during the equity market sell-off in the early part of the month. This was primarily due to underperformance of some AHL products during the turbulence. This led to a surprisingly rapid reappraisal and reduction in some analysts' performance fee forecasts for December 2018, which further fuelled its share price sell-off.

Subsequent results for FY17 on the 28th February were better than expected. Management are doing a good job and efforts to diversify the business away from AHL have paid off in the last few years. The acquisition of Numeric, a long-only quantitative fund manager, was a very good deal, with its AUM doubling under Man's ownership. Elsewhere, long-standing performance issues within GLG, Man's discretionary long-only unit, are also being tackled successfully.

Man is a genuine active investment management company built with the ethos of using technology to help generate superior investment returns. These are very attractive attributes in these times.

JOHCM UK Dynamic Fund

5 year discrete performance (%)

	JOHCM UK Dynamic	Benchmark	Relative return
1 year to 28 Feb 2018	8.81	4.96	3.67
1 year to 28 Feb 2017	28.97	23.09	4.78
1 year to 29 Feb 2016	-8.23	-7.53	-0.76
1 year to 28 Feb 2015	4.32	5.70	-1.30
1 year to 28 Feb 2014	24.67	13.14	10.19

Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as 28 February 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.