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Under the Bonnet

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Investment background

Global equity markets finished higher in September, buoyed once more by synchronised central bank action in response to slowing economic data. Global manufacturing continued to remain lacklustre, with new orders contracting at the joint-fastest rate in nearly seven years, according to the JP Morgan Global Manufacturing PMI. Over half the nations surveyed were in contraction and optimism was at its lowest level since the series began in July 2012. Global services optimism also fell to a series low, leading the JP Morgan's Global Services PMI lower.

China's central bank cut its banking reserve rate for the third time this year, releasing US$126bn into the Chinese economy. In Europe, the ECB announced its biggest package of rate cuts and economic stimulus in three years, with interest rates cut further into negative territory and its €2.6 trillion bond-buying programme revived for an unlimited period. In the US, the Federal Reserve, as expected, lowered its interest rate target by 25bps for only the second time since 2008.

Despite synchronised monetary easing global bond yields closed the month higher, triggering a significant change in the style leadership of equity markets. Global bond yields moved higher, initially reversing much of August's decline, following a pickup in the ISM non-manufacturing index and eurozone PMIs coming in ahead of forecasts. Whilst yields retraced some of these advances following the European and US central bank action and softer flash PMIs from both regions, a 12bp and 15bp increase in German and US generic 10-year bond yields, respectively, was sufficient to cause the largest one day fall in the US sector neutral momentum factor since May 2009 (as denoted by Morgan Stanley's MS00MOMO index). Such a marked one day move in a factor illustrates quite how crowded market positioning has become.

In the UK, sterling touched a four-month high against the euro and two-month high against the US dollar in September. Investor fears of a Corbyn-led government receded further, with Prime Minister Johnson's lead over the Labour leader continuing to rise in YouGov's Westminster voting intentions tracker, whilst the Supreme Court's ruling that Johnson's advice to the Queen to prorogue parliament was unlawful further reduced the likelihood of a hard Brexit outcome in investors' eyes.

Strategy update

The Fund outperformed the index in September, returning 5.30% versus a 2.60% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing (geometric) outperformance of 263bps, its best monthly performance in over five years.

Over the quarter, the Fund outperformed the index, returning 2.45% versus a 1.37% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing (geometric) outperformance of 106bps, its best quarterly performance since Q1 2018. Pleasingly, performance was mainly driven by stock selection, accounting for over 80% of the attribution effect both over the quarter and in the month of September. Outperformance came despite significant headwinds, with half of the bottom 10 stock contributors over the quarter being stocks the Fund does not own, predominantly bond proxy stocks including Astrazeneca (-46bps), British American Tobacco (-22bps) and Compass Group (-12bps).

Vodafone and **Restaurant Group** were two of the Fund's top three performers over the quarter having both previously been a headwind to performance last year following contentious M&A. This is encouraging from a performance perspective, as we have previously detailed our belief that the idiosyncratic headwinds the Fund experienced from five of its holdings undertaking M&A last year (**Vodafone, Restaurant Group, ITE, Melrose** and **Elementis**) should represent latent potential for outperformance.

Shares in Vodafone responded strongly to the announcement that it would spin off its European tower infrastructure assets in to a separate company and signs of stabilising revenue declines in its core end markets (see 'Under the Bonnet' – August 2019).

Restaurant Group shares performed well over the quarter. This was in part due to an improvement in investor sentiment towards UK stocks, especially pub assets, with both EI Group and Greene King being acquired at c.40-50% premiums. But it was also due to continued strong trading at Wagamama (+12.9% in like-for-like sales for it most recent quarter, 8.5% outperformance against the UK market), strong trading in its pubs, and contract wins by its concession business. However, interim results in September illustrated how the remainder of the leisure business (mainly Frankie & Bennys and Chiquito) continues to drag on operating performance. The company announced further impairment and onerous lease exceptional charges in order to reflect the revised aim of exiting at least 50% of Leisure sites by the time each site reaches its next lease expiry date (the estate has a median of six years). Whilst this may have been a painful message for the new CEO to deliver to shareholders in share price terms, with the shares down 12% on the day, we are left under no illusion that this is the result of a very rational, if not prudent, set of assumptions being made over future trading of these sites. The subsequent purchase of c£300k of shares by the CEO, the largest executive purchase since this Fund's ownership of this stock, adds further credibility to our belief.

In September, the Fund's performance benefited from not owning bond proxy stocks and US dollar- earners Diageo, Unilever, Imperial Brands and Astrazeneca, as sterling and global bond yields rallied.

Morrisons was the Fund's top performing stock in the portfolio in September. Its interims showed PBT ahead of analyst expectations, while the group announced a further special dividend (its fourth special dividend in 24 months). It also reported an expansion of its partnership with Amazon, as well as further wholesale supply contract wins including a new forecourt partnership with Harvest Energy, more store trials with Rontec and an export agreement with LuLu, the second-largest grocer in the Middle East. These wholesale contract wins represent important new volumes, increasing the throughput of Morrisons' vertically integrated fresh food manufacturing business (now the largest in the UK). They therefore provide the basis for further increases in cash generation as well as additional margin headroom that can be reinvested in the retail customer proposition to drive further volume.

There were also encouraging interim results from **Melrose**. These showed positive margin progress and organic revenue momentum building in its Aerospace division, whilst margins in Automotive and Powder Metallurgy surprised to the upside versus analyst expectations. This is a pleasing performance, not least because it is further evidence that the Fund's industrial holdings continue to have sufficient operational levers to pull to generate returns despite the wider economic headwinds. It is also pleasing because Melrose is another one of the five stocks that experienced M&A-related share price performance headwinds in the second half of last year. Despite this encouraging showing, management have refrained from upping their full-year guidance expectations at this stage.

Finally, the Fund exited its residual position in McBride. As previously detailed (see 'Under the Bonnet' – January 2019), the Fund had been reducing its position as the turnaround strategy had stalled in its transition from 'fix' to 'prepare' for growth. The business became dogged by intense margin pressures from customers, raw material cost inflation and logistics cost inflation, ultimately leading to the resignation of the CEO. After what had been a very promising first two years of the turnaround strategy, with McBride becoming the pre-eminent own label manufacturer to European supermarkets for household products, this is a disappointing outcome that resulted in a 57bps negative contribution to the Fund's performance over the holding period.

The stock serves as a harsh reminder of the difficulties of turning around businesses with high customer concentrations in low margin industries.

Please note this will be our last 'Under the Bonnet' in the current format. From next month, we will be producing a slimmed down monthly version in a more bullet point-style format, whilst moving to a more in-depth quarterly report to accompany our quarterly BrightTalk webinar – this quarter's webinar is at 3pm on Tuesday 12th November (Register).

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	30.09.19	30.09.18	30.09.17	30.09.16	30.09.15
A GBP Class	0.83	6.57	20.76	15.35	-2.13
Benchmark	2.72	5.84	12.62	16.43	-2.79
Relative return	-1.84	0.69	7.24	-0.93	0.68

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 September 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.