September 2017

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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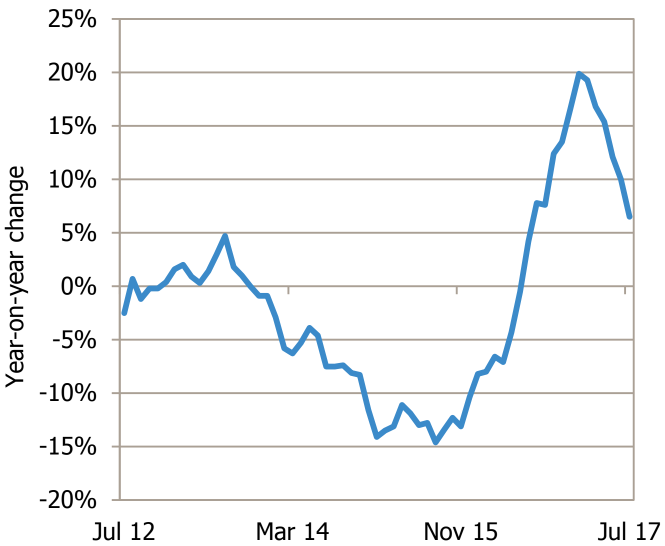
Investment background

August was a trickier month for equities with rising global tensions around North Korean missile testing and continuing uncertainty over the economic and political outlook, particularly for the UK, serving to cap the recent upward momentum. Whilst equities rose by a small amount in the UK on a headline basis, performance was volatile and sector performances diverged materially.

Treasuries broadly outperformed equities as yields declined in response to benign consumer inflation readings for July in both the US and UK which called into question the timing of any interest rate rises. The weaker-than-expected consumer inflation readings continued the theme of the past few months and mirrored the ongoing tapering in input price rises seen at UK manufacturers over the last few months (see chart).

UK ONS manufacturing input prices (materials and fuels purchased) index



Source: ONS as at 1 July 2017.

Commodity markets generally performed well, as slightly improved macro indicators in China and further trade-weighted US dollar weakness drove prices higher across the board. Copper, iron ore, nickel and metallurgical coal prices rose by 6.7%, 7.1% 15.5% and 16.4% respectively, whilst precious metals prices also rose in a general flight to safety, with Gold +4.1% and Platinum +6.2%. Oil was flat over the month.

Employment data remains highly robust in developed markets with the unemployment rate in the UK falling to 4.4% in the three months to the end of June. Average weekly earnings data as reported by the ONS continues to be fairly subdued, albeit better in June at +2.8% year-on-year. Private sector wage growth continues to outstrip public sector growth by circa 2:1, and in August the ONS reported the lowest number of Public sector workers since 1999. Government willingness to end the public sector pay cap for certain key workers is perhaps long overdue and in combination with emerging signs of private sector wage growth, suggests the recent debate over the real wage squeeze in the UK might start to dissipate a little.

The Fund underperformed slightly in August, rising by 0.41% relative to the FTSE All Share index which rose by 0.9%. Given a number of specific headwinds faced by the Fund over the month, including a profit warning from a top ten position (see below), further ongoing underperformance from QinetiQ (which cost a further 15bps of relative performance) and a 30bp negative allocation mix from being underweight consumer goods, we feel this was actually quite a creditable performance.

SDL posted a disappointing and somewhat surprising set of interim results at the beginning of the month which highlighted a good first-half revenue performance, in-line with the revenue improvement plan, but at the expense of group margins and therefore a much lower-than-anticipated profit outturn. Analyst expectations for full-year earnings were reduced by between 25-30% with the company's shares falling by a similar amount. The operational turnaround in this business is centred on an increasing focus on in-house translators, thereby reducing the costs of external translation service providers and in turn driving the utilisation rates of internal translators higher. The miss on profit in the first half was driven by the need, perversely to outsource more new work, meaning a higher cost of delivery on new business as the company is investing to deliver future efficiencies. We are encouraged by traction on the revenue improvement initiatives but obviously disappointed by the miss on gross margins. For now, we are minded to believe that the profitability issues are transitory and indeed are further proof of the need for transformation. That said, the share price fall resulted in a 74bps negative relative contribution which we are unlikely to see unwind in the very short-term as the equity story has been set back by at least six months.

The Fund's underweight position in consumer goods, a sector which strongly outperformed over the month, provided a further headwind. This was offset however by a strong performance from the Fund's position in **Stock Spirits** which posted better-than-expected interim results which led to small earnings upgrades. More important to the ongoing investment case was news of a stabilisation in market conditions in the Polish vodka market after years of intense pricing pressure and an improvement in Stock Spirits' market share as a direct result of a changed and improved pricing and promotional strategy. The results led to a marked re-rating in the shares of the company as investors responded to the markedly improved risk profile and outlook. This is now a much better business with good management, good assets, strong local market positions that make them an ideal partner for large international drinks companies and a balance sheet that can be used to make bolt-on acquisitions where necessary, as seen with the recent €15m investment in the Dubliner Irish Whiskey brand. The shares delivered a relative return of 52bps over the month but we expect further outperformance.

Anglo American shares performed well after strong interim results which demonstrated material further self-help benefits and dramatically improved cash flow and balance sheet dynamics. Cash flow for the first half was similar to that generated for the whole of 2016 and with ongoing commodity price strength, a number of negative timing issues unwinding in the second half and further productivity enhancements, we expect this cash performance to continue. Net debt:EBITDA* is now firmly below 1x and looks to be rapidly heading below 0.5x. Long-term targets for net debt are 1-1.5x EBITDA and with a large scale but syndicated copper project at Quellaveco in Peru as the only major project on the horizon (targeted to start in c. 2020), the company felt able to return to the dividend list in H1, earlier than expected. It has been a long haul with a few false dawns, but with the underlying business more cash generative, higher margins, corporate debt now rated investment grade and the equity significantly de-risked, we can now applaud the management team on tangible evidence and the rapid turnaround in the company's fortunes from the depths of the 2015 share-price lows. The shares from this point, given the changed balance sheet dynamics, should prove to be a little less volatile and we would expect, absent a major drop off in commodity prices, continued outperformance given the strong cash flow outlook, the continued positive self-help initiatives and the near historic low rating of the shares.

Morrisons shares continued to perform well in August after the announcement of a deal to supply the convenience retailer McColl's Retail Group. The deal will see Morrisons supply a broad range of fresh and ambient goods into the McColls estate of 1300 convenience stores and 350 newsagents. It also reintroduces the Safeway brand into the market, with McColls getting a one year period of exclusivity on the brand. It allows Morrisons to leverage their well invested but underutilised manufacturing estate, thereby earning a manufacturing margin on certain fresh product lines as well as the distributor margin. This is a very good deal for Morrisons and is fully in-line with management's promise to grow outside the four walls of their traditional supermarkets and in a capital light manner. Furthermore, it represents differentiated and idiosyncratic strategic progress which fully supports and strengthens the ongoing investment thesis.

*Earnings before interest, tax, depreciation and amortisation