September 2018
FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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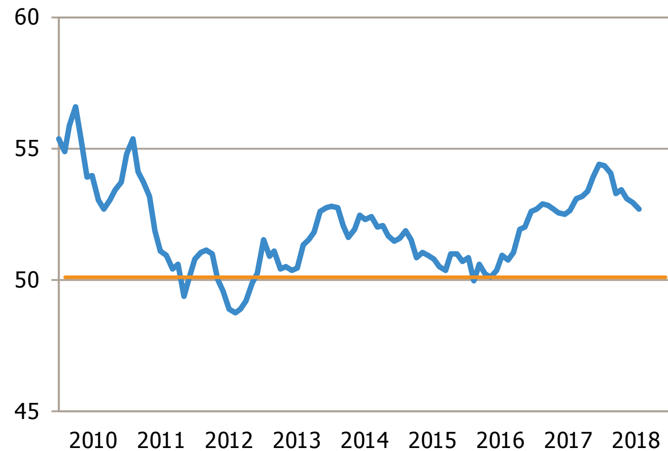
Investment background

August was a strange month for global equities, with the UK, European and certain international markets suffering from a mixture of Brexit, trade tensions and currency movements (broad US dollar strength and emerging market currency weakness), whilst the US market continued its relentless rise to further all-time highs, fuelled by the ongoing strong momentum in the economy whilst shrugging off any political or economic concerns around President Trump.

In the UK, specifically, rhetoric around a 'no deal' Brexit increased, driven in part by the UK government releasing papers publically offering technical advice to UK companies in the event of 'no deal'. The rhetoric was also ramped up by the ever louder voice of the Eurosceptic wing within the Conservative party calling for Theresa May to abandon the Chequers agreement and re-negotiate on tougher terms or pull-out without a deal altogether. For their part, the two individuals responsible for the public negotiations, Dominic Raab and Michel Barnier, made somewhat more positive noises as the month wore on, suggesting in turn that there was both a deal "in sight" and that the EU was prepared to offer "…a partnership with Britain such as has never been with any other third country". Positive words, indeed, and although sterling closed the month marginally down against the dollar at $1.30/£, it recovered from its mid-month lows of $1.27/£. A withdrawal deal, albeit a delayed one, is looking ever more likely. Whether it is subsequently ratified in Parliament and Theresa May is able to maintain the support of her party is the bigger question.

Away from politics, economic statistics over the month were broadly as might have been expected. The US continued to post strong PMI numbers, suggesting a continued healthy expansion in the economy, although perhaps not quite at a rate for Q3 comparable with the 4.2% annual GDP growth for Q2 released in late August. This was up slightly from the earlier (July) estimate of 4.1% and was the highest quarterly growth rate for US GDP since Q3 2014. Whilst the eurozone economy is not expanding at the rapid rates of 2017, the picture remains healthy with output remaining stable at relatively high levels, although August was perhaps most noteworthy for being the month in which Greece exited the final tranche of its EU bailout programme. Globally, there were further signs of divergence in the economic picture, however, with Asia remaining subdued and helping drive the JP Morgan Global Manufacturing PMI to its lowest reading in a year.

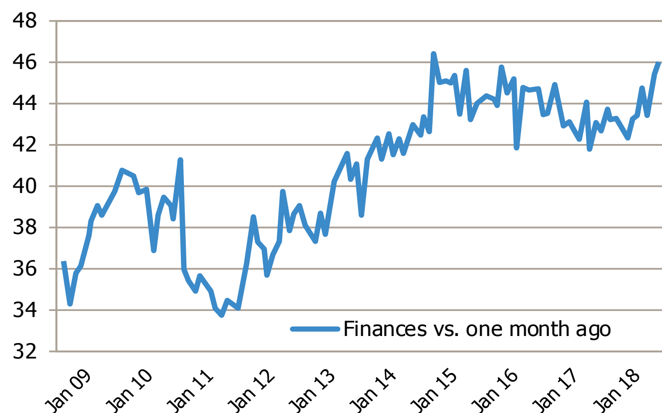
Global manufacturing takes a turn south
J P Morgan Global Manufacturing PMI (DI, sa)



Source: J P Morgan as at September 2018.

On the home front, August began with a rise in the base rate to 0.75%, a unanimous decision by the MPC and the second rise after the first last November. Data over the rest of the month was broadly supportive of the rate rise: GDP figures for Q2 recovered from the weather-affected Q1 to grow at 0.4%; labour market data remained strong, with unemployment at 4%, the lowest since 1974, whilst average weekly earnings were in line at +2.8% for the month; and CPI inflation rose ever so slightly to 2.5%. Real wages remained in positive territory and the underlying conditions of inflation being contained and for wage growth grinding higher remain in place for now. This more positive consumer picture was supported by healthy ONS retail sales data for July and then further by the IHS Markit Household Finance Index, which registered its second highest reading since the survey began in 2009, painting a healthier picture of financial wellbeing.

An improving picture on household finances
HFI, 50 = no change in household finances (s. adjusted)



Source: J P Morgan as at September 2018.

Strategy update

The Fund fell by 2.14% over the month. Whilst down in absolute terms, this represented somewhat resilient relative performance (+16bps) against the benchmark, the FTSE All-Share Total Return index (12pm adjusted), in what was a tricky month for equities and stock selection, as macro systematic factors overshadowed idiosyncratic bottom-up stock picking.

By sector, broadly neutral positions in oil & gas and basic materials offered the Fund a degree of protection from some of the more macro-dominated market movements e.g. US dollar strength, trade concerns and emerging market weakness. The oil & gas sector fell by 4.2% over the month, interestingly de-coupling from the Brent crude price, which rose by 4.3%. The basic materials sector fell by 9.3%, dragged lower by a falling copper price in particular. The tobacco sub-sector had a tough month, falling by 10.2%. The decline in BAT's share price drove a 34bps positive contribution to the Fund's relative performance.

Whilst the raw performance data tells us that the slight outperformance last month was driven by asset allocation (with a small negative over the month from stock selection), we feel the underlying reality is somewhat different, with a much healthier underlying corporate picture being overshadowed by the prevailing economic and political uncertainties. Performance should have been better.

Part of the Fund's underperformance from stock selection came in the Financials sector. Here the performance of **Barclays** and **Lloyds Banking Group**, both high conviction positions for the Fund, were a collective c. 30bps drag on performance. This to us is both odd and unreflective of the underlying reality. Interim results for both Barclays and LLoyds were good at the beginning of the month, with both companies tracking slightly ahead of expectations at this stage. Indeed, Lloyds raised guidance for both full-year net interest margin (NIM) and capital generation. The market's response in both cases was extremely underwhelming, despite the positive backdrop of a further interest rate rise in the UK. We could argue there might be other reasons why shareholders did not respond to the positive results, for example Lloyds has been linked with an acquisition of M&G (since denied by the company) and Barclays increased cost guidance for the second half. The reality is, though, that both companies are suffering from the potential negative effects of a hard Brexit. Why else would you sell shares in companies that are trading on single-digit PEs and deep discounts to book value, in the case of Barclays, or a near 6% yield (whilst upping capital generation guidance) in the case of Lloyds?

The Restaurant Group delivered a good set of interim results at the end of the month, confirming that whilst the twin effects of the World Cup and a hot summer had a short-term negative effect on trading in its High Street leisure business, strategic initiatives (far more important to the long-term future of the business) were really starting to generate a positive effect.

Like-for-like sales turned positive (+2.4%) after the end of the World Cup, proving that management are creating a more competitive offering in the core leisure business and positioning the business to slowly win back some market share. In particular, the strategy to evolve the offer to 'meet customer needs' and harness the potential of delivery is really starting to take hold. In our view the market underestimates the competitive advantage the current broad national estate offers, in particular in capital-light growth from generating new online-only brands (two thus far) serving specific local niches from the existing site footprint.

Elsewhere, management are using the strong group cash generation to rebalance the portfolio by growing more quickly (organically and through M&A) in both the Pubs and Concessions businesses, parts of the group that what we feel are undervalued. The differentiated Pubs business saw sector-leading like-for-like growth and growth has been augmented by a strong internal opening programme and the acquisition of two pubs businesses, Ribble Valley Inns and Food and Fuel. Together these have brought in 15 new sites and potentially a new brand in Coco Momo that offers the opportunity to convert some existing underperforming sites.

The concessions business performed extremely well in the period, winning 17 new units (on a base of 60) and moving into new travel hubs whilst broadening the range of partners. This concessions business is highly regarded and extremely valuable in our minds. It offers the potential to grow rapidly over the next few years, both domestically but also internationally.

Whilst we cannot change the fact that the business is a UK consumer services company and therefore its fortunes are intertwined with those of the consumer, we feel the idiosyncratic developments within this company are highly credible and far more important to future share price performance. However, they are still being ignored by a backward- looking and macro-obsessed investor set.

TT Electronics reported very strong results which were substantially ahead of expectations. This was driven by margin outperformance in each of its divisions, better-than-expected revenue growth and strong showings from recent acquisitions, which offer better-than-expected revenue synergies for the future. Cash generation, a key focus of this management team, again beat expectations. Also impressive (to us) was the continued growth in R&D spend, in order to help drive future revenue growth in higher margin areas. Ultimately this business is developing into a more sustainable (less cyclical) revenue generator, capable of generating high-single-digit or low-double-digit margins and with a balance sheet that affords further bolt-on M&A optionality. We continue to be very supportive shareholders.

Hunting also had stellar results, again beating market expectations. Performance from the Titan division, a market-leading perforation gun developer serving the US onshore shale market, was the main driver, growing by 60% year-on-year. There were also early indications of a recovery in the offshore market, previously a large business for Hunting. Better cash generation meant the dividend was restarted earlier than expected.

What we like about this company is not just the recovery

potential but the operational and business improvement that can be achieved under this management. Previously the management overspent on capital investment and at the wrong time in the cycle. This magnified the downturn when it came. That legacy spend is now a positive, with some sites being repurposed to service the growth in the perforating gun market, whilst a focus on in-sourcing is also driving utilisation and strong cash generation. This cash will be used wisely. Any new capex will be small and have strong payback characteristics; one announced investment has a cost of $2.9m but is expected to generate $3m of incremental annual earnings. Organic technology and product investment is increasing, with a focus on market need and automation.

A large part of the group's asset base remains in place to serve the global Oil country tubular goods (OCTG) market and involves storing and threading big steel tubes which are then distributed. This business line has high capital employed and low returns and masks the fact that group is actually a technology and product company. We feel that this management team might not be wedded to this business and, in time, may seek opportunities to monetise it. Any transaction would be value accretive.

The strengths of the investment case are currently being masked by the market's obsession with production bottlenecks in the Permian basin in the US. We feel the fears in the Permian misstate the economic reality. It is a short-term issue, ignores the amount of maintenance drilling, overlooks the number of uncompleted wells and neglects the fact that where the Permian might decline other basins are growing dramatically. Whilst the market focuses on this transient issue, we will continue to build the Fund's position.

Lastly, we had a profit warning from **Chemring** after an explosion at one of its manufacturing sites, which sadly, and clearly most importantly, caused a loss of life. From a share price perspective, we would expect to see these losses recovered in time with insurance covering much of the damaged property and lost earnings. Whilst this will be no consolation to the bereaving family, it has ensured the Group will accelerate its transition to more automated production, thereby reducing the likelihood of such incidents in the future. Our thoughts are with the family.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance to

	31.08.2018	31.08.2017	31.08.2016	31.08.2015	31.08.2014
JOHCM UK Dynamic Fund	7.51	20.48	10.06	-0.38	13.23
Benchmark	5.71	13.49	13.45	-3.41	9.55
Relative return	1.70	6.16	-2.99	3.14	3.35

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 August 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.

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