J O Hambro Capital Management Group

Under the Bonnet

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Investment background

World equity markets fell in August as investors adjusted their global growth expectations lower again in response to the escalating US-China trade war. Additional tariffs were announced by both sides and the US Treasury went a step further by declaring China to be a currency manipulator. The aggressive, knee-jerk and sometimes contradictory tweets from US President Trump added to the market's skittishness. Despite further trade discussions being scheduled, markets took a dim view of a near term solution leading global bond yields to new all-time lows.

Uncertainty continued to affect global manufacturing, with signs that it may now be spilling in to services. JP Morgan's Global manufacturing PMI signalled its third straight month of contraction to fall to its lowest level in nearly seven years, with 19 of the 30 nations surveyed indicating manufacturing downturns. European manufacturing continued to bear the brunt but it was the US manufacturing PMI falling to its lowest level since September 2009 that was most notable. Slowing economic growth put downward pressure on raw material prices, with oil reaching its lowest price in nearly seven months.

In Germany, the rapid deterioration in the manufacturing sector was enough to almost offset the ongoing robust growth in services, whilst in the US Q2 GDP growth was revised down from 2.1% to 2.0% and the US Composite PMI registered business confidence at fresh series lows in both manufacturing and services. These weakening trends challenge the continued logic of a trade war and the adequacy of central bank monetary policy, the latter of which was the main topic of the Jackson Hole Economic Policy Symposium held during the month. With talk of fiscal stimulus alternatives rising up the political agenda globally, it is maybe no surprise that that the US Treasury announced it might test investor appetite for a 100-year bond issue. With global stocks of negative-yielding debt reaching a new high of US$17 trillion in the month, there remains little evidence of this changing narrative being reflected in the defensive and deflationary positioning of investors.

In the UK, change continued to accelerate. Sterling touched multi-decade lows against the US dollar and the euro as fears of a hard Brexit and snap general election mounted and ONS data showed the UK economy contracting in Q2 for the first time in six years. With an election clearly in mind, Prime Minister Johnson began publically outlining his plans for increased investment in vote-winning sectors of health, education and infrastructure whilst continuing with his hard stance on leaving the EU by 31 October come what may. Polling data showed the message working, with voters with a bounce in the Conservative's approval rating and Kantar TNS's poll even indicated a Conservative majority. If sustained, this could mark an end to business fears of a Corbyn-led government. Prime Minister Johnson's decision to seek, and subsequently receive, approval to prorogue Parliament, whilst contentious, should ultimately accelerate change, with Parliament being forced to take decisive action in either direction.

Strategy update

The Fund marginally outperformed the index, returning -3.27% versus a -3.40% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing (geometric) outperformance of 13bps. Pleasingly, strong stock selection more than offset negative allocation headwinds. The Fund faced a 75bp headwind from not owning bond-like momentum stocks AstraZeneca, Diageo and Unilever. This was partially offset by a 28bp tailwind from a decline in Prudential's share price (also not owned) and a 25bp benefit from its underweight position in Royal Dutch Shell.

QinetiQ was the Fund's best performing stock over the month. The shares continued to rally after a strong Q1 update towards the end of July, no doubt aided by a perceived reduction in the threat of a Corbyn-led government. The shares have unwound nearly all their relative declines from the previous two months, an underperformance that began with two analyst downgrades that we believed to be unjustified and short-term driven (see 'Under the Bonnet – July 2019').

The most significant news for the Fund was that **Daily Mail & General Trust** (DMGT) agreed to sell Genscape, its energy information business, to Verisk for US$364m (£298m) on an eye-catching EV/EBITDA multiple of 40x, being in virtually all cases c. 3-4x higher than most analyst estimates and 2x higher than our own more bullish estimate. The sale offered further evidence (as if any was needed) of management's willingness to unlock the deep value inherent within the previous conglomerate structure of DMGT. In June's 'Under the Bonnet' we stated that we thought just two assets, Risk Management Solutions (RMS) and Mailonline, accounted for the current enterprise value of the group. This most recent sale, of a data business providing insight to clients, again confirms the value inherent in such businesses and firmly underpins the valuation of RMS, the global market leader in the catastrophe risk modelling industry and a jewel in the DMGT data crown. The growth opportunity available to that business in real-time data-driven analytics under a transformed and highly credible management team makes a mockery of some of the analyst valuations of c. £500m or c. 2.2x sales. We feel it is worth at least double that value, particularly if it successfully transitions the business model to be more of a solutions provider than just a risk model provider. DMGT is now a top five active position for the Fund.

As we have outlined previously in our quarterly investor calls, the Fund has experienced some specific factor headwinds over the last 12 months, so it was pleasing to see further evidence counter to these. Fears of an industrial slowdown have been a major headwind for the Fund. With industrials being the Fund's second-largest sector overweight, we have long believed the Fund's holdings in this sector could deliver value regardless of a tougher macro environment. Interim results from **TT Electronics** demonstrated this with 8% organic growth and increased operating margins. Management's strategic focus on picking the right customers in the right markets and investing in the right capabilities has delivered differentiated returns.

We have long spoken of the quality of this management team. Alongside a record order book in its largest division, this quality gives us confidence over the future.

Although not strictly in industrials, **Hunting**'s interim results were slightly ahead of analyst expectations. This was driven by growth in its US business and EMEA division because of stronger performance in its oil country and tubular goods (OCTG) business line. This offset a weaker performance in its Hunting Titan business, where, as anticipated, margins were reduced by the selling off of higher-than-normal inventories of conventional performance guns that had been bought ahead of tariff increases. Although Hunting has by no means been able to escape the wider economic slowdown, with management guiding to an uncertain second half, the shares already trade at a c. 20% discount to book value, with cash and working capital accounting for 40% of net assets at the half-year stage. The acquisition of RTI Energy Systems, which delivers production riser technologies for deep water applications, for below book value during the month demonstrates how the business can use its strong balance sheet during this period of softer growth to bolt on interesting strategic assets at attractive prices, putting it in a stronger position for any upturn.

The Fund also benefited from good share price performances in **Vodafone** and **The Restaurant Group**, both stocks that had fared badly after the market took a dim view of their M&A last year. Vodafone shares continued to revalue following last month's trading update and the announcement that it would look to monetise its European tower infrastructure assets. The Restaurant Group rose following further M&A activity in the sector, with Greene King announcing it had reached an agreement to be bought by Hong Kong's CK Assets just a month after Stonegate had agreed to acquire Ei Group.

Finally, Q2 results from **WPP**, a newer position in the Fund, showed signs that management's three-year turnaround strategy might already be starting to work. Q2 organic growth of -1.4% was better than the consensus forecast of -3.0% and above the company's full-year guidance of -1.5% to -2.0%. Improvements in North America were particular encouraging, with a number of new client wins and expanded assignments thereby challenging the wider market view that there are insurmountable structural headwinds affecting the industry. It is still very early stages for this new management team and strategy, but it is an encouraging start.

JOHCM UK Dynamic Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	31.08.19	31.08.18	31.08.17	31.08.16	31.08.15
A GBP Class	-3.92	7.51	20.48	10.06	-0.38
Benchmark	0.18	5.71	13.49	13.45	-3.41
Relative return	-4.10	1.70	6.16	-2.99	3.14

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 31 August 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.