J O Hambro
Capital Management Group

JOHCM UK DYNAMIC FUND

UNDER THE BONNET

Q4 2021 REVIEW

Alex Savvides, Senior Fund Manager

INVESTMENT BACKGROUND

For me, December will go down as one of the most fascinating months for global macroeconomic policy that I have witnessed as an investor, capping an engrossing quarter of policy watching. With both the Fed and the BoE having failed to deliver on actual or guided monetary tightening in October and November, despite growing evidence to the contrary, the emergence of the Omicron variant in late November turned what should have been a routine December tightening decision into a guessing game.

As markets grappled with trying to understand the severity and economic implications of the latest Coronavirus variant, bond market focus shifted away from the current inflation debate despite now overwhelming evidence of the need to normalise rates. CPI inflation in the UK, rose by 5.2% in November, the fastest rate since 2011 and in the US by 6.8%, the highest rate since 1982. Employment data substantially supported the inflation narrative with unemployment reducing even further, staff shortages continuing, vacancies increasing and permanent starting salaries hitting a fresh series high in the UK*.

Yet, remarkably, in the early part of December, both the UK and US 10-year yields hit their lows for the quarter with the UK falling from 1.2% in mid-October to 0.69% on the 13th December and the US having been at 1.7% but bottoming at 1.34% in early December.

Then the FOMC on the 15th December signalled an accelerated timeline for tapering and three rate rises in 2022. The MPC went a step further, raising rates by 15bps in the UK on the 16th December. Coming right up-to-date we then heard the news of 'quantitative tightening' on the 5th January with the release of the FOMC December minutes. Is this the monetary policy paradigm shift?

STRATEGY UPDATE

It was a strong end to a strong year for the stock market. The FTSE All share TR index rose by 4.68% in December to close the year up 18.3%. Against this, the fund fared ok, rising by 4.38% over the month, an underperformance of 28bps. This closed a tougher quarter during which the Fund underperformed by 148bps, in part due to the yo-yoing short-term macro debate. Over the year the Fund did well, outperforming its benchmark by 407bps and erasing roughly half of the prior year's underperformance.

After such a tough 2020 it is pleasing to report a better year for the Fund in 2021. The unit price** finally recovered to its pre-pandemic high (December 2019) on the 12th August 2021. Whilst there is still work to be done in recapturing all of the lost relative performance since that date, it was an important first step and a platform we will build from.

Indeed whilst the Fund fared well over the year as a whole, supported by a strong earnings recovery and by a number of takeover bids, conditions became tougher as the year progressed. This was particularly the case in the final quarter as the return of Coronavirus fears and the preference for all things growth and tech served to halt the fund's strong relative performance of the first half. Large parts of the portfolio continue to be held back by current market preferences.

That said, whilst market conditions and factor preferences toughened over Q3 and Q4, we feel sure that were it not for the very negative performance of three large and idiosyncratic positions during that period, **Convatec, Pearson and QinetiQ**, the performance story in the second half would have been much better. Over the year these stocks contributed -321bps of relative performance, with -198bps of that in the final quarter. As we wrote in last month's Under the Bonnet, none of these companies had a profit warning and we feel sure that the underperformance will prove transitory.

Our firm conviction in **Convatec** in particular is reaffirmed after an extremely encouraging meeting with the Chairman and CEO in December during which we re-visited the business transformation case from scratch. We believe the current way of thinking about Convatec as a low growth, low margin company with an ageing product profile ceding market share is wrong. Years of underinvestment in R&D, sales and marketing and overall strategy is being rapidly repaired through the P&L with the results already starting to show. With limited new product launches, a business that was essentially going backwards in revenue, profit, market share and quality is now consistently growing at a rate of 4% plus, despite ongoing Covid-19 headwinds.

More importantly, underneath the surface it is building the operational and organisational resilience to be able to both sustain and improve that level of growth. Investments in people, products and services and organisational structure through global centres of excellence for training, for R&D and for central services are at first a cost but provide substantial future benefits of resilience and sustainability of growth that sceptical analysts are not yet willing to credit.

As we look to 2022, we expect the benefits of this investment to become even more visible. New and higher margin product launches will increasingly come to market through the year adding further support to revenue growth. In some cases these product launches are unique and first to market, in others, for example ostomy care, they are long overdue and will help arrest declining market share. The organisation has been geared up to deliver these products successfully and their development has been informed by market need, de-risking them further.

The old version of Convatec that was floated on the market was never of interest to us – underinvesting, juicing margins and generally overpromising. Very few of the management team from those days survived. This new version of the company, investing in growth and capability, is a straight buy and we continue to build the Fund's position.

On the positive side, the year was defined by strong M&A activity as a number of the Fund's larger and more contrarian positions were subject to bids. **Morrisons, DMGT** and **St Modwen** made the headlines given our public opposition to the initial low-balled bids and their large positions within the portfolio, but the year should also be remembered for the completion of the bid for **Urban & Civic** and the bids for **Aggreko, Ultra Electronics** and **Stock Spirits**. Two attempted bids for **Elementis** also failed (albeit one of these bids was in late 2020). The combination of Morrisons, DMGT and St Modwen contributed 490bps of positive relative performance whilst Aggreko, the larger of the others, contributed a further 77bps.

We were disappointed to see all of these companies leave the market albeit we feel that a fair price was ultimately offered for both Morrisons and Ultra Electronics. The same cannot be said for Aggreko which we voted against and for St Modwen where we fought a fairly lone public and private battle against Blackstone to try and at least get a fairer price. Whilst our efforts were rewarded with a small increase, it was difficult given the lack of other public shareholder support. Similar can also be said about the DMGT bid which recently finalised. Whilst we are aware we were not alone in opposing the offer, it is a shame the opposition wasn't even broader.

But it is the boards that agreed to some of these bids that should perhaps reflect on their reasoning more than us and our fellow shareholders. The pandemic did many things, but one of the most obvious to us is that it created a lack of confidence and fear of the future in certain boards that permeated through to their shorter-term capital allocation decision making. This uncertainty fed through to strategies and share prices and allowed the buyers an easy foot in the door.

One of the most galling things about this Fund's heightened M&A activity over the last eighteen months is that the buyers of the Fund's holdings were what we consider to be longer-term, infrastructure style investors. Whether it was the Rothermere Family buying the part of DMGT they didn't own, The Wellcome Trust buying Urban & Civic, Blackstone buying St Modwen, CD&R buying Morrisons or TDR Capital and I Squared buying Aggreko, these were highly credible investors with a longer-term view who know their markets.

Also noticeable is that they were acquiring companies with real assets, real book values and a real basis for valuation. Taken together with strong IPO activity in 2021 (note: we don't buy IPO's) particularly for e-commerce and technology related assets at increasingly eye-watering valuations, it did not escape our attention that Private Equity seemed to be selling low asset companies at high valuations in order to buy real asset companies at low valuations. We take extreme confidence in our own long-term stock selection process.

The Fund's outperformance in 2021 was not just about the M&A activity though. It was also about the benefit of good strategic decision making from many of our boards. Whilst it was the M&A stocks that topped the relative performance leader board, in absolute terms it was another sub-set of stocks of more unheralded stocks that impressed us most. **Man Group** and **Centrica** top that list rising by 72% and 53% respectively.

Man Group, a tech-enabled, quant-based fund manager found their services in increasing demand over the year leading to strong net inflows. Combined with a very good year for performance fee generation the results were consistently ahead of market expectations. The shares continue to be pushed around based on the performance of the AHL suite of Funds and held back by the low PE ascribed to their performance fee generation. The Group PE is a lowly 10x for 2022, up from an even lowlier 8x in 2021 (on lower expected performance fees). Yet the group has a growing book of both AUM and performance fee eligible AUM from which they have generated an average performance fee of $250m per year over the last 7 years. Combined with a strict capital allocation policy this has led to an average annual 8% return to shareholders via a mix of dividend and buyback. A growing, capital efficient, technology enabled quant fund manager. The PE here seems too low.

Centrica is probably the deepest business transformation within the Fund and under the relatively new CEO, is making strong progress. This Fund looks for often complex businesses to simplify, focus, be strict around capital allocation and improve the balance sheet. Centrica is the embodiment of this investment thesis having sold its US assets in 2020 and now in 2021, the larger part of its upstream oil and gas business. The resulting company is ungeared save for the pension deficit (which in the current environment is rapidly reducing) and has much reduced earnings volatility albeit from a slightly less diversified Group. Taken with the restructuring of employment contracts early in 2021 (which led to a bruising battle with the unions) a substantially different management attitude to cost discipline and cash generation and the current seismic shifts in the UK energy supply markets, Centrica is a vastly different and rapidly improving investment case, yet still woefully ignored.

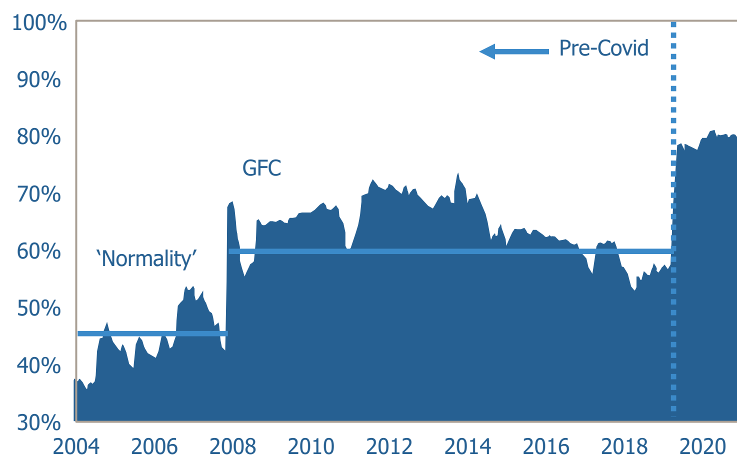
OUTLOOK

Current investment trends suggest a vastly improved outlook for this Fund's style of investing, particularly on a relative basis. Whilst we try to retain a balance in the Fund by ensuring that where our companies generate growth we hold onto it, there is an undoubted value tilt to the Fund's holdings. If a company has little history, an untested business model and does not generate profits then we cannot and do not invest. At times this can be difficult but as the relentless in-bound M&A of the last 18 months shows, it is absolutely the right way. We care about the price we pay for our assets and we believe that you should too.

In the last 10 years, a period of aggressively easy money through ongoing rounds of monetary and fiscal easing, has created the platform for the current extremes of valuation dispersion that markets now exhibit. These extremes have no doubt been encouraged by the emergence and rampant promotion of thematic and factor investing, trends that actively encourage capital misallocation through actively discouraging the whole idea of single-stock valuation and financial analysis.

Given this and the potential monetary policy paradigm shift, it is no coincidence to us that according to Citi analysis macro factors now explain around 80% of a stock's return***. This is an all-time high and up from c. 60% ten years ago. These were remarkable trends even prior to the pandemic and are even more remarkable now.

Macro driving global equity variability



Source: Citi Research, MSCI.

Where do we go from here? Most strategists now believe that even if elements of inflation prove transitory, the direction of interest rates is clear and they are going higher. For now, even though this fund is a bottom-up investor at its core, this should provide a tailwind to elements of our style of investing, at least for a period. This tailwind will not define our returns however – that remains the job of the idiosyncratic transformations that we back. But after the last 5 years of accelerating macro and factor-driven headwinds, it is welcome nonetheless.

*November REC / KPMG report.
**Y accumulation share class, Bloomberg code: JODYAGB.
***Citi research, MSCI.

Our readers should note that this will be the last 'Under the Bonnet' in this format as we switch to a quarterly report which will be combined with our quarterly webinar. You can sign up to the upcoming webinar here.

Finally, Tom Matthews has moved on to a new role within the organisation and we wish him the best of luck for the future.

FUND PERFORMANCE

JOHCM UK Dynamic Fund performance (%):

	1 month	3 months	1 year	5 years	10 years	SI annualised
Fund	**4.38**	**2.09**	**22.56**	**26.95**	**166.34**	**9.26**
Benchmark	4.68	3.62	17.77	30.73	111.39	6.36
Relative return[1]	-0.28	-1.48	4.07	-2.90	26.00	2.73

Discrete 12 month performance (%):

	31.12.21	31.12.20	31.12.19	31.12.18	31.12.17
Fund	**22.56**	**-17.62**	**20.82**	**-10.30**	**16.03**
Benchmark	17.77	-9.52	19.29	-9.06	13.10
Relative return[1]	4.07	-8.95	1.28	-1.36	2.59

Past performance is not necessarily a guide to future performance
Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as at 31 December 2021. 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. [1]Geometric relative.

ONE MONTH STOCK RELATIVE CONTRIBUTORS

Top five

Rank	Stock	Relative Return Contribution %
1	Crest Nicholson	0.20
2	Anglo American	0.14
3	Scottish Mortgage Inv Tst*	0.13
4	WPP	0.11
5	TT Electronics	0.10

Bottom five

Rank	Stock	Relative Return Contribution %
1	Convatec	-0.19
2	Euromoney	-0.19
3	Electrocomponents	-0.15
4	British American Tobacco*	-0.13
5	Barclays	-0.11

Past performance is not necessarily a guide to future performance
Source: JOHCM/FTSE International/Bloomberg. Figures are at end of day and calculated gross of fees on an arithmetic basis in GBP. All performance is shown against the FTSE All-Share TR Index (12pm adjusted). Data from 30 November 2021 to 31 December 2021. *Stock was not held during this period.

Q4 STOCK CONTRIBUTORS

Top five

Rank	Stock	Relative Return Contribution %
1	3i Group	0.46
2	AstraZeneca*	0.42
3	WPP	0.37
4	Centrica	0.35
5	Anglo American	0.34

Bottom five

Rank	Stock	Relative Return Contribution %
1	QinetiQ	-0.73
2	Convatec	-0.68
3	Pearson	-0.57
4	Euromoney	-0.32
5	Aston Martin Lagonda	-0.30

Past performance is not necessarily a guide to future performance
Source: JOHCM/FTSE International/Bloomberg. Figures are at end of day and calculated gross of fees on an arithmetic basis in GBP. All performance is shown against the FTSE All-Share TR Index (12pm adjusted). Data from 30 September 2021 to 31 December 2021.

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The Fund's investment includes shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.

Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request.

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Sources for all data: JOHCM/Bloomberg unless otherwise stated.