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Crisis or Not, Process and Patience Pay

The **JOHCM UK Opportunities Fund** employs an investment philosophy focused on three key pillars:

1. **Thematic Growth** – The team identify long term thematic tailwinds whilst avoiding cycle up/cycle down companies or those with structural headwinds
2. **Capital Preservation** – The team see capital preservation as an essential component of long-term value creation, and place significant emphasis on balance sheet strength, competitive position and valuation control
3. **Engagement** – The fund managers engage directly with companies to encourage them to improve their impact on the environment and society

The JOHCM UK Opportunities Fund is a concentrated portfolio of 20-40 large and mid-cap companies. It is not constrained by benchmark weightings.

Markets

The gloom at the end of 2022 was met by a bout of relative euphoria for the first two months of 2023, with cyclical stocks particularly strong until early March when Silicon Valley Bank poured cold water on the bonfire of the market bulls. These gyrations serve only as a reminder that market participants are hopeless at predicting near-term outcomes and how the ending of a period of ultra-low interest rates is causing 'bubbles' to rise to the surface and 'pop'.

We often get asked, "Why don't you own banks?" We have written a more extensive answer to that question here, but a key factor is excessive leverage within bank balance sheets which have the ability to hand shareholders a permanent capital loss. Banks don't work without lots of leverage. To boost a return on assets of around 0.5% to a return on equity of 10% requires leverage of 20x. Leverage has reduced significantly since the last financial crisis, however, Martin Wolf describes this neatly in the Financial Times as having "gone from the insane to the merely ridiculous."[1] Leverage amplifies mistakes. In good times, it means that an improvement in margins flows generously into higher profits. All should be fine unless someone pulls the economic rug (or makes a bad hedging decision). At this point, bad news is amplified, and all too often, equity holders get wiped out.

We remain vigilant in avoiding inappropriate leverage across the portfolio, encouraging management to invest as they see fit, have leverage which is appropriate to their business model and not to gear up through excessive buybacks and dividends. At the end of the period, we estimate the aggregate portfolio had leverage of 1.5 times Net Debt to EBITDA. Valuation, another key factor in capital preservation, remains attractive at 6.7% FCFY given our expected growth of 5% in revenues and 6% in free cash flow.

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Performance

The fund delivered a healthy performance in the first quarter of 2023, up +4.82%. This compares to the FTSE All Share which was +2.83%.

CRH was our best performing stock with the shares up +23% in the period. We have discussed the drivers in US infrastructure and onshoring trends at length in previous updates, and it is pleasing to see these strong trends being reported by the company, and investor's perceptions towards the stock becoming more positive.

In the quarter, IMI also reported a strong set of results, helping to drive the shares up +19% in the period. This is a world-leading British engineering company with 160 years of heritage, operating in arena of high-end valves. Its products help reduce the environmental impact of flaring on oil rigs, enable automation in factories and improve heating efficiency in buildings. Since 2019, a new management team has put greater emphasis on innovation and product development, and it is having a material impact on business performance. For 2023, the company expects to deliver 111p of earnings per share, which compares to the 71p in 2019. For a company which offers growth and innovation the shares remain undervalued trading on a 1 year forward P/E multiple of 12.7x which equates to 7% free cash flow yield.

Our worst performing stock was Anglo American, which fell alongside the rest of the mining sector, reflecting a muted impact from China's reopening and recovery, compounded by lower commodity prices and higher costs. Our long-term thesis is based on Anglo's exposure to the metals that enable energy transition; however, the volatility and unpredictability of cashflow are key reasons why our weighting in this sector remains modest.

The period saw some 70% of our portfolio holdings report either full or half year results. Our companies reported a consumer in unexpectedly good health, buying more clothes from Next, more cars from Inchcape and more hotel rooms from Whitbread. Consumers across the world coped well with inflation-driven price increases. Diageo saw organic net sales growth of 9% driven by price increases of +7% and volumes growing by +2% in the 6 months to December 2022. Even the UK newbuild housing market, which was dramatically impacted by September's UK budget fiasco, reported volume recovery.

Companies remain cautious on the outlook, highlighting the impact of rising energy costs and rising mortgage rates on demand. Our best guess is that the rising interest rates, which are intended to slow an economy, will do exactly that. We have continued to tilt the portfolio back towards more defensive names with strong balance sheets, where better value is emerging at last.

Back to the long term: The demographic tailwind

Away from the noise of increasingly volatile market movements, the fund remains well positioned to benefit from some important long term thematic 'tailwinds'. One of these which we would like to highlight this quarter is the evolution of global demographics and how this could impact investor returns in the coming years. As UK investors, we are mindful that the UK fertility rate has not been sufficient to sustain the population level since 1972[2]. The UK is not alone. In Japan, low birth rates and the resulting ageing population have led adult nappies to out-sell the baby varieties since 2011[3]. In the developing world, China's population is expected to peak by 2024[4].

If we look for consumers in countries with fertility rates that don't imply population decline, we find that 98% live in either Africa, Asia, or South America[5]. By 2050, these regions will constitute 88% of the global population. Our fund delivers meaningful exposure to these "faster growth" regions - balanced within established UK listed businesses where most sales come from less volatile markets.

Diageo, which generates 20% of its sales from Africa, reported 9% growth for the region during the quarter[6]. It owns the East African Brewing Company, with operations in Kenya, Tanzania, Uganda and South Sudan, as well as Guinness Nigeria. Africa is the fastest growing beer region in the world, and Diageo maintains a number one or number two share in most of its African markets[7].

India is now the world's most populous country. Both Diageo's United Spirits business, and Unilever's Hindustan Unilever, are leaders in premium branded goods sold in the country. Unilever is the market leader in clothes washing powder, hair products, dishwashing, tea, skincare, ketchup, soup and health food drinks[8]. In January, Hindustan Unilever reported sales up 16% for the last quarter.

Diageo's United Spirits is the leader in the Indian spirits market, controlling around 1/3 of volumes and poised to benefit from more affluent consumers buying more premium whiskeys[9]. Sales for the prior nine months were up 22% when it reported results in January.[10]

Whilst these companies have meaningful exposure to strong demographic trends, they are balanced by less volatile developed market exposures. For Diageo, Africa and India constitute 13% of sales, for Unilever, India represents 7%[11]. We estimate that our portfolio averages around 16% direct exposure to developing market demand[12]. We expect this area of positive exposure to have a disproportionately positive impact on the capital growth we deliver for clients.

Portfolio Activity

No new stocks were added, and no stocks were sold outright during the quarter. The main activity was to reduce the position size of the more cyclical names that performed well and to increase the weightings of those businesses that we expect to be most resilient. Our portfolio construction considers both the risk and the valuation upside of any business. Despite the rally in many cyclical names over the previous six months, the five largest positions that comprise 23% of the fund are characterised by relatively high margins and stable cashflows (Unilever, AstraZeneca, Relx, National Grid and BP). The five smallest positions comprise only 12% of the fund and are our more volatile and cyclical names (Future, Inchcape, Smiths Group, Hays, Mondi)

Happy engagement(s)

In total, the companies within our portfolio employ some one million people. As the 'fabric' of these businesses, we like to invest in companies where employees feel engaged, enthused and well-looked after. A study published by the Financial Analysts Journal showed that between 1984 and 2020, an equal-weighted portfolio of the best companies for looking after their employees earnt an excess return of between 2-2.7% p.a.*

Almost all of our portfolio holdings conduct employee surveys, and the vast majority of those that do, report the results. Despite this, few investors or analysts track the data. Our data at the end of March 2023 shows 93% of portfolio companies carry out an employee survey, 77% of which report the results. Pleasingly at the last count, 61% of portfolio holdings reported improved employee engagement. Where we find a significantly deteriorating trend, we use this as useful red flag and an opportunity to engage with management on the topic. Our analysis of the significance of employee engagement can be found here.

During the quarter, we continued our engagement with Future Plc aimed at improving the executive remuneration policy. We started this conversation in October 2021, and having made our objections clear to the board (and voted accordingly), we are pleased that the new policy appears to be a significant improvement on what went before.

The team also travelled to Leicester to meet with executives of Next Plc, where we again encouraged more ambitious targets in relation to plastic waste. At the end of the quarter, the company announced two new meaningful targets at their full year results. Next have now committed to reduce the use of non-recycled plastic by 50% and to reduce overall packaging (relative to sales) by 25%. Both targets

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are to be delivered by 2025. We have been engaging with Next since 2021 on this issue, which we see not only as environmentally important but as significant for the company's brand, reputation and long-term finances.

We also met with Barrick Gold to understand the latest developments at their most controversial mines in Tanzania and Papua New Guinea. Both mines have had significant social and economic issues pre-dating the arrival of current management, and the merger of Randgold and Barrick. Whilst we believe the company is making significant improvements across a range of sustainability issues, we continue to push for more independent site audits and better overall disclosure.

Outlook

The valuation and leverage metrics mentioned above, combined with a margin of 19.0%, and a return on capital employed of over 19.7%, demonstrate a resilient and high-quality portfolio of businesses.

The fund is positioned behind enduring growth tailwinds through a concentrated portfolio of well managed and well capitalised companies. Our investment approach continues to favour businesses that are both strong enough to withstand a tougher economic environment and positioned to benefit from long term thematic change.

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FUND PERFORMANCE

Periodic performance (%)	1 month	3 month	1 year	3 years	Since Inception	SI annualised
Fund	-2.06	4.82	5.09	32.68	232.50	7.17
Benchmark	-3.00	2.83	2.40	49.04	179.35	6.10
Relative return[1]	0.97	1.94	2.63	-10.97	19.03	1.01

Discrete performance (%)	31 Mar 23	31 Mar 22	31 Mar 21	31 Mar 20	31 Mar 19
Fund	5.09	0.13	26.10	-14.67	9.71
Benchmark	2.40	13.03	28.76	-19.06	5.93
Relative return[1]	2.63	-11.42	-2.07	5.41	3.57

Past performance is not necessarily a guide to future performance. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus. Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as at 31 March 2023. Inception date: 30 November 2005. 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.

References

[1]Office for National Statistics: https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/livebirths/bulletins/birthsummarytablesenglandandwales/2021#live-births-and-fertility-rates

[2]https://www.businessinsider.com/signs-japan-demographic-time-bomb-2017-3?r=US&IR=T#adult-diapers-outsell-baby-diapers-2

[3]Fertility, mortality, migration, and population scenarios for 195 countries and territories from 2017 to 2100, Vollset et al., The Lancet.com Vol 396 October 17, 2020

[4]UN Dept of Economic and Social Affairs, https://population.un.org/wpp/

[5]FY 2022, Source: Bloomberg

[6]Diageo Investor Conference: https://www.diageo.com/en/investors/results-reports-and-presentations

[7]Hindustan Unilever Capital Markets Day 2022, https://www.hul.co.in/investor-relations/company-presentations/

[8]Diageo Investor Conference: https://www.diageo.com/en/investors/results-reports-and-presentations

[9]https://www.diageoindia.com/en/news-and-media/press-releases/2023/unaudited-financial-results-for-the-quarter-and-nine-months-ended-31-december-2022

[10]Source: Bloomberg

[11]Company data, JOHCM Estimates

[12]https://www.ft.com/content/9dd43a1a-9d49-11e7-8cd4-932067fbf946

*https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3933687

Professional investors only.

Sources for all data: JOHCM/FTSE International/Bloomberg (unless otherwise stated).