



JOHCM UK Equity Income Fund

Monthly Bulletin: May 2020

Active sector bets for the month ending 30 April 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.24	3.23	7.01
Mining	11.38	6.25	5.13
Media	8.48	3.71	4.77
Financial Services	8.69	4.15	4.54
Food & Drug Retailers	6.21	2.12	4.09

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.88	-10.88
Equity Investment Instruments	0.00	6.16	-6.16
Tobacco	0.00	4.68	-4.68
Beverages	0.00	3.83	-3.83
Travel & Leisure	0.82	3.71	-2.89

Active stock bets for the month ending 30 April 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Phoenix Group	3.36	0.17	3.19
Legal & General Group	3.82	0.66	3.16
Barclays	4.08	0.99	3.09
Tesco	4.27	1.23	3.04
DS Smith	3.25	0.22	3.03
ITV	3.15	0.15	3.00
WPP	3.40	0.40	3.00
Standard Life Aberdeen	3.22	0.28	2.94
Glencore	3.61	0.86	2.75
Vistry Group	2.73	0.09	2.64

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.92	-5.92
HSBC	0.00	4.50	-4.50
GlaxoSmithKline	0.00	4.41	-4.41
British American Tobacco	0.00	3.81	-3.81
Diageo	0.00	3.44	-3.44

Performance to 30 April 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	9.22	-30.66	183.10	£1,851mn	£2,225mn
Lipper UK Equity Income mean*	8.86	-22.00	129.88		
FTSE All-Share TR Index (12pm adjusted)	8.64	-19.54	146.90		

Discrete 12-month performance (%) to:

	30.04.20	30.04.19	30.04.18	30.04.17	30.04.16
JOHCM UK Equity Income Fund – A Acc GBP	-25.85	-4.38	14.41	22.37	-7.58
FTSE All-Share TR Index (12pm adjusted)	-14.76	2.34	8.40	19.78	-4.99

Past performance is no guarantee of future returns. Source: JOHCM / Lipper Hindsight. NAV per share calculated net of fees, net income reinvested, 'A' accumulation share class in GBP. Performance of other share classes may vary and is available on request. Inception date: 30 November 2004. Index return is net income reinvested, adjusted for 12pm. * Initial estimate for the Investment Association's UK Equity Income sector.

Economic developments

The social distancing measures taken across much of the world have weighed heavily upon economic activity over the last few weeks. Initial estimates of Q1 GDP from the US, France and Italy showed falls of 4.8-5.8%, quarter on quarter, even though the crisis only really affected these economies in March. In most cases, this is the sharpest economic contraction since World War Two. More pertinently, the latest PMI surveys for most developed nations suggest GDP falls of 2-3x times this amount in Q2. The European composite PMI for April fell to 13.5, from 29.7, and the UK recorded 12.9, with the service sector particularly badly affected. In the UK distributive trades survey, 39% of respondents reported that they had completely shut down their operations. It is this abrupt and complete stop to activity across many sectors that means the Q2 GDP drops are likely to be the largest in 100 years.

However, the scale of the response from central banks and national governments has also been unprecedented, both in its scale and its speed. Fiscal packages currently amount to around US\$2.5 trillion in the US (c.12% of GDP) and £350bn (c.16% of GDP) in the UK. Many of these measures are intended to protect businesses and employment in particular, during the lockdown. Unemployment will still rise materially in all affected countries, but by less than it would have done otherwise. It is interesting to note that weekly jobless claims growth in the US has slowed markedly in the last three weeks after an initial spike, and similarly in the UK in terms of applications for Universal Credit support.

Whilst central banks and governments have endeavoured to support supply in the short term, the pace of economic recovery once the pandemic fades will depend upon the speed with which consumer and business confidence and demand returns. Inevitably, many of those indicators fell heavily in April, with the US Conference Board's consumer confidence indicator declining to 86.9 versus 118.8 last month, and the GFK UK consumer confidence reading hitting -34 (versus -20). In both cases, these readings are back to levels last seen in the autumn of 2008.

Given it was earlier into this crisis, China may prove instructive in terms of the depth and duration of downturn. Its Q1 GDP fell 6.8%, compared to growth of 6% the quarter before. The command nature of the country probably means it will recover more quickly from an economic point of view than most Western democracies. Its manufacturing PMI survey has already rebounded to around 50, compared with 36 at the end of February. This improvement is supported by comments from a number of manufacturing companies represented in the region, including many of the iron ore-focused miners. However, so far consumption has been slower to recover. This is likely to be a pattern repeated elsewhere.

The oil price was a focus of attention once again this month, with the current oversupply resulting in full storage facilities, leading to turbulence in a number of oil futures contracts. This culminated in the high profile expiry of the April contract at a value of -US\$37/bbl, as no-one wanted to take receipt of the physical oil given the lack of storage capacity. However, it should be noted that oil for longer-term delivery was relatively unaffected by these gyrations. Furthermore, the price of spot Brent crude actually rose slightly in April to US\$25/bbl while WTI was flattish at US\$19/bbl.

Performance

The market, represented by our benchmark, the FTSE All-Share Total Return index (12pm adjusted), rebounded during April, following a difficult period from the middle of February.

The Fund slightly outperformed the market over the month in returning 9.22% versus 8.64%. This improvement in absolute and relative performance was welcome, but there remains a lot to do given the Fund's poor performance across the initial six weeks of the Covid-19 crisis. This is reflected in the portfolio's year-to-date performance, with the Fund down 30.66% versus a 19.54% fall in the benchmark.

Looking at the peer group, the Fund ranked second quartile within the IA UK Equity Income sector for April. On a longer-term basis, the Fund is ranked fourth quartile over three years and five years, second quartile over 10 years and first quartile since launch (November 2004).

Many stocks bounced from the extreme lows registered in March. This is partly a function of how extreme the moves were in the initial market reaction to Covid-19 and partly due to the market reacting to positive management action in response to the epidemic.

Whilst a number of stocks have rallied, there remain significant anomalies where certain share prices have not seen any real recovery. Notable moves, which remain small in the context of the previous falls, included **Barclays**, where c.£1bn higher profits from the markets division (driven by the heightened volatility) were used to record and front-load higher provisions; **U&I**, where, since the crisis started, management has sold assets equal to half the company's market capitalisation, in aggregate above book value, and where book value is c. 150% above the current share price; and **DFS**, which, as we describe in the next section, raised money at a 15% premium to its prevailing share price, which places it in a position to thrive after the pandemic.

Other areas that were stronger were housebuilders and the wider construction sector. It is clear the government wants this sector to be at the forefront of a return to work and to be a driver of the economic recovery. Other strong performing sectors include media and a number of UK cyclical, such as **Redde Northgate**, started to recover.

Weakness in the oil sector offset these positives. This weakness was caused by **Royal Dutch Shell's** dividend cut, twice as big as expected, and the adverse headlines noted above surrounding the negative value of expiring oil futures contracts amid Covid-19-related demand destruction. The Fund has 10% in the two oil majors in total. This is c.1.5% above the index weight, with our clear preference continuing to be **BP**, where we are 2.5% overweight, compared to Shell. Outside of this, **Diversified Gas and Oil** continued to make new relative highs as its performance continued to exceed expectations and it confirmed its dividend profile. Elsewhere at a stock level, **Hammerson** and **Standard Chartered** were laggards.

Portfolio activity

As in the 2008/9 Global Financial Crisis, it is important that we make adjustments to the Fund to reflect not only the post Covid-19 world but also the widespread and dramatic falls in share prices during the sell-off.

We accelerated these portfolio changes in April. Our main focus here is backing companies that are industry leaders, have strong balance sheets and experienced management teams who are on the front foot and can win market share at the expense of weaker competitors.

Many of these companies have seen, or did see for a period of time (from mid-February when the market started falling), substantial falls in their share prices. We have used the market turbulence to increase our positions, at very low prices, in companies that we think will be the winners of the

next decade. This is exactly the same process we went through in 2008/9, which set the Fund up well for the following years.

As we went through April, and helped by news flow from managements, we moved more and more of the portfolio (as a percentage) into this post-Covid 'front foot' category. A large part of this portfolio shift is due to positive actions by management teams. For example, **DFS** extended its banking facilities but also raised fresh equity at a 15% premium to the then share price. We added 20% to our existing position in a stock that has, in our view, 50% upside potential on a very cautious rating of 12 times recovered earnings. DFS now has enough capital, an energised management team and an opportunity to take market share from an already significant 34% towards 40% as competitors fail.

These moves collectively improve the quality and the upside potential of the portfolio. The 10 stocks highlighted below, which make up 20% of the portfolio, are other examples (but by no means the full list) of companies in this post-Covid-19 winners category. We have, on an underlying basis, added 15% to these positions (or 3% of the Fund's capital) since the market started to fall in the middle of February. This gives a feel for this repositioning of the Fund, which we are doing in each area where the possibility exists. The average historic P/E of stocks in this list (or current P/E for those less affected by Covid-19: **Galliford, TP ICAP, Phoenix** and **Legal & General**) is around 7.5x (with a range of 5x to 10x), which highlights the value opportunity. In addition, there are a number of other stocks that we are in the process of adding to or introducing to the Fund. We will update you on these names once those purchases are complete.



Some of these additions were funded by inflows (which remained positive in April and are around £70m year to date, excluding the assets that were transferred from the Fund to two segregated accounts in January). We also sold Ninety One, where we had a small position following its spin out from **Investec**. Considering the savage stock market falls, this stock performed well after that spin-out. We also sold out of our Investec position and switched into **Standard Chartered**. Investec is still modestly valued but the move reflected our drive to raise the quality of the portfolio. Standard Chartered is a leader in its markets and had fallen a similar amount to Investec. It trades on 0.4x tangible book value and, in our view, its share price could double from here.

It is also important to assess which parts of the economy could be permanently damaged by recent events. Commercial property is one area that looks vulnerable on a number of fronts. Over the shorter term, it has suffered directly from the lockdown and economic inactivity in terms of rental income. Landlords seem to have been left carrying the can, with no government support and even the introduction of unhelpful measures such as changes to stop court action against tenants in arrears. Over the longer term, the Covid-19 crisis seems likely to accelerate the switch to remote working. Office workers have been forced to adopt this new approach over the past two months, and indeed many seem to have become more comfortable with this working arrangement.

Likely falls in valuations will also result in loan-to-value levels rising markedly. This could create its own risk as the market sees a need to raise equity as loan-to-value levels reach a tipping point. We reduced our position in **Hammerson** on this basis. It is easier to make these decisions when there are reinvestment opportunities in stocks that have fallen by a similar amount, as there are currently. Only c.1% of the Fund is now in UK REITS, which is focused on our two small caps with specific niches or management expertise.

We have also thoroughly reviewed the portfolio from the angles of liquidity and leverage. In terms of the former, nearly the whole portfolio is well placed. On the latter, we have been ensuring that debt levels will not come out of the crisis materially higher than the where they started and are low enough to allow our companies to take advantage of opportunities that may arise as weaker competitors struggle. There is a single-digit percentage of stocks that still need to take action here, in our view. The market and Fund positions on both these measures – liquidity and absolute debt – are radically different and better than after the global financial crisis.

Fund dividend

Please see the Appendix for a comprehensive Fund dividend update.

Outlook

In many respects, much of the current economic debate revolves around one question: when will the level of global or regional GDP recover to pre-virus levels? Assumptions around the length of the lockdown, the risks of second peaks, possible medical solutions, unemployment increases and potential house price falls will all have a bearing on this outcome. We will not get drawn into second guessing which letter of the alphabet the GDP path will most resemble, but we do continue to believe that this is likely to be a finite economic event due to the scale of the policy response thus far. Clearly this means that budget deficits will expand enormously. For example, in the UK it will exceed the 2009 peak of £160bn, but for now it seems that a subsequent return to austerity policies is highly unlikely. Once the pandemic passes, a policy response that is effectively money printing should engender a healthy debate about future inflation rates.

Whilst stock markets rallied during April after their heavy falls in March, leadership globally was quite narrow, with many of the leaders pre-Covid-19, such as big tech and consumer staples, once again in the vanguard. Towards the end of the month, this situation began to change a little, with some of the more cyclically-exposed sectors beginning to recover as the spread of the virus began to fade. We believe this process has a lot further to run. As we have discussed before, valuation gaps between the 'value' and 'growth' buckets are at unprecedented levels and could close quickly as economies begin to open up again.

As described above, we are leaning upon our experiences of investing in difficult markets before, particularly 2008/9, in order to focus part of the Fund upon sectors and stocks which we believe have the potential to double in share price, or more, from current depressed levels. However, because of the uncertain timing around when economies will pick up, we are focusing on companies that have sufficient financial strength to cope with an extended lockdown if necessary, as well as the management experience to make the right decisions to gain market share as activity improves. Balancing long-term share price appreciation potential against collecting certain dividend income in the short term is a tricky task at the moment. Nonetheless, we will seek a balanced approach that gives the Fund potential to deliver significant capital upside as well as to generate a reasonable current yield and scope for healthy growth in dividends in future years.

Appendix - Comments on Fund dividend

Context

It has become clear over the last six weeks that numerous pressures are leading to boards cancelling or deferring dividends. The drivers are numerous: the need to prioritise liquidity, which is understandable given we don't know how long the lockdown will last; regulatory pressure (e.g. the PRA on banks and parts of the insurance sector); soft guidance from the FRC; a lack of clarity over whether the use of government schemes (e.g. furloughing employees / Covid-19 bank facilities) means dividends are banned; a 'moral' obligation not to pay out, even if the last point does not apply; boardroom and non-executive director risk aversion; and, as more and more dividends have been cut, a reinforcing trend. In recent days we have also seen the widely publicised change in Royal Dutch Shell's dividend policy.

The extent of this means there will be a material fall in the dividend flow across the market and for the JOHCM UK Equity Income Fund in 2020.

Our response

Our near-term focus is to make sure our companies come through this crisis stronger than they went in, as far as we can. This will be a function of strong leadership, solid market positions, robust balance sheets, a healthy liquidity position and responsible management vis a vis a company's various stakeholders.

We have agreed in many of our discussions with managements that temporarily removing the dividend is the correct thing to do, given the multitude of drivers noted above. In the majority of the cases, not only is it the right thing to do, it will indeed help ensure that these companies ultimately emerge in better shape.

There is also part of the market where it is not right to cut the dividend – because of the type of the business, the strength of a company's balance sheet, or its revenues being less affected by Covid-19. Despite these fundamental factors, which means dividends should not be changed, boards have come under pressure due to the wider trend and because of the multitude of drivers noted above. In these cases, we have been pleased to note board resilience (e.g. Tesco, Legal & General). And where final decisions have yet to be taken, we have made our views known (e.g. Vodafone).

There is a fine line in many of these cases. This was summed up in the Legal & General dividend statement of 3 April 2020: 'it also recognises the importance of dividend income to retail shareholders, particularly in the current environment.'

2020 market dividend trends

It is a moving picture as there are ongoing developments, but it is very clear there will be a very material cut to market dividends in 2020. A frequently updated research report by Peel Hunt attempts to quantify the picture. In its latest report, it showed that 55% of 'spring' dividends, in value terms, have been cut.

This analysis fits in with other work we have seen and also near-term dividend futures. However, we would caution against using dividend futures too much as a predictive call, because they are used predominantly as a hedging tool by portfolio managers. As such, they tend to have more natural sellers than buyers.

2020 Fund dividend

The Fund dividend will see a similar fall to the trends noted above in 2020. On announced dividend cuts / cancellations / deferrals, the forecast Fund dividend (for 2020) is down c. 33% year on year. We have also risk adjusted the residual into a 'safe' bucket and a 'likely to be cut' bucket. Assuming the latter are cut (which is likely to be the case), the Fund dividend will be down c. 51% year on year.

On this basis, our best estimate as we stand today is for the Fund dividend to be down 45-55%. The risk to the downside from this is that more boards succumb to the pressures noted above and

a more negative view on oil dividends, whilst the risk to the upside is that after the lockdown ends some of the boards that have already cut, but reluctantly so (with their commentary more orientated around a deferral), reinstate these dividends given greater clarity that the pandemic peak has passed. This remains a very fluid situation, so forecasting risk is high.

A more negative view on oil, part of which has transpired with the 66% cut by Royal Dutch Shell (which was more material than we or others would have expected) would push the outturn towards the bottom of the range above i.e. -55%.

The Q2 dividend is likely to show the sharpest fall (currently c. 60% including dividends in our 'at risk' bucket). This is partly due to it being the 'live' quarter in terms of Covid-19, but also because a number of dividends that went ex-dividend in Q1 (and were thus included in the Q1 declared Fund dividend, which went ex-dividend at the end of March) have subsequently been cancelled (e.g. Barclays), hence are negative adjustments against the Q2 dividend. Quarterly dividends are very sensitive to one or two changes, so this Q2 assessment is subject to change. It is also based on our 2020 current full-year risked modelling, as described above, versus our current best estimate of -45 to -55% year on year.

Fund dividend in 2021 and beyond

As noted above, our principal focus is to ensure our companies come out stronger than they came into Covid-19, where possible. We also want to ensure the valuation (upside) opportunity is as high as possible, which it is across the majority of our positioning. In terms of the Fund dividend, our focus, given the nature of these events, should be and is 2021 and beyond, as opposed to 2020. In 2021, and certainly in 2022, dividends will likely rebound dramatically as the temporary / emergency cuts driven by liquidity needs, the trend, board prudence and moral pressure drop away. This is the clear message we are picking up from the majority of our engagement with our companies.

One group of stocks could come back to the dividend list at some point during H2 2020. These are stocks where the decision whether to cut in the first place was borderline, partly because these businesses are still operating relatively normally at present – examples include Central Asia Metals, DS Smith, Mondi, and the annual Morrison special dividend. This is the upside scenario for 2020 mentioned above, but these dividends are highly likely to be back in 2021, assuming a more normal backdrop.

The second group of stocks are those hurt more by Covid-19. These names are more likely not to come back with an interim dividend in H2 2020 (which will itself cover the period when Covid-19 was at its worse i.e. H1 2020), but with a final dividend for 2020 in 2021. The extent to which these dividends come back versus their previous levels will depend on the shape of the recovery. It could be very aggressive given the extent of the stimulus, which grows each day, or more sluggish. Our view is it will be the former, but we will be modelling dividend trajectories more cautiously than this.

We are currently building a detailed initial view of the 2021 Fund dividend. This is a function of individual company assessments, discussions with managements, etc., but will only be fully informed when we see the timeframe around which the lockdown ends and also the shape of the recovery. This is a difficult process that involves many judgements at this stage. Once we have completed the initial framework, we will provide details of it, but it will have a much wider margin of error than normal.

Prior to the pandemic our internal modelling of the Fund's 2020 dividend was for growth of 8-9%. The outlook was positive, with the UK economy in particular performing better than widely expected after the general election and Brexit progress. This is important to have at the back of one's mind when considering where 2021 could come out versus the last full-year declared dividend, which was 20.79p ('A' accumulation share class), as the true run rate base was higher.

Our instinct, based on the discussions we are having with managements, our balance sheet analysis, etc., is that, assuming a reasonable recovery after lockdown ends, the 2021 dividend will be closer to the 2019 base line than it will be to the 2020 outturn.

Fund dividend yield

- The 'A' accumulation share class price on 30 April 2020 was 283.1p
- The historic 2019 Fund yield is 7.3%
- The yield based on the 2020 Fund dividend growth internal forecast pre-Covid-19 was 8.0%
- The yield for 2020, assuming the mid-point of the above -45% to -55% range, is 3.7%
- The yield for 2021 and beyond: our initial view is it will be closer to 2019 than 2020

As we have shown previously in the Fund unit price versus dividend trajectory graph, the unit price is assuming a permanent c. 50% drop in the Fund dividend. We think this is wrong. Using a hopefully cautious example of a more modest 25% fall in the Fund's underlying dividend would mean the Fund would have to rise by 50% if the unit price was to reengage with the dividend trajectory.

Further information

If you would like further information about the Fund, please call our Investor Relations team on +44 (0) 20 7747 8969, email us at info@johcm.co.uk or visit our website at www.johcm.com

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