



JOHCM UK Equity Income Fund

Monthly Bulletin: September 2020

Active sector bets for the month ending 31 August 2020:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.17	3.41	+6.76
Mining	13.30	7.49	+5.81
Media	6.62	3.67	+4.95
Food & Drug Retailers	6.47	2.18	+4.29
Banks	9.83	6.56	+3.27

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.24	-10.24
Equity Investment Instruments	0.00	6.84	-6.84
Tobacco	0.00	3.67	-3.67
Beverages	0.00	3.44	-3.44
Personal Goods	0.00	2.95	-2.95

Active stock bets for the month ending 31 August 2020:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
WPP	3.64	0.41	+3.23
Barclays	4.22	1.00	+3.22
Phoenix Group	3.37	0.19	+3.18
Tesco	4.28	1.12	+3.16
Legal & General Group	3.79	0.68	+3.11
BP	5.68	2.77	+2.91
Anglo American	3.97	1.16	+2.81
Glencore	3.65	0.95	+2.70
Vistry Group	2.74	0.07	+2.67
Countryside Properties	2.70	0.09	+2.61

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.78	-5.78
GlaxoSmithKline	0.00	3.85	-3.85
HSBC	0.00	3.49	-3.49
Diageo	0.00	3.05	-3.05
British American Tobacco	0.00	3.04	-3.04

Performance to 31 August 2020 (%):

	1 month	Year to date	Since inception	Fund size	Strategy size
Fund – A Acc GBP	2.03	-32.21	176.80	£1,579mn	£1,948mn
Lipper UK Equity Income mean*	2.13	-21.29	131.38		
FTSE All-Share TR Index (12pm adjusted)	1.55	-18.18	151.08		

Discrete 12-month performance (%) to:

	31.08.20	31.08.19	31.08.18	31.08.17	31.08.16
JOHCM UK Equity Income Fund – A Acc GBP	-20.21	-10.94	6.71	19.59	6.60
FTSE All-Share TR Index (12pm adjusted)	-12.55	0.18	5.71	13.49	13.45

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

UK economic data was unambiguously positive in August. The recovery has been accelerated by positive economic policy from Chancellor Rishi Sunak, with the 'eat out to help out' scheme and the changes to stamp duty proving to be successful. Credit card data and retail spending data suggests aggregate spending is back to pre-Covid levels. The difference is in *how* it is being spent. Housing, homeware, online, food retail and cars are all beneficiaries of the spending shift while unsurprisingly travel (holidays abroad and rail), leisure and spending in shops have all suffered.

The media is very focused on the negative side of this spending shift while ignoring the (at least partial) offset from the switch to other areas. The difference in newspaper column inches on the 7,500 job losses at Marks & Spencer and 2,900 job cuts at Pret a Manger versus the 16,000 jobs created at Tesco (to expand its online activities) illustrates this point. These trends manifested themselves in UK PMI data that exceeded forecasts (in contrast to Europe – see below). We expect a material rebound in UK GDP in the third quarter of c. 15-20%. Sterling continued to modestly appreciate against the US dollar and the euro. It is now close to a two-year high against the dollar, which has been weakening against all currencies. There will be bumps in the road as the furlough scheme and other support are unwound, but the first bricks in the foundations of the recovery are clearly more solid than expected.

Inflation data has surprised to the upside in a number of regions. The August print for CPI in the UK was 1%, compared to the 0.6% previously expected. In Japan producer prices for services came in at 1.2% versus expectations of 0.8%, and in the US CPI was 1% against the expected 0.7%. This was driven, in part, by the reallocation of spending highlighted above. In the areas of the economy where spending is strong there are capacity constraints. US lumber prices are a tangible sign of this. Prices are at all-time highs and are now twice the previous average levels. Government policy such as the 'eat out to help out' scheme will reduce inflation in the nearer term, but the key focus should be what inflation does as we move through 2021. In that respect it is interesting that inflation expectations continued to increase and are now close to where they were prior to the start of the Covid-19 crisis. These trends were the main driver behind rising bond yields during the month – US and UK 10-year government bond yields rose c. 25bp, with the German 10-year Bund yield up c. 15bp.

The change in the Federal Reserve's approach to monetary policy, announced at the end of the month, in which it will now target an *average* inflation rate of 2% and tolerate overshoots that mirror previous undershoots, is a potential pivotal moment. Whilst this will keep interest rates low

at the short end, it will likely cement higher inflation in the medium term and hence there may be some steepening of the yield curve and rises in longer-dated bond yields.

In the US Covid-19 cases declined, and it seems the wave in the Southern states has been brought under control. It has become clear, however, that case numbers (the data point given the most focus and airtime) have (a) increased due to more widespread testing and (b) become disconnected from the severity, hospitalisation and deaths figures. It is unfortunate, given these observations, that case numbers are still driving policy decisions. The extent of the Covid-19 outbreak in terms of cases and severity has been a clear driver of markets, bond yields and the 'value' versus 'growth' dynamic year to date. The data on severity (in Europe and the US) and cases (in the US) is improving. This, coupled with ongoing progress on treatment and vaccines, should create a better environment for 'value' in the months ahead.

In Europe economic data was more muted, partly due to the policy response to higher cases in countries like Spain and France, with PMIs being slightly disappointing. This may limit the extent Europe and the euro can continue to re-rate versus the rest of the world, which has been the trend since the European Recovery Fund was agreed. In China infrastructure spending continued to underpin the recovery and certain commodities, like iron ore and copper, moved to two-year highs. The oil price also continued to creep up.

Performance

The market rose slightly in August, with the FTSE All-Share Total Return index (12pm adjusted) up 1.55%. The Fund slightly outperformed, with a return of 2.03%. Relative performance was initially strong before trailing off in the last half of the month as the global market mix moved back towards growth and technology stocks. This was despite better economic news and higher bond yields, which would normally lead to the opposite. The Fund remains significantly behind year to date (-32.21% versus -18.18%), with most of the underperformance arising after the pandemic first broke.

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

Small-caps started to show some positive form in August with a number of positive trading statements and results. **DFS** reported like-for-like sales up c. 50% since the reopening of the economy as consumers focused on home improvement. It also benefited from the increased market share stemming from the demise of a competitor, Harvey's. Forecasts were upgraded by c. 100%, with the additional profit and cash this created worth more than the movement in the market cap that resulted. **Kenmare** (up 23% relative) reported positive results and highlighted continued progress in the movement of equipment to a new ore body. When completed and operational, this will leave the stock on a 40% free cash flow yield operating in commodities, where supply side changes are likely to lead to supply and demand imbalances. **Tyman** (up 17% relative), **Redde** (up 14% relative) and **Diversified Gas & Oil** (up 14% relative) also performed well. It was pleasing to see stock performance differentiation start to feed through, as this has not happened since the start of the pandemic. Less positively, a few of our small caps such as **Galliford Try** continued to lag.

Other positive contributors included the life insurance sector, where all three of our stocks were up on a relative basis, and the food retail sector. **WPP** was also strong after results that beat expectations and the recommencement of the dividend 12 months earlier than we had forecast.

Offsetting these positives, stocks falling out of indices at the end of August/early September underperformed – **ITV** and **Standard Chartered** were clearly affected. This effect should normalise in due course. **BP** was also weak (down 8% relative), although the oil sector as a whole contributed positively to the portfolio. We are materially underweight **Royal Dutch Shell**, which performed similarly, and the other three stocks we own in this sector all outperformed. The mining sector, which has been strong for the last 2-3 months, was also more muted in August. Elsewhere, **Vodafone** was weak.

Portfolio activity

August was a quieter month for the Fund in terms of portfolio activity. There were two main reasons for this. Firstly, we believe there is currently tremendous upside in the Fund. Secondly, the majority of our holdings have repositioned themselves and are now on the front foot in terms of a post-lockdown recovery. The most vivid example of this is the DFS trading update noted above. For now, we should be patient, let the portfolio breathe and allow the upside to come through.

A number of our largest positions continued to edge upwards on a relative basis – examples being **Tesco**, **Phoenix** and **Legal & General**. We trimmed these positions to ensure they remained around our soft overweight limit of 300bp.

As noted above, we believe the vast majority of the Fund is in a good position strategically and operationally (we laid this out in detail [here](#)). Over 90% of the Fund is in this bucket. The other 10% is very cheap and has significant upside.

The 10% are typically stocks that have been more affected by Covid-19, or do not have the same multi-pronged investment case as the rest of the Fund. In our view, it would be wrong to sell these cheap names as they still have material upside. Having said that, where we can switch into other stocks that have performed similarly, are on the front foot, have better growth prospects across the cycle and are as cheap or cheaper, we have been doing so.

A good example is in the banks sector. Our main position, **Barclays** (where the investment banking division has performed very well, allowing provisions to be front-loaded in the retail bank and where capital has increased) currently trades on less than 0.4x book. We believe its shares can double. Elsewhere in the sector, we own **Paragon** and **Standard Chartered**, which are both high-quality franchises. In contrast, **Lloyds Bank**, whilst very cheap, does not have the same dynamics. We have therefore continued to reduce our position in Lloyds, whilst adding to Standard Chartered and Paragon, with Barclays at our maximum portfolio weight.

Our small cap exposure remains around 18% (as it has been for much of the year). This will fall slightly to c. 17% as the largest holding, **Diversified Gas & Oil** (which has performed well in relative terms) has been promoted to the FTSE 250, effective mid-September. As noted above news flow from this part of the Fund was largely positive during the month, but there remain anomalies in terms of share price performance. We added to **Galliford Try**. Its market cap has halved from its pre-Covid-19 February high. Its market cap, at c. £100m, is now below the net cash on the balance sheet, which is £140m. The company has a £3.2bn order book. It has announced various new contracts recently, has 90% of its forecast revenue for the year to 30 June 2021 already contracted and has indicated future margins will be robust. This is an example of the material mispricing that is currently happening across parts of the market, but especially in the small cap segment.

Elsewhere, we reduced our holding in **Standard Life Aberdeen**. It has recovered strongly from its lows in April and the valuation of the 'rump' of the fund management business (after stripping out the values of its associate businesses in India and the UK) is no longer as absurdly low as it was. We also continued to add to **National Express**.

Outlook

As noted in several examples above, corporate results are starting to come through better than expected. There were four main reasons for this: 1) investors were too pessimistic; 2) the economy has thus far recovered faster than expected; 3) the policy response has been larger than expected and; 4) positive management actions. In certain parts of the market this has started to flow tepidly into share prices. This is encouraging.

Covid-19 continues to develop. As we indicate above trends in the US are sequentially improving. In Europe case numbers are on a clear upward path. However, case numbers are not being mirrored in hospitalisations or deaths and there appears little desire by politicians for full national lockdowns.

The debate around inflation is intensifying, both from its trajectory in the near term, where data points have been firmer than expected, and the implications of the Federal Reserve's policy shift. As we said above, we may look back at this announcement in late August 2020 as a pivotal

moment in the history of asset markets. These trends and this policy change (which will help economic growth, lead to higher inflation and a steeper yield curve) will potentially lead to a change in the value versus growth narrative and the performance of the Fund.

The other reason we are confident of a future performance recovery is the quality of the Fund within the value camp. As we laid out [here](#), we believe we have one of the best Fund compositions we have ever had, as well as one of the cheapest. In the [second paper](#) in that series, published last month, we looked specifically at our small cap exposure, which remains c. 18% of the Fund. This paper echoes the Fund composition point from a fundamental perspective and also showcases how much upside there is in each stock (typically 100-200%, in our view).

We continue to expect strong dividend growth from the 2020, Covid-19-affected, nadir. The trough yield in 2020 is c. 3.6%, moving towards 5.5-6% in 2021. We will provide a full update on the 2021 dividend outlook next month.

It has been a very difficult period for the Fund since the coronavirus crisis started. But over the last few weeks there has been some positive evidence emerging: the faster-than-anticipated economic recovery, the policy response taking hold, company results largely being better than expected, more differentiated stock performance, inflation data and the Fed policy change. All of these factors should help underpin a recovery in the Fund's performance.

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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