



JOHCM UK Equity Income Fund

Monthly Bulletin: August 2021

Active sector bets for the month ending 31 July 2021:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.30	2.99	7.31
Industrial Metals and Mining	15.47	8.71	6.76
Media	7.65	3.08	4.57
Household Goods & Home Construction	5.48	1.68	3.81
Banks	10.11	7.17	2.94

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	8.81	-8.81
Closed End Investments	0.00	6.75	-6.75
Beverages	0.00	3.75	-3.75
Tobacco	0.00	3.16	-3.16
Personal Care, Drug and Grocery Stores	4.88	7.54	-2.66

Active stock bets for the month ending 31 July 2021:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Barclays	4.30	1.23	+3.07
Anglo American	4.70	1.67	+3.03
Legal & General	3.62	0.65	+2.97
Vistry Group	3.07	0.11	+2.96
Aviva	3.57	0.63	+2.94
Phoenix Group	3.11	0.18	+2.93
Glencore	4.55	1.63	+2.92
BP	5.23	2.42	+2.81
Paragon Banking Group	2.85	0.06	+2.79
ITV	2.91	0.17	+2.74

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
AstraZeneca	0.00	5.27	-5.27
Unilever	0.00	4.41	-4.41
HSBC	0.00	3.37	-3.37
Diageo	0.00	3.34	-3.34
Royal Dutch Shell	1.65	4.63	-2.98

Performance to 31 July 2021 (%):

	1 month	Year to date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	0.94	18.25	306.90	£2,136mn	£2,509mn
Lipper UK Equity Income mean*	0.85	12.89	189.22		
FTSE All-Share TR Index (12pm adjusted)	0.37	11.18	208.68		

Discrete 12-month performance (%) to:

	31.07.21	31.07.20	31.07.19	31.07.18	31.07.17
JOHCM UK Equity Income Fund – A Acc GBP	49.98	-25.28	-9.50	9.83	26.45
FTSE All-Share TR Index (12pm adjusted)	24.84	-16.81	1.33	9.17	15.33

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

US 10-year bond yields fell 25 basis points during July to settle at 1.22%. Opinions are very divided as to why this occurred despite very strong inflation prints (e.g. US CPI increased 5% year-on-year, the largest increase for 13 years). Undoubtedly fears that the delta variant could hold back the progressive opening up of Western economies has had an impact, but the scale of the move lower over the last couple of months suggest other factors are at play. A combination of positioning by active managers and the Fed effectively buying back all of the new issuance during the last three months will have had some impact too. Furthermore, product shortages in some industries, particularly chips in the auto industry will have restrained growth somewhat, with US auto production in May down 23% year-on-year.

In the UK, there has also been some evidence of a slowing of the trajectory of the economic recovery, again partly due to staff and raw material shortages. This has been reflected in PMI's retreating from the low 60s to 57-58, still a healthy level of growth. The labour market is becoming particularly tight, with vacancies back above the February 2020 level and numbers in employment only fractionally lower in June (versus pre-Covid levels). Consequently the level of wage inflation may continue to surprise positively (it was +6.6% over March-May 2021) which has manifested itself in income tax receipts in June being higher than they were pre-pandemic. Not only has that led to a faster than expected fall in the UK budget deficit, which fell £50bn in Q2 versus the OBR's forecast of a £65bn fall for the next 12 months but will also add to the capacity for consumer spending to pick up considerably as the economy opens up. We estimate there is around £230bn of unspent savings that have accumulated since the pandemic began and with employment markets so strong, this is likely to be progressively spent as consumer confidence rises. Indeed the 9.7% year-on-year increase in June retail sales suggests this has already begun and we have seen very vibrant activity in areas such as housing, cars and electronics. The June housing transactions number of 198,000 was the highest monthly print for over 15 years. Company feedback suggests that activity levels across the consumer discretionary sector continue to accelerate despite the summer pick up in Covid-19 cases.

The inflation debate in the UK is similar to that in the US with input driven inflation likely to ease in the coming months (PPI was +9.1% year-on-year in June) but potentially wage inflation becoming more engrained and consumer spending picking up progressively. Consequently UK CPI, which was 2.5% year-on-year in June is likely to approach 4% during Q1 2022. Whilst this is partly due to soft comparable months, it is noticeable that some monetary policy committee members are becoming more hawkish around their comments on inflation and it will be interesting to watch how this debate develops in the coming weeks and months.

Across Continental Europe, Q2 GDP rose most strongly in the tourism-dependent countries such as Portugal (+5% quarter-on-quarter) and Spain (+2.8%), whilst industrial nations such as Germany (+1.5%) have been held back, again by chip shortages in the auto industry and elsewhere. In China, the Caixin manufacturing PMI index hit a 15-month low and it is clear that the authorities have moved towards an easing bias in their policy now, to counteract this weakness.

Performance

Stock markets were flattish in July, with the FTSE All-Share Total Return index (12pm adjusted) returning 0.37%. The Fund outperformed its benchmark with a return of 0.94%. Looking at the peer group, the Fund ranked first quartile within the IA UK Equity Income sector year to date. On a longer-term basis, the Fund is ranked third quartile over three years and first quartile over five years, ten years and since launch (Nov 2004).

As noted above, bond yields were under severe pressure for most of the month, which meant the pause in the rotation towards areas of the market where the Fund has higher exposure continued. This has been the case for much of the last four months now. The Fund would normally underperform materially during a period when bond yields have fallen to such an extent. The reason that it has not (with July up in relative terms and only a modest fall - less than 1% - over the four months since bond yields started to fall) is due to very positive developments, news flow and results from our portfolio companies, while the Wm Morrison takeover process has also contributed meaningfully.

Much of the positive news flow came from the small cap segment of the Fund (c. 18% of the total portfolio). **Sthree** (up 7% relative), **Headlam** (up 20% relative), **Galliford Try** (up 12% relative) and **International Personal Finance** (up 8% relative) all warned to the upside in their trading updates. The momentum at an operational level amongst our small caps is the clearest and the strongest it has been since the Fund was launched 17 years ago. Elsewhere **Lookers**, **Eurocell** and **Kier** also warned to the upside in their trading updates.

The mining sector was also strong with **Anglo American** (up 12% relative) and **Rio Tinto** (up 5% relative) particular highlights. Both materially outperformed our dividend forecasts in their results. This has had a significant positive impact on the Fund dividend (see Outlook section). In contrast, the oil sector remained sluggish despite some good results from Royal Dutch Shell.

Very few stocks weakened on the back of results. The exceptions were ITV (more detail below) and Vodafone. Both of these offset some of the positive performance noted above.

Portfolio activity

As positive relative performance returned, we made a number of changes to the portfolio. We sold two positions – **Lloyds Bank** and **Countryside**. The former has recovered well from its dramatic fall in the first quarter of 2020, and remains cheap in an absolute sense, but is expensive relative to our other bank holdings (**Barclays**, **Standard Chartered**, **NatWest Group**) and also has less positive fundamental drivers. Unlike the other UK banks Lloyds still has a number of material 'below the line items' (costs), which mean its headline results and headline valuation are flattered. This was a feature in its latest results just before month end. We sold Countryside on valuation grounds. It has been an excellent contributor to Fund performance (c. 150bp on a relative basis) and whilst it has strong growth prospects, in our view, this is largely already reflected in the shares.

We have reduced our position in **Morrison** by c. 40% since the takeover approaches became public knowledge. This decision was initially driven by risk management / portfolio construction requirements - we have an active weight limit of c. 300bp. After the bid from Fortress was announced the shares moved to 265-270p, in line with our publicly communicated view that the business is worth 'approaching 270p'. The decision to materially cut our position as it reached that level was also driven by a number of new ideas presenting themselves during the month (detailed below) - all of which have meaningful upside.

Two new names were added to the Fund in July – **Dixons Carphone** and **Endeavour Mining**. The latter is a gold mining company that few are aware of and even fewer have analysed. It has moved its primary listing from the Canadian market to London. It has a £4bn market cap and will

enter the FTSE 250 in September. It is very cheap compared to the global peer group, has a clear capital allocation policy, which means at spot prices c. 50-60% of its current market cap will be returned to shareholders over the forecast period, and has an embedded growth profile due to current projects. As the stock becomes better known, the valuation gap is likely to close. This stock also offers us more defensive exposure as gold tends to do well when markets fall. We will only add such exposure (which tends to be very expensive e.g. the classic defensive stocks like Diageo) when the upside on entry meets our criteria (which is currently at least 30-40%).

Dixons Carphone is the market leader both on and offline for technology, gaming and white goods in the UK (Currys) and Scandinavia. Its market share is c. 25%+. The price differential between online and physical retail has now closed to such an extent that physical retail profitability will not incrementally be pressured by further price adjustment. The demand for its products has step changed upwards due to Covid-19 as people work at home more and technology within the home becomes more important. The negative issue at Dixons over the last three years has been the structural changes in the mobile market. This has resulted in large losses (from the Carphone Warehouse side of the business), although these are close to being eradicated. The big reduction in the mobile business has released a large debtor position, which has moved the balance sheet to a net cash position. Our normalised earnings expectation is 20p per share, meaning the stock trades on a P/E of 6x. We think 10x would be a more appropriate valuation given the market dominance creating headroom of 60-70%.

We also continued to add to other recent additions, namely **First Group** and **Kier**. These are now c. 70bp and 100bp positions respectively. A few stocks were weak as noted above. We added to **ITV** following its results, which beat estimates and led to an increase in forward forecasts. There was also very encouraging evidence surrounding the new initiatives developed by the CEO, which the market completely ignored. We also added to **Drax**. In our view, its share price is mispriced given the positive changes happening within the company and its multiple options on the new low carbon world.

Numerous stocks performed well and reached our target weights over the month. We trimmed our positions in **Sthree**, **Headlam**, **Page Group**, **Galliford Try** and **Polar Capital** as a result. In our view, all of these still have material upside.

Outlook

There has been a material fall in bond yields since the end of the second quarter. The Fund has continued to move higher in an absolute sense, but has lagged by c. 100bp in relative terms. As we noted above, given the scale of the movement of yields, the (relative) performance of the Fund has been better than one would have expected. This is due to the strong performance operationally of our holdings at a company level. The majority of our holdings are coming out of the Covid period strongly, which is very clear from trading updates and our engagements with our management teams. The strength of this operational performance should continue into H2 2021 and 2022 and underpin future relative performance.

We expect economic data to continue to exhibit strong momentum, particularly in the UK. It is clearer now than in early April (when the fall in bond yields started) that growth will remain robust and inflation will accelerate and likely be much stronger than the already rising consensus expectations. This will lead to bond yields rising. In our view, as this happens, it will, like it did in November 2020 and March 2021, be a further turn of the key that unlocks more of the significant upside that exists in the 'value' part of the market and, more specifically, the Fund.

We upgraded our expectations for Fund dividend growth in last month's bulletin from 37% to 42.5%. The start of the interim results season has been much stronger than expected and this has had a material positive impact on the Fund's dividend trajectory, with growth in 2021 now likely to be above 50%. In the next few months we will provide further detail on this and how it rolls into 2022. The Fund dividend yield troughed at 2.7% in 2020 (based on the current unit price) – the worst year ever for dividends globally. In 2022 we hope to be back where we were pre-Covid, which equates to a yield of c. 5%. This compares to UK 10-year bond yields of 50bp – it does not make sense. The Fund is very cheap on this and every other metric.

We are still finding compelling new ideas with significant upside, such as First Group last month and Dixons Carphone this month. This is a good time in the cycle as there are more than the

normal number of anomalies like this or late-cycle recapitalisations. These create opportunity and also allow us to keep the valuation trajectory of the Fund very low.

The confluence of a very strong economic recovery, low valuations and forecasts that are materially too low should bode well for the Fund's absolute and relative performance. Whilst we have recovered the majority of the underperformance associated with Covid-19, we remain c. 4% below both our absolute and relative high watermarks. We are very confident we can reach new ground in due course.

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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