

JOHCM UK DYNAMIC FUND



UNDER THE BONNET



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Q3 2020 REVIEW

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INVESTMENT BACKGROUND

When we come to reflect on the year, September will likely be seen as the month of peaking extremes. The NASDAQ 100 continued its rise, reaching new all-time highs for the fourth consecutive month (an incredible +42% year-to-date, +76% since the March lows) only to fall 11% in three trading sessions and end the month down. Rising fears of a contested US election led volatility to increase (the VIX index was up 11 points in a week) and was possibly the trigger of the market correction, but, even as President Trump's resurgence in the polls unwound, equity markets failed to push on.

Signs deflationary fears may have peaked could have been another factor. Five-year USD inflation swaps rates retained their previous month's gains with inflation expectations now at pre Covid-19 levels, reflecting the scale of fiscal stimulus and increasing likelihood of further stimulus if there is a Democratic sweep. After 10 years of falling inflation, a reflationary outlook will have meaningful implications for markets, not least for valuation spreads which have reached 90-year extremes according to Bernstein analysis*.

In the UK, fears of a hard Brexit re-emerged as negotiation brinkmanship saw Prime Minister Johnson threaten to breach the withdrawal agreement with an internal market bill. This fracas could mark the final weeks of over four years of uncertainty with the withdrawal deadline now less than a month away. Markets looked less favourably on events with sterling collapsing (-5% against the dollar in just over a week) and the FTSE 250 total return index down 100bps against the FTSE 100 total return index. These moves overshadowed a significantly improving UK domestic picture: all PMIs remained near multi-year highs; nationwide house prices rose at their fastest rate since 2016; and mortgage approvals reached 13-year highs. The Bank of England believes that UK consumption has already returned to pre-Covid-19 levels having risen 2% per week since May and that Q3 GDP will be only 3-4% lower year-on-year compared to the 18% fall they had predicted in May. Such is the disconnect between the data and perceptions of the UK economy that the Bank of England's Andy Haldane gave a speech titled "[Avoiding Economic Anxiety](#)".

*Bernstein - Portfolio Strategy: Value is dead, long live value (24 September 2020)

STRATEGY UPDATE

The Fund underperformed the index in September, returning -4.61% versus a -2.05% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted). This closed off a very disappointing quarterly performance of -6.39% versus a -3.21% return by the benchmark. September was a very odd month and end to the quarter, however, there were clear signs of change emerging in the market. Liquidity in shares at low prices was non-existent, implying prices were transitory or not real for any investor of size and M&A activity picked up over the period with UK targets including G4S, William Hill, **SDL** and KKR's investment in Great Portland.

90% of the Fund's quarterly underperformance came in the two week period that started with news of Prime Minister Johnson's internal market bill. There were no negative stock specific news announcements during this period. In fact, **Morrisons** (the Fund's third largest active position) reported interims during this period which showed Q2 LFL sales at a possible all-time high of 11.1%, beating analyst expectations of c. 8.0%, and ahead of consensus profit estimates. Yet shares fell to new post Covid-19 lows relative to the benchmark, ending the month down an incredible 10% relative to the benchmark. An absurd reaction but by no means unique in September.

Shares in all four of the Fund's real estate holdings (**Crest Nicholson**, **Urban & Civic**, **St Modwen** and **McCarthy & Stone**), which account for c7% of absolute capital, were either flat or down versus the benchmark. Valuations here remain at a 25% discount to book value (at least) despite record rises in house prices and mortgage volumes. The absurdity of the situation is evidenced by the reaction of insiders. Crest Nicholson management and non-executives bought nearly £150,000 of stock in the month and the founder of Redrow bought £18.1m of McCarthy & Stone stock.

Shares at **Aggreko** fell 22% relative to benchmark on no news other than shocking analytical work from a major US bank. The analysis valued the shares using discounted cashflows but with a 48% cash conversion to perpetuity implying an ever-expanding capex program but with returns on this capex at below the cost of capital. This makes no economic sense and would lead to short careers for management. Normalising this cash conversion to 100% would add 225p to the analyst's target price of 400p, implying 69% upside to the share's month-end closing price.

Interims from **QinetiQ**, a top ten active position for the Fund, were positive across the board. The return of management guidance and a strong order intake led to consensus upgrades. The suspended final dividend was also re-instated. Despite all this, shares ended down 3% relative to the benchmark for the month.

Possibly the only bit of positive Covid-19 related news for the Fund was that **TT Electronics** secured a contract to build iAbra's Virolens, a potentially ground-breaking Covid-19 screening device. Shares rose 42% on the news that, if the device is proven to work, indicative customer orders would lead to associated revenues of £280m for TT Electronics, compared to Group revenues of £478m in FY19. A



sharply worded article in the Financial Times quickly doused these hopes leading the share price gains to unwind. There still remains a chance this technology proves to be successful. **Provident Financial's** shares unwound all their relative gains made in the previous month following strong interims despite no news.

Share prices cannot ignore good news for ever. This is evidenced by the share purchases undertaken by the management teams of the Fund's holdings over the quarter with notable transactions including **Aviva's** CEO (£1m), **Jupiter's** CEO (£0.7m), **Ultra Electronics's** Chairman (£0.2m) and the new Pearson CEO who has acquired £3m as part of a co-investment plan.

If inflation expectations continue to rise then it is likely we will see a change in market leadership. Analysis shows that 'value' is the only factor negatively correlated to all the factors that have driven the market rally thus far (see Under the Bonnet – July 2020). There is early evidence a rotation may have begun. However, we will not just wait for the market, we will engage heavily with our management teams to enact positive change both operationally and for the benefit of society. Significant engagements undertaken by the Fund in the quarter include: Aggreko, where a new sustainability-led strategy day in November will reveal its progress; **Ricardo**, where change is being accelerated across the organisation; and Pearson, where strategy, leadership and remuneration have been challenged. The Fund has also become a partner in ShareAction's [Healthy Markets Initiative](#) which is aimed at getting supermarkets and food manufacturers to play their part in actively reducing levels of obesity in the UK.

FUND PERFORMANCE

JOHCM UK Dynamic Fund performance (%):

| | 1 month | 3 months | 1 year | 5 years | 10 years | SI annualised |
|------------------------------|--------------|--------------|---------------|-------------|--------------|---------------|
| Fund | -4.61 | -6.39 | -30.55 | 3.96 | 74.56 | 6.54 |
| Benchmark | -2.05 | -3.21 | -16.51 | 19.01 | 63.82 | 4.58 |
| Relative return ¹ | -2.61 | -3.28 | -16.81 | -12.65 | 6.56 | 1.88 |

Discrete 12 month performance (%):

| | 30.06.20 | 30.06.19 | 30.06.18 | 30.06.17 | 30.06.16 |
|------------------------------|---------------|-------------|-------------|--------------|--------------|
| Fund | -30.55 | 0.83 | 6.57 | 20.76 | 15.35 |
| Benchmark | -16.51 | 2.72 | 5.84 | 12.62 | 16.43 |
| Relative return ¹ | -16.81 | -1.84 | 0.69 | 7.24 | -0.93 |

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 30 September 2020. 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. Inception date: 16 June 2008. ¹Geometric relative.

ONE MONTH STOCK CONTRIBUTORS

Top five

| Rank | Stock | Relative Return Contribution % |
|------|-------------------|--------------------------------|
| 1 | 3i | 0.36 |
| 2 | Melrose | 0.25 |
| 3 | Electrocomponents | 0.24 |
| 4 | ITV | 0.23 |
| 5 | Royal Dutch Shell | 0.18 |

Bottom five

| Rank | Stock | Relative Return Contribution % |
|------|---------------------------|--------------------------------|
| 1 | Morrisons | -0.34 |
| 2 | British American Tobacco* | -0.34 |
| 3 | Barclays | -0.33 |
| 4 | Aggreko | -0.31 |
| 5 | Provident Financial | -0.23 |

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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 31 August 2020 to 30 September 2020. *Stock was not held during this period.

Q3 STOCK CONTRIBUTORS

Top five

| Rank | Stock | Relative Return Contribution % |
|------|-------------------|--------------------------------|
| 1 | 3i | 0.93 |
| 2 | Royal Dutch Shell | 0.40 |
| 3 | SDL | 0.36 |
| 4 | Electrocomponents | 0.32 |
| 5 | Aviva | 0.28 |

Bottom five

| Rank | Stock | Relative Return Contribution % |
|------|----------|--------------------------------|
| 1 | Vodafone | -0.49 |
| 2 | Barclays | -0.35 |
| 3 | Unilever | -0.33 |
| 4 | BP | -0.30 |
| 5 | Hunting | -0.27 |

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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 June 2020 to 30 September 2020.

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