



JOHCM UK Equity Income Fund

Monthly Bulletin: September 2022

Fund Overview

- The Fund aims to generate long-term capital and income growth through active management of a portfolio of UK listed equities.
- Established income investors James Lowen and Clive Beagles abide by a strict dividend yield discipline, which leads to an emphasis on higher-yielding stocks and promotes a naturally contrarian style.
- The Fund will typically have significant exposure to small and mid-cap stocks, often giving the portfolio a different holdings profile to many other income funds.
- Benchmark: FTSE All-Share Total Return Index.

Active sector bets for the month ending 31 August 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.75	2.47	7.28
Industrial Metals and Mining	12.93	6.70	6.23
Construction and Materials	6.50	1.41	5.09
Household Goods & Home Construction	5.33	1.06	4.27
Media	6.72	3.05	3.67

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.70	-10.70
Personal Care, Drug and Grocery Stores	0.00	7.34	-7.34
Closed End Investments	0.00	6.45	-6.45
Tobacco	0.00	4.13	-4.13
Beverages	0.00	3.98	-3.98

Active stock bets for the month ending 31 August 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
Glencore	5.88	2.72	3.16
Barclays	4.20	1.18	3.02
BP	6.70	3.69	3.01
NatWest	3.56	0.54	3.02
Phoenix	3.11	0.19	2.92
Standard Chartered	3.53	0.62	2.91
Legal & General	3.53	0.65	2.88
ITV	2.93	0.10	2.83
DS Smith	2.94	0.15	2.79
Paragon Banking	2.77	0.06	2.71

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.68	-3.68
Unilever	0.00	4.30	-4.30
HSBC	0.00	4.58	-4.58
Shell	2.94	7.55	-4.61
AstraZeneca	0.00	7.31	-7.31

Performance to 31 August 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	-1.74	-5.08	307.50	1,888.6	2,200.0
Lipper UK Equity Income mean*	-2.63	-4.63	189.68		
FTSE All-Share TR Index (12pm adjusted)	-1.42	-2.07	220.20		

Discrete 12-month performance (%) to:

	31.08.22	31.08.21	31.08.20	31.08.19	31.08.18
JOHCM UK Equity Income Fund – A Acc GBP	-2.72	51.34	-20.21	-10.94	6.71
FTSE All-Share TR Index (12pm adjusted)	1.06	26.19	-12.55	0.18	5.71

Past performance is no guarantee of future returns. 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 / 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 main focus of the month was the continued rise in certain energy prices (before some weakening in the last few days). This was particularly the case for gas. In the US, the Henry Hub spot price nearly hit \$10 (vs \$4 prior to the start of the Russia / Ukraine conflict), before settling up 10% on the month. UK prices rose more markedly.

Linked to this, the UK economic narrative has been negative, with the October energy price-cap and the associated implications for household disposable income dominating news and market dynamics. The continued rise in UK gas prices also led to much higher predictions of where the next energy price cap (in January 2023) could move to. The situation is clearly difficult, but we see the negatives as transparent and clearly articulated.

What is not appreciated is government action, which sadly has been delayed by the Conservative leadership election. With the result due soon and Liz Truss likely to win, we expect material action on her part within days (and definitely before the end of September) at least to part neutralise the energy cost increases and hopefully to instil confidence that any future rises will be offset by policy action. This is not yet discounted. Policy actions could include a 'cap on the energy price cap' which would reduce forward concerns (and also inflation), further specific measures to add to already announced policies to offset some of the energy cost increase and further fiscal measures (e.g. reversing the National Insurance rise, which is a clear Truss policy, will add 2.5% to the average household free cashflow). Government assistance, along with reduced energy usage, as households and businesses are increasingly focused on energy efficiency, is likely to significantly soften the blow to average household free cashflow. We are of course cognisant that the greatest pressure is on lower socio-economic groups, which averages disguise. If a 'cap on the energy price cap' was announced it could mean we will pass the peak in UK inflation in the next few months, rather than reaching the 15-20% levels, that investment banks are leaping over each other to predict. Such a policy would have important implications for calming wage demands, associated industrial action, consumer confidence and monetary policy. It would have a pivotal impact on stock market performance.

Another issue we will be watching is other policy initiatives announced by Truss. We know from her public remarks that there are several positive regulatory changes that will impact the life insurance sector (and possibly in time the banking sector) but there could be others that are both positive (e.g. more levelling up infrastructure spending) or negative (a tax on banks to reduce the cost to the government of reserve balances) or changes to how electricity prices are set (to reduce the influence of gas prices on the wider structure of energy prices, similar to what is being discussed in Europe). We hope her clear opposition to windfall taxes means that any adjustment will be proportionate.

Meanwhile, whilst UK economic activity has slowed and will continue to do so, it is not collapsing. We see this in company results, which have by and large been solid and certain economic datapoints e.g. retail sales grew month on month in July (vs a predicted fall), UK Services PMI remained in expansion territory and was higher than expected. As we continue to note, job vacancies remain at record levels, with close to 1.3m jobs unfilled.

Elsewhere, Fed commentary has been changeable. After suggesting a potential pivot in July, the Jackson Hole speech was more hawkish and bond yields continued to rise over the month. This was most dramatic in the UK, where the 10 year bond moved up materially – by 90bp. The latter move, which was more than the change in US bonds, was accentuated by the rise in gas prices, the rise in the predicted energy cap and the rise in peak inflation forecasts as described above. As we indicate we expect policy action to now take over, which could change this dynamic and stabilise bond yields. We also expect the last outsized Fed rate move will be in September as in the US we are now past peak inflation and there is evidence that price pressures are abating in this geography.

Performance

Despite all the negative newsflow, the UK market finished only marginally lower in August, with the FTSE All Share total return index falling 1.42%. The fund modestly underperformed during the month, recording a return of -1.74%. Year to date the fund is down 5.08%, behind the index return of -2.07%. Looking at the peer group, the fund is ranked 3rd quartile within the UK Equity Income sector so far in 2022. On a longer-term basis, the fund is ranked 2nd quartile over five years and 1st quartile over three and ten years and since launch (Nov 2004)^[1].

The strongest sector was oil (and parts of the mining sector). Whilst the oil price was flat across the month, it rallied from a low in the middle of the month and related commodities like natural gas were strong. Good results also helped propel shares higher e.g. **BP** and **Diversified Energy** were both up 13-15% in relative terms. The banking sector was also strong with rising interest rates helping profitability and higher than expected shareholder distributions a feature of most sets of results. The interim results season was strong with few disappointments. Of note, **Lookers** beat forecasts and highlighted a property and cash value per share of c 95p (vs a pre-results share price of c 75p); **Aviva** signalled additional annual excess free cashflow, and **TP ICAP** beat expectations for the first time in a long time. All three were up around 10% on the day of the results. TP ICAP ended the month up 30%. The only disappointment was Curry's results.

Fund performance was also helped on a relative basis by the large fall in GSK (down close to 20%) as concerns over Zantac litigation became a focus. This is one of the Fund's largest void holdings.

Offsetting these positives, most other areas of the Fund were sluggish. Small caps were very weak – falling in many cases 5-10% relative on no news (or in many instances positive news – e.g. **Keller**). Both the Fund's housebuilders – **Vistry** and **Bellway** – fell c 12% in relative terms, as did both our media holdings (**WPP** and **ITV**). **DS Smith** was also weak.

The bid approach for **First Group** lapsed and the stock fell c 15%.

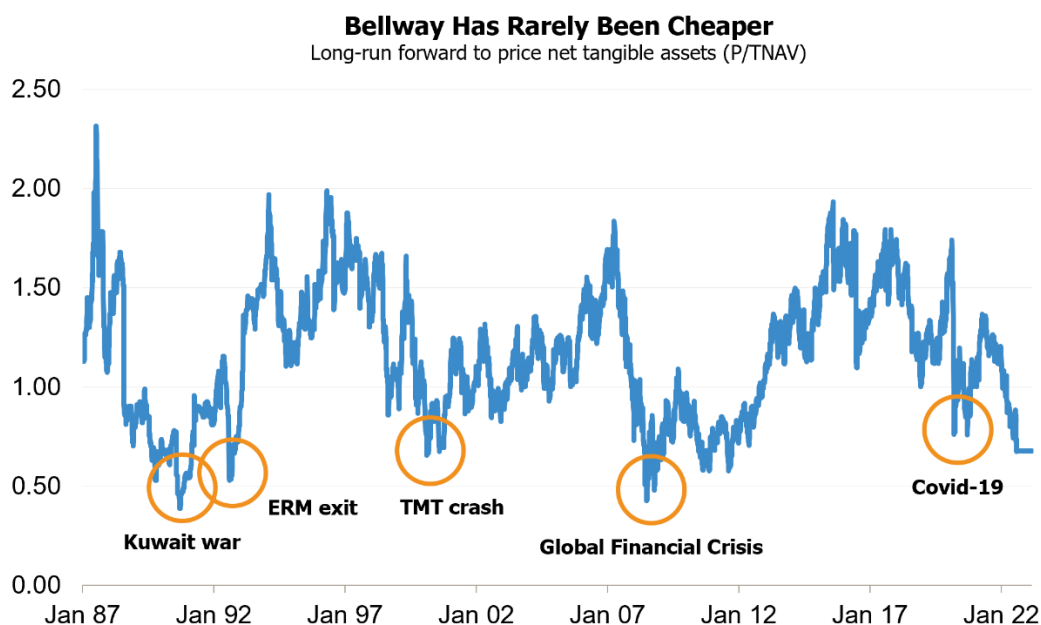
Portfolio activity

As noted above, the mining sector was strong during the month. We continued the long running process of reducing (and are close to exiting) our position in **Rio Tinto**. The drivers of this remain the same – an over-focus on iron ore, which (unlike other commodities) we feel is likely to fall over the next few years, as well as ESG concerns and the need to increase investment after a number of years of underinvestment. We have been patient in the sales process, of what was a 400bp position, to ensure we get maximum value. Our mining position is now focused on two large caps, **Glencore** and **Anglo American**, and two small caps, **Kenmare** and **Central Asia Metal**, which have superior commodity mixes (copper, cobalt and nickel etc) and are very cheap (e.g. Glencore is on a free cash flow yield of c. 35%). The oil sector was also strong and we marked **BP** to 300bp and kept our weight in **Diversified Energy** under control as it went up. We moved part of the capital released towards **Shell**. Most of the oil stocks are on free cashflow yields of 20-50% (e.g. BP is at 35%). Our oil and mining exposure, which currently represents 28% of the Fund, looks very well placed given prevailing events.

A number of stocks that performed well during the month hit our 300bp maximum position and we top-sliced accordingly (BP as noted above, Glencore and **Natwest**). Readers will note Glencore ended the month just above 300bp, reflecting its imminent ex-dividend date (due today, the first day of the month), which will lower its weighting.

^[1] Source: Lipper Hindsight

In parts of the market that are being impacted by the other side of this, i.e. pressure on consumers from rising energy costs and on businesses due to recession risk, valuations have discounted a material economic dislocation and earnings collapse. As we note above, the negatives are known and focused on, unlike the mitigation factors (strong employment picture, excess savings and likely action by Liz Truss to neutralize the energy cost increase, along with further fiscal action). We continued to selectively add to these positions. Examples include **Tyman**, **Bellway** and **Page Group**. We showed last month (see [here](#)) that Page Group was trading at its lowest valuation in the last 20 years, including during the financial crisis and Covid. Below we show a similar chart for Bellway – focusing on price-to-tangible-book value (P/TNAV). It shows Bellway has rarely been cheaper than it is now. And when it was it was accentuated by carrying debt (e.g. 2008/9) vs now, when it is cash positive. On a 'live' basis using the estimated (and as yet unreported) TNAV for the end of July 2022 (the year-end date for the company) of 2900p, the stock is trading on a 30% discount. Are we really at a worse point than we were during the financial crisis when the banking system was in retreat and the housebuilders carried too much leverage, or of Covid when housebuilders could not build and sales were prevented for a period of time? The message is the same whichever subsector you look at – valuations are discounting a major economic dislocation.



Source: Numis

It is our job to carefully build exposure in good quality stocks like those mentioned, when the valuation signal is as powerful as it is now. In this vein we added a small new position in **Wickes** (currently 30bp). We purchased the stock after its warning that earnings would be lower than expected (in late July) and after a half day of site visits with the management. This followed a good initial meeting earlier in the year. Wickes is misunderstood as it emerged from a spin out from Travis Perkins into small-cap territory. Our review of it suggests it is a tightly managed business that is taking market share due to initiatives such as Tradepro – a click and collect reward scheme for trade customers, which has a membership of c 700,000. The stock is down close to 60% since the spin out from Travis Perkins and 40% so far this year. It has net cash of c £120m which is c 40% of its market capitalisation, it is on a PE of c 5x the recently downgraded numbers and yields either 9% (if the dividend which was only started a year ago is held, which in our view it should be given the cash position) or 7% if the dividend cover policy is held.






We also added to First Group, following the withdrawal of bid interest. The stock at 113p is materially above our entry price of c 85p but is also materially below our view of fair value (c 180p). Finally, we trimmed TP ICAP to keep around 200bp as it rose following the results noted above.

Dividend Update

Despite volatile market conditions and ongoing economic risk, the dividend picture remains strong. Why? – 1) the oil / mining sectors, as described above, are delivering strong free cashflow, which is proportionally underpinning stronger than expected dividends. The majority of the excess cashflow is however funding share buybacks, which will help dividend growth in future years, as there will be a materially lower number of shares to spread the dividend cost across. The table below shows the power of this. 2) The banking sector remains well underpinned with low dividend pay-out ratios and with most stocks also undertaking buybacks, as the table also shows, reflective of the discount to book value all stocks are trading at. The low pay-out ratios (typically 20-30%) mean dividends would be defensible even in a worst-case economic outcome. 3) The insurance sector is equally robust with substantial excess capital ahead of the 'Truss' regulation roll back noted above and 4) Elsewhere, as we have discussed before, strong balance sheets create an underpin to dividend levels.

De-equitisation – material and powerful



Stock	% age of Fund	% age of share cap announced to be acquired in 2022	Forecast Dividend %	Total Distributions
 bp	6.5%	12.5%	4.9%	17.4%
 SHELL	2.7%	10.6%	4.2%	14.8%
GLENCORE	5.7%	4.8%	10.5%	15.3%
 BARCLAYS	4.3%	5.6%	5.1%	10.7%
 NatWest	3.8%	13.9%	4.9%	18.8%
 Standard Chartered	3.6%	5.6%	3.4%	9.0%
Total / average	c. 26% of Fund	9%	6%	15%

If no one else will buy our shares, we will buy our own

*Natwest buyback includes the special dividend / B share consolidation

Source: Bloomberg

At the end of March, we upgraded our forecast for Fund dividend growth for calendar 2022 from 20-25% to 25-30%. Following continued strength in dividend newsflow, with a large number of our holdings exceeding our forecasts, we increased this again, at the end of June, to growth of 30-35%. Given that most of the interim reporting season has now passed, and we are running around the top of this range, we are now upgrading the forecast for Fund dividend growth for 2022 to c. 35%. We will provide a final update on this during Q4. At this level the dividend is c 10% above its pre-Covid level.

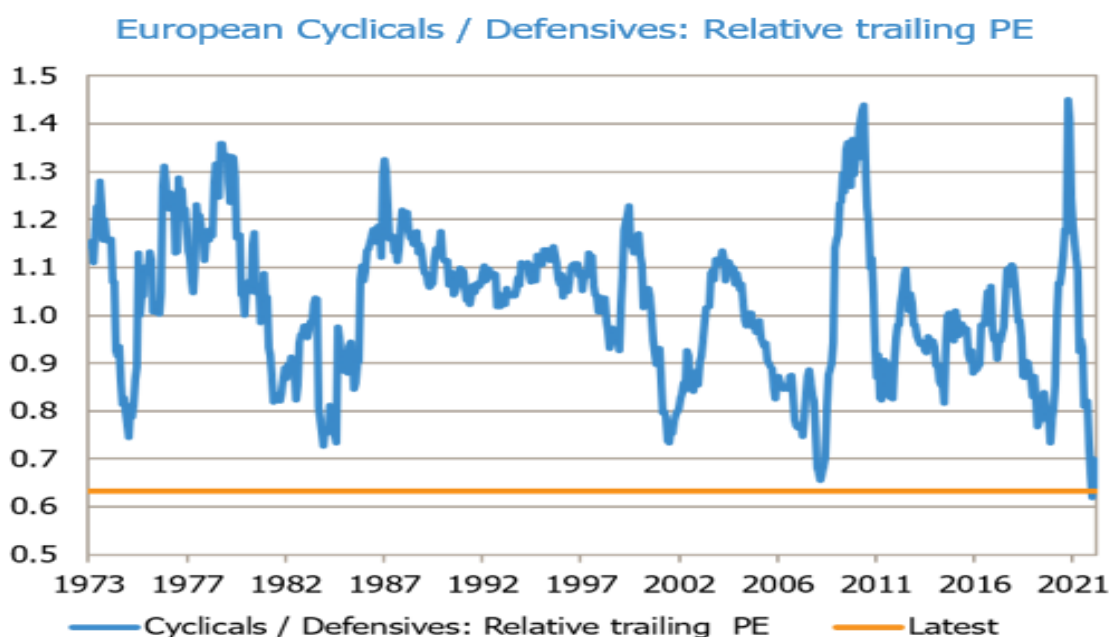
The Fund is now expected to yield 5.5% for 2022 as a whole. As we showed in our recent paper; [Get Paid Whilst You Wait](#), this yield has only been higher twice in the Fund's 18-year history – most notably during the financial crisis. We also continue to expect the Fund dividend to grow in 2023, with current modelling prudently suggesting at least mid single digit percentage growth. This would leave the dividend yield closer to 6% for 2023. We will also provide the first formal guidance on the 2023 outlook, for the Fund dividend, during Q4.

Outlook

A few months ago we made a number of simple points, which are still relevant as we come back from summer and look at how the rest of this year and 2023 could evolve. We have updated these and extended them with more recent observations.

As noted above, the dividend dynamic remains positive – we have upgraded guidance of growth for 2022 for the third time in this report and expect the Fund dividend to continue to grow in 2023. The Fund's yield of 5.5% for 2022 is at a level seen only twice in the Fund's 18-year history.

The UK market valuation structure remains polarised. Seven stocks – AstraZeneca, the two tobacco stocks, GlaxoSmithKline, Reckitt Benckiser, Diageo and Unilever currently make up nearly quarter of the UK market. They are all on very high valuations (particularly when adjusted for leverage) – in many cases 4x higher than the stocks in the Fund. The biggest danger remains 'valuation' risk – with all these heavily owned stocks trading on extreme relative ratings. The chart below shows 'cyclicals vs defensives' and as can be seen the relationship is exceptionally stretched, comparable to periods such as the First Oil Shock, the Global Financial Crisis and Covid-19. Typically, having reached an extreme, the differential moves swiftly back to a more moderate level. When people are most fearful / bearish as they are now, it is normally the time to look at Funds like ours. Now is certainly, in our view, not the time to buy an index tracker.



Source: Exane

The gap between the operational performance / newsflow at a stock level and share prices is close to the widest it has ever been. With the odd exception, as noted in the last few reports (e.g. **DFS**, or Wickes before we acquired it), the majority of our holdings are delivering strong operational performance despite the external pressures that all market participants are well aware of. Part of this is due to the amount of non-cyclical growth we have embedded in the Fund, which we have discussed before – 'growth in a value jacket', which includes plastics to cardboard, clean energy, infrastructure and the like. Part of it is the close to 30% of the Fund in oil / commodities, and part of it is being driven by rising interest rates which is a major tailwind to certain financials. Obviously, we are aware that the stock market is a forward looking mechanism that is anticipating sharply deteriorating economic growth and we have built this weakening into our modelling on a stock by stock basis. We are not being complacent in our assessment of how the prevailing economic picture impacts at a sector or stock level, but in most cases this looks to be more than discounted in share prices. The

most common discussion in the last 10 minutes of each management meeting that we have had across the interim results season is their disbelief in where their shares are trading vs where they see their businesses – this is why share buyback activity is so pervasive. We clearly share their sentiments.

Valuations remain eye-wateringly cheap across the Fund – there are now no stocks to sell on an absolute basis. There are multiple PE / yield crossovers, many stocks trading at or close to all-time lows (and in many cases below the low points seen through the pandemic), and most stocks are visibly cheap on a vanilla absolute basis. We have highlighted numerous examples in recent reports, with some new ones in this paper.

The most common question we are asked is what will change the picture we are faced with today – we can't answer that with any certainty as it is never clear what will create change. Factors could include a proper policy response in the UK from Truss in September to the energy cost issue, a clear peaking in US inflation (and then elsewhere), the ending of the Russia / Ukraine war or the market starting to look at where we will be in 2023 and 2024 as we go through the 'v' of the downturn. It could be just that the valuation extremities are so wide that this in itself is the driver of the change.

When there are periods such as this, we know the Fund tends to struggle as the focus moves away from the micro, away from specifics and away from valuation. After a good start to this year, this has been the case since the Russia / Ukraine war started. We also know that these times tend to be a prelude to very strong performance, as happened following the TMT bubble, the Global Financial Crisis and more recently following the initial six weeks of Covid. We believe we are at one of those points in time again.

In our experience, we believe this is the time to be looking at a Fund like this.

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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Investments include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile.

The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth.

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