



JOHCM UK Equity Income Fund

Monthly Bulletin: October 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 as at 30 September 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	9.65	2.43	7.22
Industrial Metals and Mining	12.63	7.35	5.28
Construction and Materials	6.56	1.37	5.19
Household Goods & Home Construction	5.07	0.89	4.18
Media	6.94	3.16	3.78

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.44	-10.44
Personal Care, Drug and Grocery Stores	0.00	7.98	-7.98
Closed End Investments	0.00	6.49	-6.49
Beverages	0.00	4.31	-4.31
Tobacco	0.00	4.28	-4.28

Active stock bets as at 30 September 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
BP	6.88	3.77	3.11
Glencore	5.96	2.99	2.97
Standard Chartered	3.60	0.64	2.96
DS Smith	3.11	0.15	2.96
ITV	3.04	0.10	2.94
Phoenix	3.11	0.18	2.93
NatWest	3.44	0.53	2.91
Diversified Energy	2.89	0.05	2.84
Legal & General	3.39	0.59	2.80
Barclays	3.89	1.10	2.79

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	4.01	-4.01
HSBC	0.00	4.42	-4.42
Shell	3.23	7.71	-4.48
Unilever	0.00	4.87	-4.87
AstraZeneca	0.00	6.90	-6.90

Performance to 30 September 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	-7.66	-12.35	276.30	1,715.8	1,995.9
Lipper UK Equity Income mean*	-7.21	-11.49	168.93		
FTSE All-Share TR Index (12pm adjusted)	-5.72	-7.67	201.89		

Discrete 12-month performance (%) to:

	31.09.22	31.09.21	31.09.20	31.09.19	31.09.18
JOHCM UK Equity Income Fund – A Acc GBP	-10.15	58.36	-29.23	-4.57	5.63
FTSE All-Share TR Index (12pm adjusted)	-4.33	28.31	16.51	2.72	5.84

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

In a normal month, we would comment extensively on the 50-75 bps of monetary tightening that we saw across the developed economies, trying to ascertain whether or not we are at peak velocity of interest rate rises, given that many underlying inflationary pressures, not least energy, are beginning to weaken. However, this debate can be revisited in subsequent months. Instead, we will focus on the UK's inappropriately named 'Mini Budget'.

Despite flagging most of the proposed policy measures in the preceding days, the Chancellor startled markets with the overall package of proposed policy changes. In particular, the cut in higher rate income tax from 45% to 40% became a lightning rod of criticism and discontent at home and abroad. The policy was however soon abandoned, which was the right move in our view, as much as anything, as it made little difference to the overall fiscal balance and it was unclear how it would have acted as a short-term stimulant to growth.

One of the problems with the aggregate scale of the policies announced is that the energy price guarantee is, by its nature, open ended. Current estimates put the winter 2022/3 cost at around £60bn, but it could easily be £20bn more or less than that figure. However, removing the uncertainty for consumers, in particular, was a positive move that will be replicated across Europe. Combining this with the short-term cost of the "Growth Plan", we will likely see the budget deficit rise to 6.5 to 7.0% in the next 12 months. This compares to a long-term average of around 3%, a peak above 14% during COVID and a previously anticipated fall to below 2% in 2023/4. In that context, whilst the move is bold, it is not completely outsized relative to history, particularly when allowing for the fact that the UK has the second lowest debt-to-GDP ratio in the G7 and the longest average debt maturity in the OECD at around 16 years. The UK also does not have large external liabilities in a foreign currency.

However, the market reaction was severe, particularly in moving implied short-term interest rates to around 6% by the spring of 2023. If such an outcome were to occur, any economic stimulant from the fiscal loosening will be more than offset by the impact on consumers and corporates of elevated borrowing costs. Herein lies Kwarteng and Truss's other major error, an assumption that markets will accommodate such a plan without greater colour or conviction about the proposed future improvement of the debt trajectory. In this regard, the Bank of England's intervention in the long-term gilt market has bought the UK Government time either to convince markets of the credibility of their policies and/or to temper the Chancellor's plans somewhat, as has already been done with scrapping of the cut in the 45% tax rate, which may be followed up with some changes of personnel. The Bank of England intervention has been successful so far, bringing 30-year bond yields back to the levels they were a week ago. However, higher fiscal deficits do justify somewhat higher yields and a lower exchange rate.

We continue to believe that most of the growth plan has considerable merit, particularly many of the supply side reforms and the focus upon accelerating infrastructure projects. However, it was delivered in an arrogant and crass manner leading to a short term sense of crisis, although it should be noted that sterling only fell around 1.5% vs the Euro during September.

Performance

After starting September positively, investors saw a material fall in the UK market with the FTSE All Share total return index falling 5.72%. The Fund, which started the month well from a relative and absolute perspective, fell materially following the Mini Budget and ended up underperforming across the month, returning -7.66%. Year to date the fund is down 12.35%, behind the index return of -7.67%. 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 10, five and three years and 1st quartile since launch (Nov 2004)^[1].

The turning point in the performance dynamic was the 'Mini Budget'. The announcement generated volatile moves in currency and bond markets and triggered substantial risk aversion amongst investors. Some of the Fund's underperformance was also derived from the void in defensives, which outperformed significantly. We have noted before and continue to do so that these stocks were already very expensive and are now more so, particularly on a relative basis.

In terms of the Fund, there were three areas of underperformance. First, small caps underperformed, with stocks like **Savannah Energy**, **Severfield**, **Tyman**, **Eurocell** and **R&Q Insurance** all off markedly. Small Caps always see discontinuity across any major risk event, but the focus will return to the fundamentals and valuation in due course. Most small caps had good updates during the month (e.g. **Galliford Try / Kier**, which we cover in the next section). Second, interest rate rises impacted housebuilders and property, which had already been weak, with **Vistry** falling 25%. It is now at a level last seen at the start of Covid. Third, life assurance stocks underperformed, stemming from worries about liquidity in the bond market, with **Legal & General's** share price falling 20% over the last two weeks of September. Assurers further suffered from the turmoil among pension funds, where rising yields triggered collateral calls on the many funds using liability driven investment (LDI) strategies, turmoil that ultimately drove the Bank of England's decision. This is an issue for defined-benefit pension funds rather than life assurers, which will have seen a major improvement in solvency ratios due to the rise in bond yields. Assurers are now likely to see a wall of demand from corporates looking for pension buyouts (enabled by higher bond yields), while the roll-back in regulation, announced in the Mini Budget, will add further stimulus in the sector. Unfortunately, all these factors have been forgotten for now.

Outperformance was limited to parts of the mining and oil sector. **Glencore** and **BP** were both strong in relative terms, with some more defensive stocks (**DS Smith**), dollar earners (**WPP & Lloyds insurers**) and certain stocks that had especially good news flow (**Sthree & Wickes**) also proving more robust. Disappointing updates remain few and far between, with **DFS** being the only one of note. This will of course change over the next six months. Still, forecasts are reasonably prudently set, and as we have articulated before, valuations are at similar levels to previous crisis epicentres.

TP ICAP continued its recovery, up 20% over September. Favourable market trends (higher volatility and rising bond yields) drove this, accompanied by the reaction to the previous month's positive results. In addition, press reports suggest that shareholders were pressuring the board to sell the data business, which could be worth more than the current market cap.

Portfolio activity

We finished selling our **Rio Tinto** position in the early part of September. The rationale remains that the company is too focused on iron ore, where prices (unlike other commodities) we feel are likely to fall over the next few years. There are also ESG concerns and the need to increase investment after a number of years of underinvestment. The Fund held a position in Rio Tinto for nine years and it was a material contributor to relative performance (close to 300bp). 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) and are very cheap (Glencore is on a free cash flow yield of c 35%). Glencore was trimmed to keep it around the maximum 300bp active position level. We added to Kenmare during the month.

^[1] Source: Lipper Hindsight

The commodity and oil sectors are clear dollar earners and should have benefitted (more) from the short-term trends in foreign exchange markets. However, these sectors were not as robust as they should have been, with the focus on 'risk-off', which tends not to favour these sectors. This anomaly should resolve itself over time.

We top sliced a few names to reflect recent strong performance. **TP ICAP**, as noted above, performed well due to recent market volatility and rising interest rates. Our two Lloyds insurance names, **Conduit** and **Lancashire**, were helped by \$ strength and a generally limited hurricane season, albeit Hurricane Ian will eat into their catastrophe budgets.

Over the last 12 months, the market has been underpinned by a narrow number of sectors and stocks. Much of the Fund is not in these buckets and share prices have fallen materially over the last 12 months, even before the events of the last 10 days of September. The stocks the Fund does own are exceptionally cheap and in many cases are cheaper than they were during the initial phase of the Covid-19 outbreak or the Global Financial Crisis. We have shown examples of this in previous bulletins (as an example, see our commentary on **Page Group** in the [August bulletin](#)). As the events discussed above occurred, we found many 'add' opportunities in the latter part of the month.

We continued to build up our bank holdings. The mark-to-market earnings upgrades stemming from higher interest income, primarily from reinvesting the hedges that roll off at current interest rates, is material and will likely dwarf any rise in impairment caused by economic volatility. Two of our main 4 bank holdings, **Barclays** and **Standard Chartered**, have sizeable non-sterling earnings and trade on a less than 0.5x book value. Where we top sliced positions on stocks in this sector to stay at our 300bp maximum active position earlier in the month (eg **Natwest Group**), we reinvested the proceeds in **Lloyds Bank** (a new position) to ensure our sector overweight stays at a similar level. Since we sold Lloyds a year ago, it has underperformed the sector markedly. Yet, the issues we identified at that stage have been resolved with a new management strategy and an end to the use of material exceptional items. Consequently, the high valuation against the sector has dissipated.

We also continued to add to the Fund's recent additions, **Tyman** and **Wickes**, which are now, combined, 100bp of the Fund.

There were several clear 'micro' positives in the Mini Budget, particularly the accelerated construction spending on energy transition, roads and the digital economy. A total of 138 named projects are expected to start by the end of next year, with many funded by private capital, but facilitated by government policy. We added to **Kier** and **Galliford Try**. Even before any extra work is permitted, this sector is posting strong order book growth, with Kier's recent results indicating a 27% rise in its order book. During the month, Galliford Try reported results ahead of forecasts. Its dividend was 10-15% more than expected and it launched a share buyback equal to 10% of its market cap. Galliford Try is still trading below its current net cash position. Our target price of 390p compares to the current price of 150p. The target price is based on a price-to-earnings ratio of 10x normalised profits, to which we add excess capital.

The property sector was one of the worst parts of the market impacted by the events of the Mini Budget. We have limited exposure to this area, less than 150bp, but used the weakness to continue building our position in **Land Securities**. It trades on less than half its historic book value and lower than it did during the Global Financial Crisis and the Covid-19 outbreak. In the last few days of September, they sold a significant London asset for approximately £800m (now 25% of its market cap) at a 9% discount to book value, 80% above the current implied valuation of the whole business.

Dividend Update

We upgraded guidance for Fund dividend growth at the end of August to c 35% compared to the 2021 outturn. We are currently running ahead of this guidance and will provide a final update at the end of November.

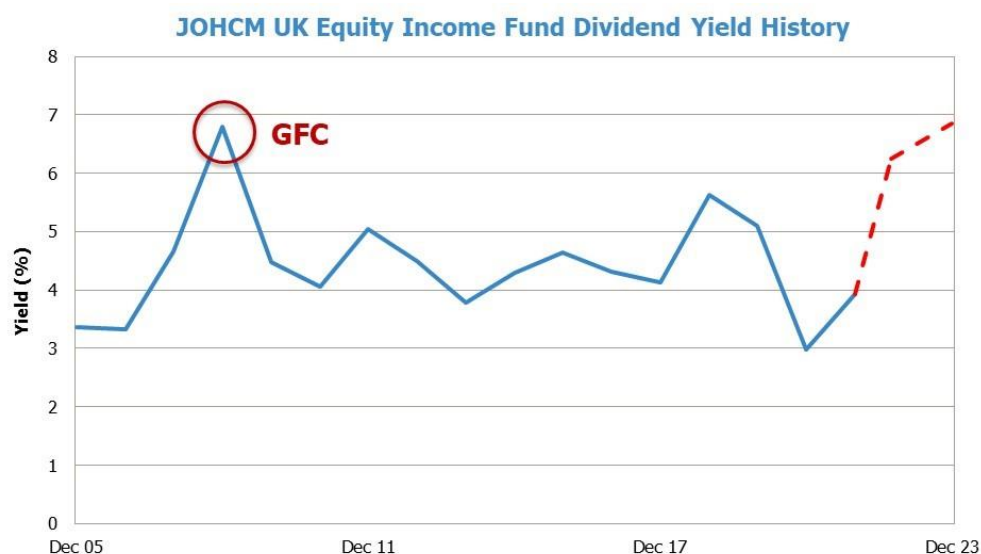
At the current unit price, the Fund yields 6.25% for 2022. We discuss in the Outlook section where this yield sits vs the Fund's history.

For the discrete Q3 2022 Fund dividend, which went ex at the end of September, the increase was c. 7% year on year (based on the A class accumulation unit). Growth in Q4 will be materially stronger (between 40-60%). We remind readers that quarterly growth rates are driven by the ex-dividend dates of the current portfolio of stocks, which evolves over time. The focus should therefore be on the annual rate of growth and our guidance.

Outlook

We have highlighted on many occasions that the process of markets re-establishing a credible cost of capital or discount rate could prove problematic, particularly for the more highly rated stocks and sectors. In September, the interest rate increase became somewhat dis-orderly worldwide, not just in the UK. As a result, markets have very quickly increased real bond yields, which is driving a de-rating of developed stock markets. However, this impact should be more marked in the higher rated markets such as the US. Unfortunately, in the last 10 days, this dynamic has shifted to a very risk averse mindset, with little consideration given to valuation or positive correlations with rising interest rates.

This risk aversion has been more magnified in Europe and particularly the UK, due in part to the pessimistic reaction to the Mini Budget. Whilst macroeconomic risks are rising, we still believe that the most likely outcome in the UK is for a relatively modest real GDP contraction, but where nominal growth remains positive. As the graph below shows, the dividend yield on our fund has never been higher, with the 2023 outcome likely to settle or rise close to 7%. We are not blind to the risks of dividend disappointments if the economy contracts more sharply, but we have already attempted to accommodate some of those risks within our forecasts. As we have highlighted before, we believe that the quality of our dividend yield is very high in a historical context because many companies used Covid-19 as a mechanism to reset their distribution policies. In addition, corporate balance sheets in our Fund are in a strong position relative to history, which is why around 50% of the Fund is currently engaged in a share buyback, in addition to their regular dividend distribution.



Source: JOHCM/Lipper as of 30 September 2022. Data to 31 December 2023 includes JOHCM estimates

It is also striking how narrow leadership has been within the UK market. Investors have fled to perceived safety in an increasingly narrow cohort of stocks, mainly in large cap sectors of commodities, pharmaceuticals and consumer staples. Consequently, everything else has been heavily sold, regardless of fundamentals or valuation. In our 30 years of investing, we have rarely seen such a divergence, apart from during 2008. For illustration, of the 59 stocks in the Fund, only 14 have outperformed the market in the last 12 months. In contrast, 37 have underperformed the market by more than 20%, despite sitting on extraordinarily low valuations. Sadly, many will be vulnerable to incoming corporate activity if nothing changes.

We are not apologists for the UK economy or indeed for our politicians. We invest in companies, not economies, and the UK continues to have many well-run, conservatively financed and very modestly valued groups. But as recent years have shown us, politicians and policies can change quickly and meaningfully. In the meantime, many stocks in the UK are on sale at multiples we have NEVER seen before. We urge investors not to give up on our market or indeed our strategy. We believe it is likely to look very different in 12 months' time.

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

Professional investors only.

Issued and approved in the UK by J O Hambro Capital Management Limited (“JOHCML”) which is authorised and regulated by the Financial Conduct Authority. Registered office: Level 3, 1 St James’s Market, London SW1Y 4AH.

This is a marketing communication.

Please refer to the fund prospectus and to the KIID before making any final investment decisions. These documents are available in English at www.johcm.com, and available from JOHCML at the address set out above.

Information on the rights of investors can be found [here](#).

The distribution of this document in jurisdictions other than those referred to above may be restricted by law (“Restricted Jurisdictions”). Therefore, this document is not intended for distribution in any Restricted Jurisdiction and should not be passed on or copied to any person in such a jurisdiction.

The registrations of the funds described in this document may be terminated by JOHCM at its discretion from time to time.

The investment promoted concerns the acquisition of shares in a fund and not the underlying assets.

The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. The dividend yield forecast and commentary is an estimate of future performance based on evidence from the past on how the value of this investment varies and current market conditions and is not an exact indicator. Returns will vary depending on how the market performs and how long the investment is held.

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.

The information in this document does not constitute, or form part of, any offer to sell or issue, or any solicitation of an offer to purchase or subscribe for any funds described in this document; nor shall this document, or any part of it, or the fact of its distribution form the basis of, or be relied on, in connection with any contract.

Telephone calls to and from JOHCML may be recorded. Information on how personal data is handled can be found in the JOHCM Privacy Statement on its website: www.johcm.com.

The registered mark J O Hambro® is owned by Barnham Broom Holdings Limited and is used under licence. JOHCM® is a registered trademark of JOHCML.

Sources for all data: JOHCM/Bloomberg (unless otherwise stated).