Professional Investors Only

JOHCM UK Equity Income Fund

Monthly Bulletin: January 2023

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 31 December 2022:

Top five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Life Insurance	10.25	2.77	7.48
Construction and Materials	6.95	1.40	5.55
Industrial Metals and Mining	12.40	7.87	4.53
Household Goods & Home Construction	5.46	0.97	4.49
Media	6.93	3.23	3.70

Bottom five

Sector	% of Portfolio	% of FTSE All-Share	Active %
Pharmaceuticals & Biotechnology	0.00	10.87	-10.87
Personal Care, Drug and Grocery Stores	0.00	7.51	-7.51
Closed End Investments	0.00	6.26	-6.26
Tobacco	0.00	4.03	-4.03
Beverages	0.00	3.86	-3.86

Active stock bets as at 31 December 2022:

Top ten

Stock	% of Portfolio	% of FTSE All-Share	Active %
NatWest	3.64	0.58	3.06
Phoenix	3.25	0.19	3.06
Barclays	4.06	1.08	2.98
Legal & General	3.60	0.64	2.96
Standard Chartered	3.57	0.64	2.93
ITV	3.05	0.12	2.93
Paragon	2.93	0.06	2.87
DS Smith	3.04	0.18	2.86
Aviva	3.39	0.54	2.85
Glencore	5.93	3.09	2.84

Bottom five

Stock	% of Portfolio	% of FTSE All-Share	Active %
Diageo	0.00	3.56	-3.56
HSBC	0.00	4.50	-4.50
Unilever	0.00	4.59	-4.59
Shell	2.57	7.18	-4.61
AstraZeneca	0.00	7.22	-7.22

Performance to 31 December 2022 (%):

	1 month	Year-to-date	Since inception	Fund size (£m)	Strategy size (£m)
Fund – A Acc GBP	**-0.95**	**-0.86**	**325.60**	**1,646.00**	**1,962.00**
Lipper UK Equity Income mean*	-0.54	-2.03	199.02		
FTSE All-Share TR Index (12pm adjusted)	-1.14	0.74	229.40		

Discrete 12-month performance (%) to:

	31.12.22	31.12.21	31.12.20	31.12.19	31.12.18
JOHCM UK Equity Income Fund – A Acc GBP	-0.86	24.76	-15.72	20.02	-13.19
FTSE All-Share TR Index (12pm adjusted)	0.74	17.77	-9.52	19.29	-9.06

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 interplay between peaking inflation and a potential moderation in the pace of monetary tightening proved to be a tug of war throughout December. Whilst the Federal Reserve (Fed), the Bank of England (BoE) and the European Central Bank (ECB) all raised rates by 50 basis points during the month, the accompanying language and future policy implications were quite different.

In the US, there was a second consecutive month of inflation slowing quicker than anticipated, with the November Consumer Price Index (CPI) only rising 0.1% month-on-month, equating to a 7.1% annualised increase. Several key components of the CPI have now moved meaningfully lower, including used cars, lumber and wheat, whilst rental inflation also showed signs of moderation. Furthermore, the pending home sales index at -36% is even lower than during the early months of COVID. Consequently, it was no surprise to see the Fed begin to lessen the pace of monetary tightening and imply a further slowing during 2023. Whilst it is impossible to predict how many more rises there will be, the process will likely be complete by the end of Q1 2023 as policymakers will then reflect upon the lagged impact on the real economy. The inverted yield curve implies that rates will begin falling later in 2023. Whilst this is possible, a more likely scenario is a period of flat rates at the higher plateau level.

In the UK, inflation has also begun to show clear evidence that it has peaked, albeit at a higher level than in North America, predominantly due to the larger energy price impact. In November, the annual CPI increase fell from 11.1% to 10.7%, with food and energy contributing more than 50% of the increase. The recent sterling recovery is beginning to positively impact inflation in areas such as fuel prices. News from the broader economy was mixed rather than uniformly bad, contrary to what readers / watchers of the mainstream media might presume. Whilst retail sales volumes in November were 0.4% lower than in October and down almost 6% compared to last year, the value of sales paints a brighter picture. Clearly housing activity fell heavily after the Kwarteng Budget and has yet to recover, with the latest RICS survey of price moves at its weakest level for two years. However, the December composite PMI survey recovered to 49.0 versus 48.2 in November, with the key services sector back to 50.0; similarly, the GFK Consumer Confidence Index rose 2 points to -42 in December, whilst still low in historical terms, it is 7 points higher than where it was in September. GDP grew by 0.5% in October, reversing the fall seen in September, where the extra bank holiday for the Queen's funeral had driven a decline. Labour markets are slowing, but only gently, with vacancies still higher than where they were pre-pandemic, whilst accelerating wage inflation at 6% over the last three months, is slowly closing the gap versus inflation. These more positive data points were borne out by some positive trading statements, particularly by companies in the UK hospitality sector. Given these mixed messages and the problem of disentangling "transitory" inflation from "sticky", it was not a surprise to see significant differences of opinion in the Monetary Policy Committee, with six members voting for a 50bps increase, one for 75bps and two for no change at all. This suggests that rate increases will slow from here, again likely to flatten off during Q1 2023.

In Europe, inflation also fell 50bps to 10.1%, and in a similar vein, PMI surveys suggest a troughing of activity, with the November composite at 48.8 versus 47.8 the prior month. However, after the latest monetary tightening, Lagarde's language was more hawkish than others, suggesting that terminal interest rates were more likely to be closer to 4% than 3% and that markets should expect further 50bps incremental raises. The ECB was, of course, later than others to begin tightening; as such, it would not be a surprise if the peak was later too.

In Asia, the Bank of Japan also adopted a more hawkish approach than markets had been expecting, with an increase in the cap on 10 year bond yields to 0.5% from 0.25%. In China, economic data was weak, with November's industrial output slowing to 2.2% year-on-year and retail sales falling by almost 6%. This economic weakness, combined with civil unrest, has undoubtedly led to a shift in policy on COVID restrictions. This policy shift is an important dynamic as we start 2023.

Performance

December was a weaker month for markets albeit there was a pronounced recovery towards the end of the month which left the UK FTSE All Share down just -1.14%. The Fund outperformed slightly – down -0.95%. The FTSE All Share ended the year slightly up (0.74%), which is a decent outcome compared to most other global asset classes (e.g. the Nasdaq decline of over 30%). The Fund was down -0.86%. Looking at the peer group, the fund was ranked 6th decile within the UK Equity Income sector for the year. On a longer-term basis, the fund is ranked 2nd quartile over three years, 3rd quartile over five years, 1st quartile over 10 years and remains the best Fund in the sector since inception in 2004.

The mining and bank sectors were robust over the month. It is becoming increasingly clear that bank earnings and returns on capital are rising materially as interest rates have increased. **Paragon** results were strong, with further upgrades; the stock was up over 20% relative. **Standard Chartered** also ended the year at its highs. All bank stocks remain exceedingly cheap, with Standard Chartered and **Barclays** on 0.5x tangible net asset value (TNAV).

Most of the Fund (c.85%) is on the front foot, with good results and positive trading updates continuing to be a feature. This is partly due to the rise in rates impacting certain sectors (e.g. banks), economies being slightly stronger than expected (see comments above on the UK) and our companies having clear tailwinds (e.g. infrastructure spending, green energy, market share gainers) that will provide a bridge across the current period of economic weakness. We had several strong statements – **DS Smith** (up 5% relative) results were accompanied by a further upgrade, **Phoenix** (up 5% relative) delivered a positive capital markets day and **Redde Northgate** (up 15% relative) results were also strong. The collective strength of results means this feels very different to 2008/09, which was the last time our Fund was as cheap as it is now.

Drax (up 10% relative) rebounded after the Government clarified higher input costs would be adjusted for, in the calculation of the windfall tax, an excellent outcome. Drax has a market cap of less than £3bn; this does not reconcile with a company which produces 6 to 7% of UK electricity and has a key position in strategically important on-demand electricity (i.e. pumped storage). It is also one of the top three global pellet/biomass producers, will be the largest player in UK carbon capture and is trying to replicate this outside the UK. Drax is on a PE of 5x - this feels too low. **First Group** completed the sale of its residual Greyhound assets, which was accompanied by the announcement of a buyback of £75m (c.10% of its market cap). The stock was up marginally with a target price that remains two times the current price.

We noted above that 85% of the Fund is on the front foot regarding results, however, the residual is seeing more challenging conditions but is accompanied by very low valuations. The largest component of this is housebuilders and, to a lesser extent, retail which we comment on in the next section. Additional negative contributors in December include **Petrofac,** which had a weak trading update, **Vodafone** announced a CEO change and analysts lowered 2023 forecasts for **National Express**.

We have had a strong year for corporate engagement. Across the Fund, we have had detailed discussions (which includes letters and meetings) with 10 stocks on matters ranging from strategy, board composition, capital allocation, remuneration and environmental issues. A recent example of this was in Q4 on National Express, where we wrote to the Board suggesting they sell their US business (one of the current three geographical legs). The rationale was to reduce debt that we view as too high and unlock value (which is trapped by the market view that the debt is too high). The downgrades noted above make the points we made more acute.

Quantitatively we voted against or abstained in 5 AGM's which is c.7% of the total, and the final position on ESG MSCI rating changes (which is one of the measures we track) was '14 up' versus just '3 down', indicating substantial improvement vs the average in the market.

Portfolio activity

There were no new additions or sales in December. As we have noted in previous monthly commentaries, this low turnover reflects the significant upside embedded in the Fund and the lack of any negative catalysts that would lead to any reappraisals at a stock level. We feel 2022 will be shown as a year for patience, locking in low valuations and preparing the Fund for when sentiment changes. We have seen this before in Q1 2009, the recovery post the June 2016 Brexit vote and the 'vaccine moment', that the performance mix of the market can change quickly. The Fund's skewed positioning means the move will likely be quick and substantial. Now is the time to put the 'foot on the ball' and be patient, as most stocks have 75-300% upside.

With few stocks even close to prudently set target prices, most sales continued to be driven by stocks performing well and hitting our 300bps maximum active position, including **Standard Chartered** and **Phoenix Group**. As well as the Standard Chartered adjustment, we pared back **Paragon,** the strongest performer, post results. As noted above, most results continue to be strong and were met with outsized share price moves given low valuations, with **DS Smith** and **Redde Northgate** fitting into this category.

On the other hand, some stocks were down materially on almost no specific news. Nevertheless, we added to both of our housebuilders, **Bellway** and **Vistry**. The comments above on the UK economic outlook should resonate in Q1 2023. Tangentially, we added to the brickmaker **Ibstock**. All three of these stocks are below the lows of COVID-19 in early 2020.

We own three retailers, **DFS**, **Lookers** and **Currys** (c.4% of the Fund in total) DFS is taking market share (currently around 40%), which showed through in its last trading update, which was better than expected. Lookers is also taking market share, and has a strong order book to take into 2023. It currently trades below its property value and net cash. Both stocks are presently conducting share buybacks. Currys provided a disappointing update, as the Nordic business fell short due to excess competition (partially offset by the UK businesses performing better than expected); we continued to add to this stock. We also added to **Petrofac** and **Easyjet**.

As we move into 2023, we have decided to move our focus for small cap allocation up slightly from 17-19% to 18-20%.

The main driver of this slight adjustment is the quantum of upside that resides in small cap vs large and mid-cap. The gap is close to the widest across the 18 years we have managed the Fund. Most small cap stocks can easily double, based on prudent target prices, whilst a number **could** triple, e.g. **Keller**, **International Personal Finance** and **Kier**.

In common with most UK Funds, we have seen continued outflows during 2022. Given the valuation of the Fund and the positive position most of our stocks are entering in 2023, we believe the opposite should be happening. In addition, the slightly smaller Fund means the move to 18-20% does not change the liquidity profile of the Fund versus historical trends.

In December, **Petrofac** (c.100bp of the Fund) fell from the FTSE 250 into the small cap space. This is the main reason we were at the top of the new small cap allocation range at the end of the year. On 4 January, Keller moves from the small cap index to the FTSE 250, which means the current small cap proforma weight is the middle of the new range i.e. c.19%.

During December, several small caps performed well, e.g. **Tyman, Conduit** and **DFS;** we marked these positions to target weights.

Dividend Update

The 2022 Fund dividend grew by 39%. The discrete fourth quarter dividend, which went ex-dividend at the end of the year grew by 50%. The Fund dividend is now 13% above its pre Covid level.

The outturn for 2022 was 2 percentage points higher than our guidance of 37% discussed in the last monthly report. The difference is DS Smith, which as noted above had strong results. It moved its ex-dividend date from April 2023 (which had been the month the stock had gone ex dividend for close to a decade) to December 2022. This has the effect of increasing the 2022 dividend by c. 2%, and reducing the growth rate for 2023 (as the base is higher) by a similar amount. The actual Fund dividend for 2023 stays the same as DS Smith will still pay two dividends in 2023.

Our previous guidance for 2023 was for Fund dividend growth of 3-7%. The DS Smith effect moves this to 1-5%. The historic 2022 Fund dividend yield is 5.5% and the prospective 2023 dividend yield is 5.7%.

Outlook

2022 was a challenging year for many asset classes and investment strategies as the world finally moved away from the long era of zero interest rates. In many respects, this is a very healthy development as it means that a positive cost of capital has been re-established, and it provides central banks with policy ammunition in future years. However, the valuation adjustment has proven painful in many areas and the process may have a little further to run. The extremely powerful tailwind that 'growth' orientated strategies have enjoyed for over a decade has now, not only ended, but has reversed. All market participants must reflect upon their regional and style allocations and assess whether they are appropriately positioned for the next decade. In 2022, 'value' as a style performed better in North America than in the UK and Europe, where the fog of war clouded the operating environment, particularly for value stocks with any degree of cyclicality. Consequently, the value versus growth opportunity is still very significant across the UK and Europe.

There has never been a period where a global recession is more anticipated than now; as such, markets are braced for earnings disappointments across many parts of the market and any outcome which is less painful than the gloomy consensus expectation could well see better share price performances. We believe that aggregate earnings performance will prove more resilient than the market expects. Developed markets, including the UK, are likely to see nominal GDP growth of 4-5% in 2023, and it is this, rather than real GDP growth, which drives most companies' revenue performance. Whilst not all companies can pass on input inflation entirely, the majority of stocks in the Fund have and will continue to do so, which should lead to operating profit resilience. Of course, pockets of the economy will struggle to adjust to this environment, but at the aggregate level, we think the outcome will positively surprise.

Furthermore, the UK may not actually experience a meaningful real GDP recession anyway. The second half of 2022 may prove to have been mildly contractionary, but the final outcome will depend upon how big an impact the rising levels of industrial action have on the way that the ONS measure GDP. But stepping back from the detail, it feels unlikely that unemployment will significantly rise during 2023 given the continued high level of vacancies and the limited growth in the labour force. We also believe that the market continues to ignore how the economy is structurally in a very different place to 2007; for example, the UK's loan-to-deposit ratio sat at around 140% in 2007 but is now at 81%, which is the lowest for 40 years. Part of the reason for this is the dramatic growth in consumer deposits seen since COVID, which itself is a useful economic buffer and underpin to consumer activity.

It feels to us that markets are increasingly being driven by asset allocators trying to anticipate and front run central bank's policy actions. In that regard, it is likely that this phase of monetary tightening will broadly end by March 2023. Inflation will progressively fall during the year, partly due to base effects, but the trajectory of that fall will dictate policy actions later in 2023. The ECB has adopted a more hawkish position than others during the last few weeks, but market participants should be wary in assuming that central bankers have any greater predictive economic insights than we do – after all, this time last year, Christine Lagarde said "It is very unlikely that we will raise interest rates in 2022", since then they have delivered 250bps of increases.

Regardless of how and when the economic picture clears during 2023, we continue to believe that our portfolio offers exceptional value. The dividend yield is within c. 50bps of its highest ever level, dividend cover in the UK is the highest it's been for at least a decade, the balance sheets of our companies are the strongest they have ever been and valuations are as attractive as they were in late 2008. Whilst our Fund has shown resilience during 2022 compared to other markets and styles, we strongly believe it should have and will perform more strongly in an absolute sense. Many of our financial stocks are clear beneficiaries of higher interest rates, whether they are insurers experiencing accelerating demand for bulk purchase annuities or banks enjoying the restoration of net interest margins. Our commodity exposed stocks enjoyed a better year in 2022, but the coming year will likely see further tight supply conditions due to the lack of new capacity added over the last decade. If peace breaks out in Ukraine, that may cause a short term downward adjustment, but other parts of the portfolio would benefit. Many of our domestically orientated stocks are on very low valuations and are vulnerable to any element of good news, resilient trading or a resumption of corporate activity. Housing related stocks are likely to experience subdued demand in the short term, but valuations are highly supportive and mortgage rates continue to fall gently from September’s spike.

Lastly, we would like to thank you all for your continued support during 2022; at times this year it was hard work owning a UK fund, but in the end, the market has proven more resilient than any other major developed market, and the primary reason for this is because of its modest valuation. With a positive cost of capital re-established, we believe valuation will continue to be the most critical factor in driving returns in the coming years, and as such, we look forward with confidence and excitement at the potential returns on offer from the stocks in our portfolio.

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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