JOHCM UK DYNAMIC FUND

UNDER THE BONNET

2019 ANNUAL REVIEW

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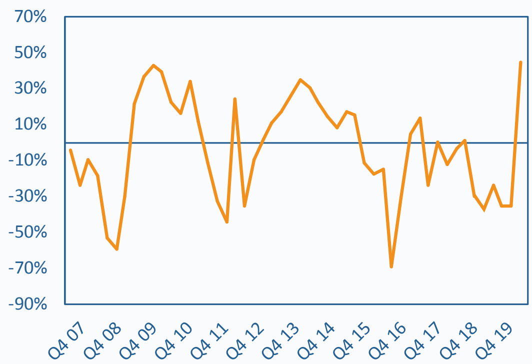
INVESTMENT BACKGROUND

Global equity markets continued to move higher in December as economic indicators showed a pick-up in global growth, there was further progress in US-China trade discussions and the UK's Conservative party won an overall majority in the general election. The JP Morgan Global Composite PMI ticked up from the previous month's 44-month low following a steepening in China's composite PMI growth rate and a strengthening in US business activity. US equities had a remarkable year, capped by President Trump announcing he would sign a phase one trade deal with China in January and move to negotiations on phase two. The S&P 500, Dow Jones Industrial Average and NASDAQ 100 total return indices all reached new all-time highs in December, with gains of 32%, 25% and 40% respectively for the year.

We wrote the following in August's 'Under the Bonnet': "When we come to reflect on 2019, July will likely be seen as a decisive… a month in which geopolitical brinkmanship came to a head, leading government and central bank policies to be reappraised which ultimately may lead to a new market narrative." The progress in the US-China trade deal marked a clear de-escalation in this brinkmanship globally, but starker still were the final quarter's developments in the UK: a new withdrawal agreement negotiated with the EU and - in December alone - the Conservative Party winning an historic majority in the general election and the withdrawal agreement subsequently being passed by parliament more than 13 months after Theresa May's cabinet first backed her deal. The scale of these changes in the UK and their importance in unwinding the last three years of uncertainty should not be underestimated. The Conservative party's win represents its largest since 1987 whilst the Labour party – campaigning on one of the most anti-businesses manifestos ever seen in the UK – suffered its largest defeat since 1935. Although Brexit uncertainty is far from over, with UK-EU trade negotiations yet to begin, the final outcome and broad timeline are now clearer and the highly feared 'hard Brexit' outcome seems an unlikely end point.

UK business optimism at all-time highs

% of CFOs who are more optimistic about the financial prospects for their company than three months ago



Source: The Deloitte CFO Survey as at Q4 2019.

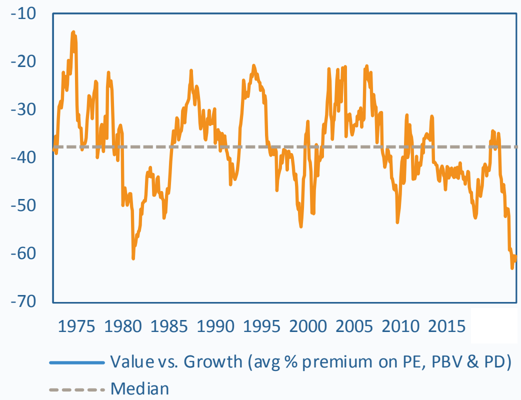
Although it is too early yet to see any evidence of these changes in UK politics positively affecting PMIs or corporate trading, a number of confidence surveys are already reporting significant upticks. GfK's Consumer Confidence index (surveyed the week before the election) showed the largest increase in confidence about the economic future since the summer of 2016, whilst Deloitte's Q4 CFO survey (surveyed the three weeks after the election) showed the largest increase in business optimism in the survey's 11-year history, even beating the surge in corporate confidence that accompanied the recovery following the financial crisis (see chart left). Of particular note in the survey is the percentage of CFOs concerned about the long-term impact of Brexit falling to just 66%, its lowest level in over two years having peaked at 83% two quarters earlier. We have written many times before that confidence is the missing link in terms of economic growth in the UK.

The changes in the UK domestic outlook pushed sterling to close the year up 4.8% - as measured by the Bank of England's GBP trade-weighted index - with all these gains made in the final quarter. UK equities likewise rallied, with the FTSE 250 total return index reaching an all-time high in December to close the year up 29%. The FTSE All-Share total return index had its best run since 2009, up 19% for the year, with a 4.2% increase in the final quarter despite currency headwinds.

Despite the de-escalation of geopolitics, governments and central banks continued to use monetary policy as their main economic tool with a total of 80 rate cuts globally over the year. However, there were signs that policy may be beginning to change. Mario Draghi's final speech as European Central Bank president (28 October) urged member nations to use fiscal policies whilst a poll by the Financial Times of 34 economists (23 December) showed more than half believed his replacement, Christine Lagarde, would change the ECB's inflation target to allow higher inflation. In the UK, changes are already afoot with the forthcoming February budget likely to increase the UK's deficit for the first time in eight years and, with the US entering an election year, it seems likely government spending will be a major feature here, too. Despite this, US and UK generic 10-year government bond yields ended the year down 76bps (to 1.92%) and 46bps (to 0.82%), respectively, their lowest ever levels at a year end. Even despite the changes in the UK political landscape, it is maybe therefore no surprise that valuation disparities in UK equities did not change, with the average valuation premium of value stocks against growth stocks remaining at lows not seen in over 45 years (see chart right).

UK valuation dispersion still at all-time extremes

UK equities value vs. growth average valuation premium



Source: MSCI,Morgan Stanley as at 17 December 2019.

The Fund outperformed the index in December, returning 3.73% versus a 2.63% return by its benchmark, the FTSE-All-Share Total Return index (12pm adjusted). This closed off a year of outperformance for the Fund, with a return of 20.82% versus a 19.29% return by the benchmark and a final quarter of outperformance, with the Fund returning 4.77% versus the benchmark's return of 4.17%. Pleasingly, Fund performance in all of these time frames was driven by positive stock selection. It accounted for 80% of the year's return, with positive stock selection occurring in all four quarters of the year.

Performance in December was generated entirely by stock selection, with strong performances from some of the Fund's consumer services holdings – still the Fund's largest overweight – as share prices began responding to the changing UK domestic landscape plus a number of stock-specific factors. **The Restaurant Group** was the Fund's largest beneficiary (+10% for the month), however, it must be noted the Fund's holding in supermarkets **Morrisons** and **Tesco** received little or no benefit as pre-Christmas Kantar and Waitrose data raised doubts over the health of forthcoming trading updates. Tesco's shares did, however, react positively to the news of takeover interest in the company's Asian business, with early estimates suggesting a potential value of c. £6.5-7bn, implying net proceeds could be equivalent to 12-14% of the group's market capitalisation at the time.

Further stock-specific positives in December included **Hyve** (previously named ITE Group), which was the largest contributor to the Fund's performance in December. Its shares were up 24% in response to the strategically attractive acquisition of two US e-commerce events, via a small equity placing. This further diversified the business away from its legacy Russian exposure and enhanced earnings. Importantly, these assets were not acquired through a competitive process, as the founders were well known to Hyve's CEO, Mark Shashoua, having acquired their previous business, Money20/20 whilst in his previous role at Ascential. Money20/20 remains one of Ascential's most successful franchises, so this transaction marks an important vote of confidence in Mark Shashoua further confirmed by the founders and two members of the management team of the acquired businesses using $15m of their sale proceeds to buy shares in Hyve in the equity placing.

There was also a strong performance from **Chemring**, a smaller but long held position, with shares up 20% over the month as full-year results showed the quality of the business improving as the protracted turnaround began to take hold. Growth in the higher margin sensors and information division was ahead of expectations, group order book coverage increased, net debt continued to fall and, importantly, it was the first year of no exceptionals in over 10 years. Full-year results at **Stock Spirits** also came ahead of consensus expectations following impressive year-on-year revenue growth of 14% in Poland, its main market, but reactions from analysts and the market remained muted as both await certainty over the impact of forthcoming alcohol duty changes in Poland and the Czech Republic. Management remain confident of their strategic positioning into these events.

Whilst the Fund outperformed in Q4, it was a disappointingly sluggish period with few wins from some of the larger positions. None of the Fund's top five performing holdings for the year (in order **3i**, **Electrocomponents**, **DMGT**, **Melrose** and **Hyve**) appeared in the top five for Q4, with 3i Group in fact being the second worst performer as the share price digested the updated valuation of Action and foreign exchange headwinds. As we wrote in last month's 'Under the Bonnet', 3i has increased its investment in Action at this valuation, thereby taking advantage of what might have looked like an underwhelming mark-to-market valuation to increase its exposure to this high growth situation. 3i remains the largest position in the Fund.

Fund performance in Q4 was also hindered by an unusually high level of CEO related news: temporary losses of CEOs – albeit yet to return – at Electrocomponents and **SIG** and the announced departure of CEOs at Tesco and **St Modwen** (the latter to become CEO of Land Securities). This Fund believes that CEOs are an integral part of determining the success of any turnaround, however, the return available to any equity investor is in the first instance determined by the underlying value of the business's assets. In our mind, none of these CEO changes alter the underlying value of these assets but we will await meeting the new CEOs, where relevant, to assess what implications some of these changes may have for the continued speed of these turnarounds.

With regard to top contributors to performance for the year it is pleasing to see DMGT in the top five as the share price responded to management successfully executing a transformational year. The distribution of the group's shareholding in **Euromoney**, and the sales of RCA, On Geo and Genscape, were significant steps in unlocking the hidden value within this conglomerate business, something we have written about previously at length. Disposals demonstrated not only a clear commitment to unlocking this value but also illustrated the premium valuation that some of these high quality, data-led, imbedded businesses can reach. This has very positive implications for many of the businesses that DMGT still owns, most notably RMS (the world's leading natural catastrophe modelling business), Landmark (the UK's leading provider of land and property information), Hobsons (a global leader in education technology),Trepp (the largest commercially available database of securitised mortgages) and MailOnline. DMGT is now a top five active position in the Fund.

Q4 corporate engagement

We were actively involved in amendments to the proposed remuneration policies at two companies the Fund owns: **McCarthy & Stone** and **TT Electronics**. At McCarthy & Stone, we successfully argued the case for existing directors' pension policy to be aligned to the wider workforce policy. The remuneration committee have now proposed a policy that phases the proposed 10% difference to 0% in 2.5% increments over four years. At TT Electronics, we were not so successful in terms of amending the pension policy – albeit the remuneration committee had at least already brought the policy for new executives to be in line with the wider workforce – but the company did withdraw the introduction of a flexible LTIP award for 'exceptional circumstances'. We argued that the use of one-off awards should not be needed if a remuneration policy has been properly constructed.

We also had a meeting with the Chairman of **Aggreko** as part of our continued analysis of this newer position in the Fund. The meeting was an opportunity to apply pressure on its board to bring the executive pension policy closer in line with the wider workforce and to further understand the company's environmental policy and plans for the future.

Outlook

As we look in to 2020 we are cognisant that global asset valuations look to be at the upper end of their historic ranges. Morgan Stanley reports that the S&P 500 next 12m P/E of 18.6 is close to its all-time peak of 19.0 made in January 2018, which preceded a 24% jump in US profits due to tax cuts. With Morgan Stanley's US team currently forecasting eps growth of 0% in 2020, this is a cause for concern.

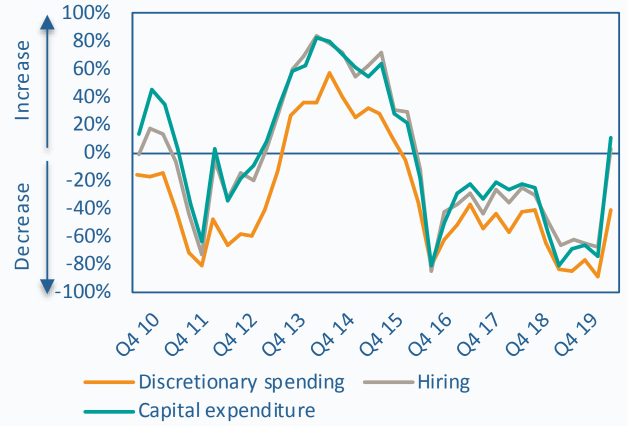
In the UK, the picture looks less worrying. Next 12m P/E valuations of the FTSE 100, FTSE 250 and FTSE Small-cap indices are at only their 30th, 73rd and 24th percentiles versus their five-year history (compared to the MSCI USA and MSCI EMU on 98th and 77th respectively). As discussed above, within UK equities the record-breaking dispersions between value and growth stocks also provides some clear opportunities and, whilst the FTSE 250 may look expensive versus the FTSE 100 and FTSE Small-cap, the recent changes in the UK political landscape will – all things being equal – lead to strong earnings tailwinds for UK domestic focused stocks. The recent Q4 Deloitte CFO Survey for the first time in four years showed CFOs expecting to increase capital expenditure and hiring over the next 12 months (see chart right).

Recent analysis from Goldman Sachs shows that changes in earnings forecasts have been the most successful factor in determining share price performances since 2009. This will have important implications for the valuation of UK domestic stocks if earnings profiles turn positive. The Fund has further increased its capital weighting to UK revenues from c. 39% of total capital to c. 41%*, with increased position sizes in **ITV**, **Barclays**, **Crest Nicholson**, **McCarthy & Stone** and a new position in **Travis Perkins**.

*Calculated as the cumulative total of each holding's absolute weight multiplied by its percentage of revenue derived from the UK.

Positive outlook for capital expenditure and hiring

Net % of CFOs who expect UK corporates' spending to increase over the next 12 months



Source: The Deloitte CFO Survey as at Q4 2019.

Beyond clear asset valuation risks, we expect political and economic risk associated with the forthcoming negotiation of a UK-EU trade deal, any fallout from mounting demands for another Scottish independence referendum and the US elections to name a few. It will be a tricky year but, as always, we will remain vigilant with an especially careful eye on valuations. Once again, we thank you for your continued support over the last 11 years.

Alex Savvides   Tom Matthews

FUND PERFORMANCE

JOHCM UK Dynamic Fund performance (%):

	1 month	3 months	1 year	3 years	5 years	SI annualised
Fund	**3.73**	**4.77**	**20.82**	**25.74**	**52.41**	**10.86**
Benchmark	2.63	4.17	19.29	22.69	44.16	6.92
Relative return[1]	1.08	0.58	1.28	2.49	5.73	3.69

Discrete 12 month performance (%):

	31.12.19	31.12.18	31.12.17	31.12.16	31.12.15
Fund	**20.82**	**-10.30**	**16.03**	**20.95**	**0.22**
Benchmark	19.29	-9.06	13.10	16.05	1.25
Relative return[1]	1.28	-1.36	2.59	4.22	-1.02

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 31 December 2019. 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. [1]Geometric relative.

ONE MONTH STOCK CONTRIBUTORS

Top five

Rank	Stock	Relative Return Contribution %
1	Hyve	0.22
2	*Unilever**	*0.18*
3	Restaurant Group	0.17
4	Tesco	0.14
5	Wood Group	0.13

Bottom five

Rank	Stock	Relative Return Contribution %
1	Vodafone	-0.14
2	*British American Tobacco**	*-0.12*
3	*London Stock Exchange**	*-0.09*
4	Morrisons	-0.09
5	Moneysupermarket.com	-0.07

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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 November 2019 to 31 December 2019. *Stock was not held during this period.

ONE YEAR STOCK CONTRIBUTORS

Top five

Rank	Stock	Relative Return Contribution %
1	3i	0.98
2	Electrocomponents	0.58
3	Royal Dutch Shell	0.58
4	*Glencore**	*0.52*
5	DMGT	0.51

Bottom five

Rank	Stock	Relative Return Contribution %
1	Morrisons	-0.66
2	*Astrazeneca**	*-0.56*
3	*British American Tobacco**	*-0.53*
4	Hunting	-0.52
5	McBride	-0.51

Past performance is not necessarily a guide to future performance

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 December 2018 to 31 December 2019. *Stock was not held during this period.