J O Hambro Capital Management Group

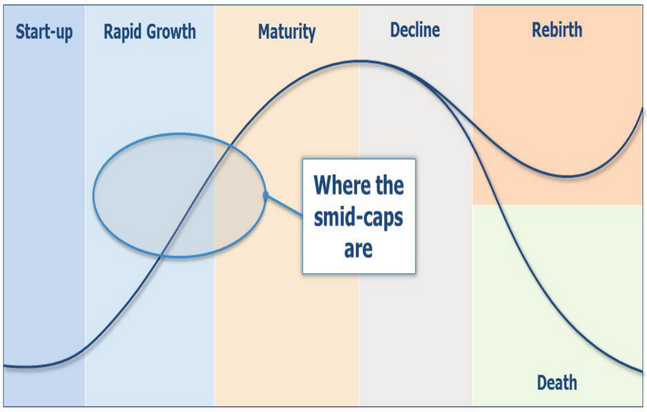
Investing in corporate America's sweet spot

Thorsten Becker, Arun Daniel, Vince Rivers – JOHCM US Small Mid Cap Equity Fund

Fifty small and mid-sized stocks we like most across sectors we know in depth. That's how we describe the **JOHCM US Small Mid Cap Equity Fund**. With an average market cap within the portfolio of less than $10 billion, we invest in companies in the sweet spot of their life cycle. These are companies that have moved beyond the uncertainty of their start-up years to achieve critical mass, but who still have ample potential growth ahead of them.

As a nimble team of three fund managers based in Boston, we collaborate to identify cross-sector investment themes and trends and work individually to develop bottom-up investment ideas for our respective sectors. We then reconvene collectively to assess risk, conviction and to size positions appropriately. The result is a concentrated portfolio of lowly correlated names across different sectors intended to capture the future long-term winners of corporate America.

In the sweet spot of the corporate life cycle



Source: JOHCM.

Portfolio highlights – banks, infrastructure plays and cybersecurity

Banks

The Fund remains overweight financials with a significant exposure to banks. Valuations for the mid-sized banks remain reasonable while the sector is supported by a positive backdrop of rising interest rates and a shift towards a lighter regulatory touch (a change in the rules for small and medium-sized banks means they no longer have to follow strict FICA rules). Names we like in the banking space include **First Republic Bank**, which we have been adding to in recent months and is one of the largest active individual positions in the portfolio. We are also keen on **Silicon Valley Bank Financial Group**, which operates the largest bank in the Silicon Valley region. As home bank to many venture capital and private equity firms, it often negotiates stock options as part of any commercial financing package, offering indirect exposure to the booming tech sector. However, the main attraction here is the expanding loan and deposit book.

Financial services

The world of title insurance may seem arcane to non-Americans but title insurance plays an important role in the US residential real estate market, protecting both home buyers and lenders in claims arising from title disputes. We hold **First American Financial**, a leader in the title and settlement services industry. Its margins are expanding as the US residential real estate market continues to bounce back from the global financial crisis and property valuations continue to rise. First American is also well-placed to meet growing demand for faster deal closing timelines through automated title solutions. A strong consumer backdrop of low unemployment and rising disposable incomes means higher fixed rate mortgages do not change our view of the stock's prospects.

Infrastructure

Industrials remain an important overweight in the portfolio. In particular, we continue to be bullish on infrastructure stocks given the need for infrastructure construction and renewal in the US. This was a theme that President Trump campaigned on in 2016, and where he has since set out a plan to plough $1.5 trillion into infrastructure through a combination of federal, state and local government spending.

America needs to spend more on infrastructure. A lot more. Many roads, bridges, railways, airports and schools are in dire need of repair, and dated water and electricity systems are depreciating as they age. A 2017 report by the American Society of Civil Engineers graded America's overall infrastructure a lowly D+, ranging from a 'B' ('adequate for now') for its rail system to a 'D-' ('poor, at risk') for transit.[1] The potential bill for addressing US infrastructure needs between now and 2025 was estimated to be as high as $4.6 trillion, while the report claimed the failure to address this inadequacy in the nation's economic fabric would knock $3.9 trillion off US GDP by 2025.

Trump's infrastructure bill has been delayed, and it looks like it will not be presented in Congress until early 2019 at the earliest, particularly given mid-term Congressional elections scheduled for November. Nevertheless, we remain optimistic on the outlook for the sector. Names we like here include **Jacob's Engineering Group**, which provides an array of technical, professional and construction services, serving both commercial and government clients. We expect the company to benefit directly from planned spending to modernise airports and transportation infrastructure, as well as from its domestic orientation and improved operating leverage. We also like **Terex Corporation**, a producer of cranes and other lifting and material handling equipment. Elsewhere we hold **MasTec**, an infrastructure engineering and construction company. Among other activities, it builds cell phone towers and installs broadband optic fibre. It is well positioned for the rollout of 5th generation mobile networks, so-called 5G, which most US mobile carriers expect to introduce within the next 12 months. 5G will rapidly increase download speeds, enabling a user to download an HD movie in a matter of seconds, have much lower latency, meaning users of mobile devices will experience no discernible delays or lags when using applications, vital for technology such as self-driving vehicles, and create far greater network capacity.

Housing

Housing stocks have pulled back recently on rising mortgage rate concerns, but we still see opportunity here as the US residential property market remains in rude health. We recently brought **Toll Brothers** ($6.5 billion market cap) into the portfolio. It has a leading position as a luxury home builder, serving both move-up and empty nester buyers in several regions of the United States. The company builds customised single and attached homes, primarily on land that it develops and improves. It benefits from limited competition at the high end of the residential market, has a strong brand, a good land bank and development expertise. It has become more diversified in geography and product and should see the benefits in its return profile over the next three years, helped by a management team focused on improving returns on equity. We used a recent pull-back in the stock driven by interest rate worries as an attractive entry point.

Technology – cybersecurity and business analysis

The investor love affair with technology stocks in recent years means the overall sector is undeniably expensive, whether it is large-cap or smaller-cap tech stocks under the valuation microscope. For that reason, we have tried to focus on technology cycles that the market is largely ignoring, away from hyped up areas such as artificial intelligence and machine learning.

One of these under-appreciated areas revolves around Intel's powerful new chip, Purley, launched last year to widespread acclaim from within the technology community. We own California-based **Integrated Device Technology**, a designer and manufacturer of semiconductor solutions for the advanced communications, computing and consumer industries. It is benefiting from the new cycle towards using the Purley chip in data centres, along with the move to 5G, trends towards wireless charging in communications, and increased use of electronics in the autos and wider industrials sectors.

Cybersecurity is a theme we have long had exposure to in the portfolio. The huge reputational (and share price) damage wrought by numerous high profile data breaches and network attacks in recent years has taken the issue of cybersecurity out of the IT department and into the boardroom. As network attacks have become increasingly sophisticated and prevalent, with more involvement from large governments and organised crime, both governments and commercial enterprises have been upgrading their networks to prevent and fight these attacks, driving the need for more investment in network security.

As well as cybersecurity specialist **Rapid7**, we own **ForeScout Technologies**, which offers a leading network access control application. The abundance of devices (smartphones, laptops, tablets) that the modern employee might use to access a corporate network poses a major risk to network security, if not properly monitored and controlled. ForeScout's product is a security solution to tackle the issue of rogue end-points lurking undetected inside a network, as occurred in a serious network breach at Equifax in 2017. If a firewall software package is effectively the moat around a castle, then ForeScout's package acts as a guard patrolling inside the castle courtyard, quickly able to identify and repel unwanted intruders, helped by an ability to spot unusual patterns of usage.

Elsewhere in the technology sector, we own Seattle-based **Tableau Software**. Its products help non-specialists quickly organise and analyse data sets. In doing so, it taps into where the actual spending is happening in the technology sector, namely business analytics and business intelligence.

US small and mid caps – A sweet spot within a sweet spot

This is just a flavour of the themes and type of names we are currently backing in our portfolio. On a broader view, we believe US small and mid-cap stocks currently represent a sweet spot within a broader, atypical US equity bull market that, in our opinion, still has some runway remaining, even after nine years. A sweet spot within a sweet spot, if you will.

With capex poised to surge over the next 12-18 months, the regulatory environment becoming more business-friendly, potential for fiscal stimulus through the proposed infrastructure bill in 2019, and the US consumer in rude health, the outlook for US earnings growth, the factor that drives share prices over the long term, remains highly positive. Meanwhile, with global trade tensions a source of concern for many investors, the domestic bias of small and mid-caps insulates them from the worst effects of any nascent trade war. Be bold, go small.

Seed US dollar share class offer: 0.25% annual management charge (plus performance fee)

We are offering a discounted US dollar seed share class of 0.25% p.a. (plus 15% annual performance fee – subject to a high watermark) on the JOHCM US Small Mid Cap Equity Fund. Subject to a minimum investment of $1,000,000, this discounted fee will apply until the NAV of the US dollar seed share class reaches the US dollar equivalent of £100,000,000. Thereafter the US dollar seed share class will remain open for subscription only to existing shareholders of the US dollar seed share class, subject to approval. The total expense ratio for the US dollar seed shares will be capped at 0.50% per annum.

[1]'2017 Infrastructure Report Card – A Comprehensive Assessment of America's Infrastructure', The American Society of Civil Engineers, https://www.infrastructurereportcard.org/