

Conference call highlights

Absolute return funds update

January 2011



Quentin Fitzsimmons
Head of Government Bonds

Growth background improving

The extension of the Bush-era tax breaks and unemployment benefits has removed a potential brake on US economic activity. Meanwhile, recent consumption and purchasing managers' index readings support the view of a US recovery that is gradually gathering pace. Reflecting these developments we have increased our 2011 US GDP growth forecast to 3%. Elsewhere, we remain cautious on the outlook for growth in most of the developed economies and continue to expect global growth to be led by emerging markets in 2011.

Pockets of inflation

With unemployment remaining high and wage bargaining power low, we see little threat of inflation in the US or the eurozone. However, inflation remains an issue in the UK and also in a number of emerging markets, and recent commodity price increases will provide further upward momentum to inflation over the next few months. The most recent GDP print in the UK showed an unexpected contraction in the fourth quarter. This combination of stalling growth and sticky inflation presents a difficult backdrop for the UK government and the Bank of England.



Matthew Cobon
Fund Manager

Rate hikes on the horizon

Monetary policy is already being tightened in the emerging world, and growing evidence of inflation has led investors to reassess the likely timing of the first interest rate hike in developed markets. This has led to an upward move in government bond yields. Expectations on the timing and magnitude of rate hikes are likely to ebb and flow as further data is released, and markets may well continue to over-react in the short term. This will provide opportunities to take tactical views when markets become too hawkish or dovish on rates.

Upward pressure on yields

Looking to the medium term, ongoing inflation concerns and expectations of rate hikes, combined with the highly indebted nature of many governments and signs of asset allocation flows turning in favour of higher risk assets, suggest that upward pressure on yields may persist. While this will make life difficult for traditional government bond funds, the flexibility built into our absolute return portfolios gives them the potential to deliver positive returns in a rising yield environment.

A strengthened team

Matthew Cobon's arrival has reinforced the team's foreign exchange expertise. Matthew joined Threadneedle from Aberdeen Asset Management, where he held the role of Head of Currency. He has also gained FX trading experience at Deutsche Asset Management and Citigroup. His proven ability and experience in the foreign exchange arena make him a valuable member of Threadneedle's absolute return bond team, where currency strategies form a key part of the funds' approach.

Currency trades

We have established long positions in the Chinese renminbi, Korean won and Singapore dollar and shorts in the US dollar, Japanese yen and Malaysian ringgit. Our positive view on the renminbi is based on ongoing tightening in Chinese policy and an expected long-term appreciation in the Chinese currency against the US dollar. This appreciation is not fully priced into the non-deliverable forwards market. Shorting the ringgit against the Singapore dollar affords protection against weakness in commodity prices, as Malaysia is a net commodity exporter. Our position in the won versus the yen is a relative-value trade, whereby we expect the won to appreciate given Korea's strong competitive position as a global exporter versus Japan.

Good value in Australian dollars

The flexible remit of the fund allows it to seek value wherever it occurs in the world's fixed income and currency markets. As an example, we have exploited the difference in the interest rate cycle in different parts of the world by investing in KFW bonds denominated in Australian dollars. As Australian rates are already being raised, these bonds, which are guaranteed by the German government, are offering a significant yield pick-up over their euro-denominated counterparts.

Remain conservative in the underlying bond portfolio

The bedrock of the funds is a highly liquid, short-dated bond portfolio that is designed to provide a "cash-like" return over the medium term. It should be noted that there is no capital guarantee attached to this return. We have always focused this portfolio on high quality, highly liquid holdings. In recent months we have further increased the quality of this portfolio, as we have been concerned about the prospect of heightened issuance as companies seek to refinance at attractive levels. The short-dated nature of our holdings has been helpful as yield curves have continued to steepen. However, we believe that curves will flatten over time and are looking for opportunities to move into marginally longer-dated bonds.

Looking to use more of our risk budget in the overlay

Over the past year or so, we have pursued a capital preservation policy in the funds' tactical overlay, reflecting our concerns about the politicisation of markets and heightened sovereign risk. However, we now feel that the sovereign debt crisis is closer to a conclusion. Meanwhile, the approaching normalisation in interest rates provides good opportunities to increase risk. Having been running at around 25% of the permitted risk budget, we have managed the funds' overlays up to approximately 50% of the budget and are in the process of raising risk further. This should give our reinforced team a good opportunity to generate good performance.

Summary

The outlook for global economic growth is improving and we are beginning to see pockets of inflation, notably in the UK and emerging markets. Interest rate expectations have risen and we expect this to place upward pressure on government bond yields. While this provides a testing background for traditional bond funds, absolute return portfolios have the flexibility to make money in a rising yield environment. We have recently strengthened the idea generation engine that drives the funds via the recruitment of Matthew Cobon, whose foreign-exchange expertise complements the existing skills in the team. We believe that there will be good opportunities to add value in both fixed income and currencies over the next few months and are in the process of increasing risk-budget utilisation in the funds' tactical overlays to take advantage of these opportunities. This should allow us to build on the funds' strong long-term track records over the remainder of 2011.

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