

Threadneedle thinks

Conference call highlights



Richard Colwell
UK Equity Income Manager

EQUITY INCOME FUNDS UPDATE – OCTOBER 2011

Credibility deficit

In recent calls we have consistently highlighted the economic and political challenges facing markets. News flow on the sovereign debt crisis in Europe continues to unfold but, in summary, one of the key factors holding equities back over the summer has been a credibility deficit on the part of politicians and policymakers. In Europe, the path to a solution to the debt crisis has been tortuous; in the US we have had the wrangling over the debt ceiling, which is likely to recur in November; and in the UK we have a government set on a course of fiscal consolidation which is causing significant pain in a number of areas.



Stephen Thornber
Global Equity Income Manager

Lacklustre growth

The reality is that we are in a protracted phase of lacklustre growth in the developed world. There will be data points that come in better than expected and others that disappoint, with the latter leading to periodic fears about recession. Our forecasts for Western economic growth have been consistently cautious over the past two years and they remain so today. However, we are not predicting a recession; our estimates are for low positive growth, with a high possibility of negative quarters along the way. Meanwhile we remain confident that emerging markets will produce superior levels of growth.

Stimulative monetary policy

The good news is that, with developed economies flirting with recession and inflation expected to fall, interest rates are likely to stay at their current low levels in the UK and US and to return to their all-time lows in the eurozone. At the same time, other stimulative measures such as quantitative easing and the US's "Operation Twist" programme are likely to continue. This loose monetary policy is a necessary balance for the tight fiscal policies being run in many economies.

The search continues

With interest rates at historic lows and economic growth and inflation subdued, core government bond yields are unlikely to rise substantially from their current unappealing levels. Therefore, the search for alternative sources of income will continue. We believe that equity income products will be key beneficiaries of this trend. The combination of a higher level of income than can be achieved through investing in government bonds or cash deposits, together with the prospect of growing both income and capital, is likely to prove very appealing over the medium term.

Good prospects for good companies

Another factor that has been troubling equity investors in recent months is the ability of companies to maintain profitability and grow their dividends in a slow growth environment. We believe that these concerns are overdone. We have cut our forecasts for aggregate earnings growth in a number of markets recently and some companies will undoubtedly see their profits

decline. However, we are not expecting to see profits fall at the aggregate level and we see good potential for well-managed companies with strong balance sheets, premium products and sensible business models to grow their earnings. Tough economic conditions led to significant dividend cuts in 2008 but today, balance sheets are much stronger and dividend cover is substantially higher. We therefore see a limited risk of widespread dividend cuts over the coming year. Indeed, dividends are likely to provide an important part of the total return from equities in a low growth environment.

Bedrock of quality franchises

Our UK equity income portfolios are built on a bedrock of strong franchises in relatively defensive sectors; companies with robust balance sheets and proven management, which we believe will be able to prosper and grow their dividends despite the difficult economic conditions. Some of these are traditional income stocks; others are not names that would immediately be associated with income funds, but certainly have strong balance sheets and are growing their dividends. Valuations of defensive companies had become very cheap earlier in the year and we were steadily adding to positions. These purchases have subsequently stood the funds in good stead as defensives have outperformed and moved to a valuation premium.

Cyclical opportunities

Balancing these defensive holdings we have a number of positions in quality cyclicals – companies that are able to offer superior returns through good management, premium products or access to fast-growing international markets. Cyclical sectors sold off over the summer as economic concerns mounted, but we used this as an opportunity to add to some of our favoured holdings in areas such as industrials.

Taking a global approach

Access to fast-growing markets can also be achieved through the Threadneedle Global Equity Income Fund. This portfolio features high yielding stocks from a wide range of markets. Alongside well-known income stocks such as the UK's Imperial Tobacco, the fund has significant investments in companies that may be less familiar to income investors, such as mobile handset manufacturer HTC from Taiwan, US healthcare business Bristol-Myers Squibb and energy trust BP Prudhoe Bay. This variety of holdings affords investors high levels of diversification at the company, sector and country level.

Strong performance

Our equity income products in the UK and globally have delivered high yields together with impressive relative performance. This track record is attributable to the highly experienced fund management team, the clear processes used by the teams and the culture of teamwork and communication that typifies Threadneedle's investment approach. We are confident that these factors will allow us to continue to deliver good performance and to help investors meet their income requirements.

Conclusion

With interest rates and core government bond yields at low levels, demand for equity income products is likely to remain high. Threadneedle offers a wide range of such products, providing access to income opportunities in the UK and globally. Although the economic background is likely to remain lacklustre in the Western world, we believe that well managed companies will be able to grow their earnings and dividends. We are finding many opportunities to invest in good quality companies at attractive valuations and have used the weakness over the summer to add selectively to businesses that we expect to be long-term winners.

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