

Conference call highlights

February 2012



Ann Steele
Fund Manager

European equities update

Inexpensive and under owned

European equities fell significantly in the second half of 2011 as global attention focused on the continuing sovereign debt crisis. During this period, there were many 'half-a-second to midnight' moments, but no single summit or meeting that actually delivered a solution to the problems. Furthermore, questions arose over emerging market and Asian growth, and whether it was moderating at a greater rate than forecast. As a result, European stock prices ended the year looking both very cheap and very under owned.

One continent, different speeds

The year was also a tale of one continent moving at different speeds. Across Europe, growth was diverse, with gross government debt (as a percentage of GDP) rising to between 120% and 150% in some peripheral countries. This was compared to 40-50% in Scandinavia. Unemployment in Germany fell dramatically from 9.0% to 6.7%, while in Spain it continued to rise and today sits at 23.0%. From a political perspective, five governments in Europe changed hands in 2011 and we now have technocratic administrations in both Greece and Italy. Austerity measures are still being rolled out, but this is a very long path and we expect social unrest to continue.

Best of both worlds

At the end of the year we saw signs of economic improvement, driven by two forces which you might argue would tend to cancel each other out. The first is the promise of loose monetary conditions to stave off a credit crisis and the second is the belief that global economies are faring much better. This, in turn, implies that borrowing rates will tighten going forward. We would argue, though, that it is possible to have the best of both worlds because, as the European and US economic cycles have drifted apart, there is 'easy' money in Europe and some economic growth in the US. This is the scenario that has been reflected in our portfolio for some time, as we have tried to identify stocks that will benefit from international growth.

Has Europe turned the corner?

It could be argued that the despair that we saw in 2011 has dissipated and been replaced by more straightforward market nervousness. This change in mood was largely driven by the measures introduced by the ECB to promote stability. Firstly, the Long-Term Refinancing Operation (LTRO) provided €489bn of cheap financing to banks for a wider range of collateral in December. We believe this has reduced the risk of a Lehman-type moment and avoided a major credit crunch in Europe. Questions remain though: does this action change the growth outlook, will it feed through into the end economy and is the additional liquidity enough to get the banking sector back on track? We also need to ask whether it is Germany that will write the cheques. Germany thinks the answer is no, the ECB thinks the answer is no and all non-Germans think the answer is yes. What we do know is that Europe's largest economy will do everything possible to keep the eurozone project on-track.

“European stock prices ended the year looking both very cheap and very under-owned”

Increased cyclical exposure

From a sector perspective, we have taken profits in some of our more defensive holdings and used the money to increase our cyclical exposure. The other significant move has been to close our large underweight position in financials with the addition of some of the larger European banks. Overall, we favour global growth over European domestic growth, and think that sectors such as automobiles and luxury goods will continue to do well this year.

Stock selection

The Threadneedle Pan European Fund is built from the bottom up and, over a market cycle, we expect around 80% of our outperformance to come from good stock picking. Our largest holding is currently Tullow Oil, which has finally signed a drilling deal in Uganda that will net the company around €2.9 billion. Another company we prefer is industrial company Weir Group, which provides engineering solutions to large mining companies. We do not believe Weir's share price fully reflects the firm's true value.

Country perspective

We have reduced our significant overweight exposure to the UK market - this position worked very well last year as the UK is a much more defensive index. The fund's overweight position in Germany has been retained, as has our above-index weighting in the small Scandinavian countries where both growth and stocks look particularly attractive. Finally, we have added to the fund's positions in Spain and Italy.

Summary

Many challenges remain. The European crisis has not yet been solved and we still expect to see low growth or indeed no growth in many peripheral countries. There will also be political change with the impending elections in France and Greece. Furthermore, there is the threat that cash-strapped governments may not be able to resist imposing punitive 'Robin Hood' taxes if company dividends start to look too attractive. Despite this, we feel there are still many investment opportunities and themes for us to benefit from: pricing power, emerging market and Asian growth as well as company innovation and M&A activity will all prove helpful.

As we write, the Greek parliament has voted to approve the further austerity measures demanded by the eurozone and IMF that will pave the way for a further €130bn bailout. In the short term this eases concerns over default, but concerns over longer-term Greek funding will remain.

Our portfolios have performed well through all market cycles, which is a reflection of our strong, consistent investment approach and solid teamwork. Moreover, by picking quality companies with strong balance sheets and good dividend cover, we believe the funds will continue to perform well this year.

Important information

For Investment Professionals use only, not to be relied upon by private investors. Fund performance source Morningstar, bid to bid, gross of charges as at 31 January 2012. Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. Subscriptions to a Fund may only be made on the basis of the current Prospectus and the Key Investor Information Document or Simplified Prospectus, as well as the latest annual or interim reports, which can be obtained free of charge on request, and the applicable Terms & Conditions. Please refer to the 'Risk Factors' section of the Prospectus for all risks applicable to investing in any fund and specifically this Fund. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: 21F ICBC Tower, Citibank Plaza, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPHSKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.