COVERING AUGUST 2017

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FUND COMMENTARY
THREADNEEDLE GLOBAL EQUITY INCOME FUND (Unhedged)

Summary

- Global equity markets finished August higher.
- The fund underperformed its benchmark; this was driven by stock selection, largely through the continued outperformance of technology stocks and a pullback in rate-sensitive financials.
- Detractors included L Brands, Regal Entertainment Group and Manulife.
- Kroton Educacional, Novo Nordisk and Sydney Airport added value.
- The fund built up positions in Coca-Cola and Axel Springer, while exiting ProSiebenSat.1 Media and Pegatron.

Market Background

The MSCI All Countries World Index finished the month with total return of 1.1% in Australian dollars. Data on the global economy continued to indicate growth, notably in the eurozone and Japan, while the US second-quarter earnings season continued to surprise on the upside. Sentiment was checked, however, by escalating tensions between the US and North Korea, and further doubt about President Trump's ability to implement pro-growth reforms.

The S&P 500 rose during August, setting a new all-time high in the second week of the month. Despite some expectation around tax reforms, investors remained generally sceptical about the prospects for "Trumponomics" – though this didn't stop a fifth consecutive monthly rise for the index amid strong earnings, particularly in technology, energy and financials. Other US economic indicators beat expectations in August, though inflation data remained relatively soft. In the UK, the weaker pound and gains in commodity prices helped the FTSE 100 post a monthly rise, while the Bank of England's downgrade to its growth forecast for the year saw rate-hike expectations pushed further out.

Generally buoyant economic indicators were well received in Europe ex-UK, though geopolitical concerns and a strong euro offset the positive sentiment. The region lost ground in local-currency terms as a result.

In Japan, the annualised Q2 growth rate of 4% was the best in more than two years. Despite this, the Topix edged downwards in yen terms as a stronger currency dampened sentiment on Japanese equities.

Meanwhile, in emerging markets, Brazilian equities gained as the country's Congress voted against subjecting President Temer to a corruption trial, bolstering hopes he would proceed with his reform programme. Chinese equities also outperformed as investors cheered solid corporate earnings.

Performance

The fund underperformed its index in gross terms, but extended its positive total returns year-to-date. In another strong month for technology stocks, the fund's structural underweight detracted, though this was partially offset by the overweight in materials. Stock selection was the main source of detraction during the month, again due to the continued outperformance of technology stocks, with companies such as Apple, Alibaba and Microsoft persisting with strong returns. This now sees the technology sector over 13% ahead of the MSCI ACWI year-to-date in AUD terms, with several low or non-dividend paying technology companies among the top contributors.

The fund's holdings in banks were responsible for a large proportion of detraction elsewhere, as a decline in US 10-year bond yields (among others) hit rate-sensitive financials. In the fund manager's view, however, the portfolio's bias towards banks is well-founded, as they offer the prospect of strong shareholder returns in the form of growing dividend streams and robust balance sheets.

More positively, stock selection was particularly strong within consumer staples and healthcare, with Wal-Mart de Mexico and Novo Nordisk leading the way in these sectors.

Elsewhere, speciality retailer L Brands fell: as noted last month, the company is undergoing a transition in strategy, moving towards higher margin products. Though its comparable sales fell in August, the decline was lower than expected and the fund manager believes the market is fundamentally underestimating the strategic transition taking place. Notwithstanding, the team continues to monitor concerns regarding US mall traffic trends. Manulife gave up some of its strong gains in July, as insurers sold off in the wake of Hurricane Harvey, while UBS and Wells Fargo traded lower, with falling bond yields dampening sentiment towards certain US financials.

Positive contributors included college operator Kroton Educacional, which gained after reporting a 15% rise in net profits in the second quarter. Sydney Airport also traded higher as growing international passenger numbers led to an 8% rise in first-half revenues, while pharmaceutical giant Novo Nordisk's gain was driven by strong second-quarter results. Rio Tinto was another holding to rise, performing well in the second half of the month as strong first-half results translated into the prospect of record dividend streams.

Activity

Key activity during the month included adding to positions in Coca-Cola and Axel Springer. Coca-Cola appears poised to gain from shifting its focus from volume to value in the US; this, coupled with the realignment of its US bottling operations, should boost returns. The addition to Axel Springer reiterated the manager's conviction in the publisher's ability to diversify away from its legacy print business and generate sustainable, double-digit revenue growth. Indeed, the firm should benefit from its recently consolidated position in the French property market.

These purchases were funded by the sale of ProSiebenSat.1 Media. The fund manager's confidence in the stock had waned, due to declining expectations of the German TV advert market. Another exit was Pegatron, which had performed very strongly year-to-date, allowing the fund to reallocate to opportunities offering greater upside.

The fund had holdings reduced in HSBC and Legal & General – which have also delivered strong returns this year – enabling the topping up of high-conviction positions in Merck and PG&E. PG&E has an effective monopoly in distributing gas and electricity in certain parts of California. There have been some recent headwinds, but the firm has a new management team in place and its return on equity is attractive. Further re-rating seems likely as confidence around the stock returns. Merck is trading on an attractive valuation relative to its sector, but possesses equally strong prospects to its peers.

Elsewhere, Novartis and Drillisch were reduced, again to take profits from solid runs in performance. The proceeds were reallocated towards Deutsche Telekom, which the fund manager prefers as a risk/reward opportunity, with the company looking set to benefit from the strength of its T-Mobile US division.

Outlook

Although doubts persist about Trump's ability to push through market-friendly reforms, the Fed's plans to continue with interest-rate rises suggest that prospects for the US economy remain broadly positive. Improving economic data from Europe continues to provide grounds for optimism. While any tightening of monetary policy in the eurozone and even the UK might indicate a welcome move back towards "normality", it could generate headwinds for the global economy in the near term.

Against this backdrop, the fund continues its focus on "quality income", seeking competitively advantaged companies that generate strong cashflows and offer high, growing and sustainable dividend streams. In the fund manager's view, a strategy that emphasises both income and growth characteristics should remain attractive to long-term investors. Despite recent headwinds, this approach looks well-placed to outperform in the coming years, with quality and income styles both continuing to outperform over the long-term. The fund manager also retains conviction in the ability of high dividend paying stocks to outperform over these longer time periods. Historical stock selection within the fund has also been strong, validating the focus on quality income, while performance has historically bounced back from more challenging periods as income stocks offer quality over longer-term horizons.