COVERING MARCH 2018

Your success. Our priority.

FUND COMMENTARY
THREADNEEDLE GLOBAL EQUITY INCOME FUND (Unhedged)

Summary

- Global equity markets fell in March.
- Net of fees, the fund underperformed its benchmark over the month.
- The fund initiated a position in Eclat Textile.

Market Background

In local-currency terms, the MSCI All-Country World index posted a total return of -2.2% in March (and -0.5% in Australian dollar terms). Early on, news of US tariffs on aluminium and steel hit global equities and the dollar, and prompted Gary Cohn to resign as the president's economic advisor. His departure troubled investors – as did Trump's later announcement of levies on Chinese imports. The S&P 500 fell by 2.5% in dollar terms over the month. As expected, the Federal Reserve hiked rates by 25 basis points. UK and Europe ex-UK equities lost ground in March, pressured by the weaker dollar, fears about a global trade war and, in the latter's case, signs that the eurozone's economic momentum could be slowing. In Japan, concerns about US-led protectionism and the possibility that Prime Minister Abe could have been involved in a corruption scandal propelled the yen higher but weighed on equities.

Performance

Net of fees, the fund underperformed its index in March. Sector allocation was neutral, and security selection detracted from relative performance, most notably within the financials and consumer discretionary sectors.

The majority of stock-level detraction during March was derived from L Brands. Having seen several months of sequential improvement towards the end of 2017, when investors became more confident in the retailer, the company recently announced that it was investing tax reform benefits into staff wages before producing underwhelming February sales results. The fund's management expects results to improve from here, driven by sustained growth from the company's Pink and Bath & Bodyworks brands, alongside a stabilisation and improvement in its Victoria's Secret business.

By contrast, Unilever was the fund's strongest performer for the month, bouncing back from a subdued period of performance – rising yields had seen the broader staples space underperform earlier in the year. Optimism surrounds Unilever's ability to secure large deals in order to strengthen its beauty products segment. The company possesses a durable competitive advantage in its brands, and customer reach is being enhanced by development of its market-leading distribution. Unilever's strength in depth across emerging markets is particularly well-noted. Looking ahead, the fund's management believes the company can continue delivering resilient earnings growth, and that the stock remains attractively valued following earlier underperformance.

Heating, ventilation and air-conditioning (HVAC) player, Watsco, and British pharmaceutical name, GlaxoSmithKline, also contributed materially during the month. The news that GlaxoSmithKline was no longer planning to purchase

Pfizer's consumer health unit bolstered sentiment around the strength of the company's balance sheet, and subsequent dividend sustainability. Meanwhile, Watsco has recently been supported by a positive HVAC outlook, owing to indications of organic supplier growth and US demand for the replacement of existing units.

Elsewhere, Moneysupermarket.com generated positive returns following the extension of the position in February. Having initially fallen on indications that operating leverage may take longer than expected to come through, the stock stabilised in subsequent weeks on expectations for the resumption of profit growth from 2019 onwards. The fund had topped up its position on the view that February's fall was overstated, given the company's long-term direction. Moneysupermarket.com possesses a favourable business model: a scalable platform with high free cash flow generation.

Activity

During the month, the fund established a new position in Eclat Textile, a market-leading integrated functional fabric manufacturer which is a supplier to major sports brands. Following prior caution, optimism surrounding a US sportswear recovery and the potential for capacity ramp-up through construction of new Vietnamese garment plants has been driving sentiment. Strong order growth and steady margin expansion – owing to vertical integration – bolsters the investment case further.

Elsewhere, the fund topped up its position in Canadian integrated energy company, Suncor, a best-in-class company both operationally and in terms of its capital allocation. The fund also extended its position in global tyre manufacturer Bridgestone, following a meeting with company management. Fund management believes Bridgestone remains well-placed to maintain its strong free cash flow generation and solid returns. Furthermore, the fund grew its holding in British American Tobacco – fund management remains positive on the company's next-generation products, exposure to US tax reform gains, and the development of synergies generated by last year's acquisition of Reynolds American.

These purchases were funded by the sale of insurance company AXA, and reduction of the fund’s position in derivatives exchange operator, CME Group. The fund’s purchase of AXA was built on the belief that its move away from the US at a reasonable valuation would signal improving capital allocation, along with a welcome shift in the source of its profitability. However, AXA’s subsequent purchase of US rival XL Group substantially reduced the conviction in the company moving in this direction, leading the fund to sell. CME Group was trimmed on a valuation basis. Strong performance has been driven by the company’s diversification of strategy into new areas of demand; most notably across commodities, base metals and crypto trading. Recent results indicated further progress in operational efficiency, leading the stock to appreciate further.

The fund also reduced positions in Spar Group, Philip Morris and Wal-Mart de Mexico; these consumer staples names had held up well in a challenging period for the broader space, and had therefore seen valuations rise relative to peers. The emerging-market exposure of Spar Group and Wal-Mart de Mexico softened the effects of recent rotations out of defensives, while longer-term confidence surrounding Philip Morris' heat-not-burn tobacco products ensured greater resilience against near-term sentiment.

Outlook

Recent months have ultimately seen a continuation of the challenging conditions for dividend investors that were experienced through 2017. US bond yields have risen on signs of improved economic growth, coupled with creeping inflationary expectations. Nonetheless, the fund’s management believes that recent trends are only likely to persist on a short-term basis, and that more deeply entrenched structural factors which favour a low-growth, low-inflation environment remain firmly in place for the long-term. These include debt, demographics and technological disruption.

The fund’s management continues to focus on quality income, seeking competitively advantaged companies that generate strong cashflows and offer high, growing and sustainable dividend streams. Despite headwinds which can generate shorter-term challenges, the fund managers retain their belief that this approach will outperform in the coming years – as indeed the strategy has done overall since inception. They also retain conviction in the ability of high dividend paying stocks to continue outperforming over these longer time periods.