Columbia Threadneedle Investments

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FUND COMMENTARY
THREADNEEDLE GLOBAL EQUITY INCOME FUND (Unhedged)

Summary

- Global equity markets rallied in February.
- The fund underperformed its benchmark.
- Allocation effects were negative at the sector level.
- Significant positive contributors included Unilever, Cisco Systems and Cypress Semiconductor.
- Regal Entertainment Group, ProSiebenSat.1 and L Brands detracted.
- New positions were opened in Coach and Watsco while exits included Aozora Bank, AMP and Pattern Energy.

Market Background

Global equities continued to rally in February. Sentiment towards the asset class was buoyed by optimism about the likely impact of President Trump's policies. Encouraging economic data, elevated M&A activity and growth in corporate earnings provided additional support.

US equities were propelled to a series of record highs in anticipation that the new administration would make cuts to taxes and regulations while ramping up infrastructure and defence spending. The president's address to Congress at the end of the month reinforced these expectations but was low on detail. Strong economic data, including forecast-beating job-creation, manufacturing-activity and inflation figures for January, provided a further tailwind. The Federal Reserve kept interest rates unchanged, but the odds for a hike in March shortened after Fed chair Janet Yellen's mid-month testimony to Congress, which was deemed hawkish in tone.

European bourses gained despite worries that far-right candidate Marine le Pen could ultimately lead France out of the EU should she win the upcoming presidential election. Economic markers in the Eurozone were broadly encouraging, including Markit's composite purchasing managers' index for January, which indicated growth for the 43rd month in succession. Annual consumer price inflation in the region surged to a four-year high of 1.8%. However, the European Central Bank was careful to assure markets that it would not tighten its policy in response, pointing out that core inflation was still low. In the UK, investors welcomed a raft of better-than-expected data, including figures from the Office of National Statistics (ONS) covering manufacturing growth, industrial output and construction activity.

In Japan, the yen weakened against the dollar mid-month, sparking a Topix rally, when Donald Trump promised "phenomenal" US tax reforms; later, though, nervousness ahead of his aforementioned speech saw the safe-haven yen strengthen. Within emerging markets, China outperformed the index, supported by better-than-expected trade data, but India was stronger still, buoyed by an investor-friendly budget. By contrast, Russia was weak on fears that expectations for improvement in relations with a Trump-led US might have been unrealistically high.

Performance

Net of fees, the fund underperformed its index during the month. Regional allocation had a broadly neutral effect but selection effects detracted in aggregate, driven by stock picks in the US. However, stock selection in emerging markets, Japan and the UK added to returns. Sector allocation detracted in aggregate: in a strong month for technology stocks, the underweight to the sector weighed on returns. The overweight to materials was also disadvantageous; late in the month, the sector was pressured by worries about a proposed new property tax in China and the impact it could have on construction there.

Shares in consumer-goods giant Unilever soared on news that Kraft Heinz had launched a takeover bid for the company. The deal ultimately foundered after Unilever rejected the initial bid. Cisco Systems, which produces networking equipment, and Cypress Semiconductor rose on solid quarterly results. Pharma giants AstraZeneca and Pfizer also enjoyed a strong month, helped by Trump's promise to speed up the approval process for new drugs. AstraZeneca also benefited from positive trial results for a breast cancer treatment.

Detractors included speciality retailer L Brands, which fell sharply after issuing disappointing guidance, and banking giant UBS, which continued its recent slide. Regal Entertainment Group, a theme-park operator, and ProSiebenSat.1 both moved lower despite releasing solid results. Agrium, which produces agricultural products, declined following broker downgrades.

Activity

Over the month, the fund opened new positions in apparel company Coach and heating, ventilation and air-conditioning (HVAC) business Watsco. With a strong balance sheet, Coach is executing its turnaround strategy well and is also improving margins and delivering better returns. A fall in the share price presented an opportunity to buy back into Watsco, which should benefit from pent-up demand in the replacement market, particularly within the Sun Belt states. In addition, the fund manager believes Watsco should continue to consolidate a still fragmented market with deals tending to be highly accretive.

Cyclical names including Rio Tinto and Valero Energy were topped up during the month. This activity was funded by selling Aozora Bank and Pattern Energy and trimming the holdings in Royal Dutch Shell, Crown Castle and Six Flags Entertainment.

The recent bounce in AMP's share price provided an opportunity to exit the holding; the fund manager is concerned that the life insurance business is taking longer to turnaround than expected.

Outlook

Political uncertainty, rising populism and policy divergence dominated markets in 2016, and a similar situation appears likely in the year ahead. Interest rates have already moved away from emergency settings in the US and are likely to rise further in 2017, but monetary policy in Europe and Japan will probably remain accommodative. Sharp changes in politics, including Brexit, and the potential for a rise in populism suggest that a loose monetary stance is likely to remain a common theme in Europe this year. The outlook for Asia and the emerging markets will be challenging for those countries that are exposed to the threat of Trump's protectionist policies.

Against this backdrop, the fund continues to focus on 'quality income', seeking competitively advantaged companies that generate strong cashflow and offer high, growing and sustainable dividend yields. In the fund manager's view, a strategy that emphasises both income and growth characteristics should be attractive to long-term investors even during a rising rate environment.