

COVERING DECEMBER 2017

FUND COMMENTARY

THREADNEEDLE GLOBAL EQUITY INCOME FUND (Unhedged)

Summary

- Global equity markets gained in local-currency terms, but declined in Australian dollar terms.
- The fund outperformed its index, driven by strong stock selection.
- The fund re-established a position in Tapestry (formerly Coach), while initiating positions in Transurban and Coloplast.

Market Background

The MSCI's All Countries World Index (ACWI) posted a total-return of 1.3% in local-currency terms in December, though currency moves meant it fell in Australian dollar terms. Key factors affecting stock markets included optimism over the US and eurozone economies, and anticipation that President Trump's proposed tax reforms would be signed into law. The S&P 500 rose, and Congress' approval of the tax-cut bill bolstered sentiment, as did some strong economic markers. As expected, the Federal Reserve's final meeting of 2017 saw a quarter-point rate hike.

Economic indicators from the eurozone remained buoyant – consumer confidence reached a 17-year high in December, though the political landscape remained unfavourable, due to worries about the potential for a populist victory in the Italian general election in 2018, the German chancellor's lack of progress in forming a coalition government, and a victory for pro-independence parties in Catalonia. In the UK, initial optimism around Brexit, as British and EU negotiators agreed on key sticking points, faded later in the month amid some concerns about the next stage of the talks. This contributed to sterling's weakness in December, which, along with the rally in commodities, led both the FTSE-100 and the mid-cap index to record highs.

Performance

Net of fees, the fund outperformed its index in December, as strong stock selection drove relative returns. Sector positioning also proved positive, primarily due to the fund's underweight exposure to technology; investors responded to the passage of US tax legislation by rotating out of the sector in favour of spaces more sensitive to the reform.

Consumer staples and materials were the standout sectors for security selection during December, with British American Tobacco – the fund's strongest performer – and Rio Tinto leading the way in these respective spaces. British American Tobacco rebounded from slight weakness experienced towards the end of November, supported by favourable Japanese proposals relating to tax changes on heat-not-burn tobacco products. Wells Fargo, a beneficiary of the US tax rewrite, also rose, while international mining company Rio Tinto climbed on a prolonged strengthening of the iron ore price. UBS and L Brands rounded out the top five contributors for the month.

PG&E Corporation was the fund's largest detractor during December, amid on-going uncertainty around a US investigation which led to an unexpected dividend

cut. However, the resulting detractor from this news did little to offset a positive month for the fund.

Activity

During the month, the fund re-established a position in Tapestry (formerly Coach), a holding which had been closed earlier in the year when the stock was trading at higher valuation levels. The fund managers continue to like the underlying dynamic in the business: a turnaround augmented by the strategic acquisition of undervalued brands such as Kate Spade. The fund also initiated positions in Transurban and Coloplast. Healthcare-products company Coloplast is experiencing structural growth in its end markets, and is taking share from competitors in the process. The company also enjoys high barriers to entry in its markets, including a low risk of product obsolescence. Transurban, a developer and operator of urban toll roads, operates primarily in Australia. Given the long-lived nature of the company's assets, investors can participate in a strong and sustainable income stream with high forward visibility. Other top-ups included those of ANTA Sports, Erste Bank and British American Tobacco, the latter of which should build on its strong performance for the month on sustained price increases, tax reform and cost management.

These purchases were funded by closing positions in Givaudan and Cypress Semiconductor, both of which approached their price targets following strong runs of performance. Having started reducing the latter last month, following continued optimism surrounding trends in the semiconductor space, we took profits in order to reallocate towards ideas with stronger upside. The fund also took profits in Valero Energy, which has been rising on refining margins and crude differentials, and Las Vegas Sands, which has continued to appreciate in anticipation of stronger high-end gaming revenues. Other reductions included those of Occidental Petroleum, Unilever, and tobacco company Altria.

Outlook

Markets remain largely buoyant on the back of the Trump administration's progress in enacting market-friendly reforms and broader synchronised accelerations in economic growth, although ongoing uncertainties including Brexit, US mid-term elections in 2018 and a slowdown in Chinese growth momentum remain very much in the spotlight. Improving economic data from Europe continues to provide grounds for optimism. While any tightening of monetary policy in the eurozone and UK may indicate a welcome move back towards "normality", it could generate headwinds for the global economy in the near term. Against this backdrop, the fund's managers continue to focus on quality income, seeking competitively advantaged companies which generate strong cashflows and offer high, growing and sustainable dividend streams. Despite headwinds which can generate shorter-term challenges, management believes combining income and growth is an approach that will outperform over the longer-term.

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