

Viewpoint & fund profile

European Smaller Companies
January 2011



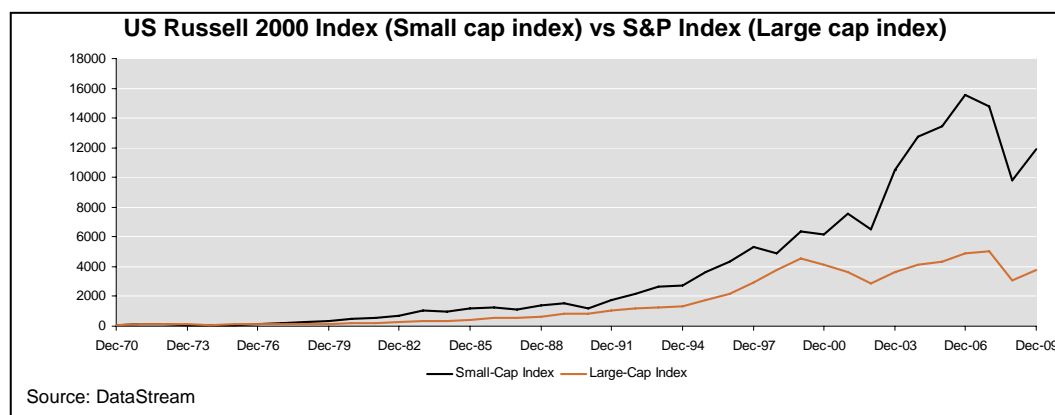
Philip Dicken
Fund Manager

Small cap stocks strongly outperformed large caps over 2010 – the HSBC European Smaller Companies Index generated a total return (in Euros) of 25.7% compared with an equivalent return from the MSCI Europe Index of 11.8%. This followed a strong return for small caps in 2009 of 58.6%, compared with a rise of 32.6% for the MSCI.

Why invest in small cap?

Firstly, it is logical to have some investment in small cap at all times. Over the long term rising markets will tend to favour smaller companies on the basis that it is easier to double profits when profits are €10m than it is when profits are €1,000m. Small cap companies carry more risk in terms of individual stock volatility, liquidity and also in terms of cyclical (note that they underperformed in the down years of 2007 and 2008) but they have historically provided superior long-term growth.

To demonstrate this outperformance and also the volatility of small caps relative to large caps, the chart below shows the performance of the US Russell 2000 index since 1970 compared with that of the S&P Index. (US figures have been used as the long-term data is more reliable).



Secondly, European equities are attractive: the Europe ex UK market is trading on a PE of around 11.0x for 2011 according to Threadneedle's forecasts. This compares favourably to the 10-year average forward PE for the market of 14.8x and 16.7x for the 15-year average. Similarly, on a price to book basis, the market is trading at 1.5x compared with a 10-year average of 2.6x and a 15-year average of 2.3x. And looking at price to cash flow, the current multiple is 7.7x compared with 10.2x over 10 years and 8.2x over 15 years.

European companies are likely to grow profits by 15% in 2011, higher than the US and Japan, but also higher than Asia Pacific ex Japan – even though conventional wisdom would have it that emerging markets and China are racing ahead of Europe.

If valuations are attractive for large cap, how does small cap stand after the recent period of outperformance? JPMorgan Cazenove data shows that smaller companies in Europe are trading on a current year PE which is slightly higher than large caps. We believe that it is generally more profitable to buy small caps when they trade at a discount to large caps, but in their favour, small cap 2011 earnings per share growth (ex financials) is expected to beat large cap by as much as ten percentage points. In addition, small caps are trading below their long-term average price to book valuations and this discount is greater than for large caps.

Risks

There are undoubtedly risks attached to our positive stance. Most obviously, the Eurozone's peripheral problems remain unresolved, but we are also seeing rising inflation which could lead to tighter monetary policies worldwide. So, we expect equities and small caps to remain volatile asset classes and this lends a note of caution to our generally positive outlook.

Conclusions

With valuations attractive and European growth recovering, we are positive on equities including small cap. More specifically, given the apparent risks, we retain our long-term approach when analysing stocks and constructing our portfolios.

This consistent approach has helped the Threadneedle Pan European Smaller Companies Fund, managed by Philip Dicken since inception, beat the index by 47.0% since launch just over 5 years ago and we have an optimistic approach towards 2011. Below are the details of the Fund managed by Philip.

Investor Profile

The Fund may be suitable for investors with a long term investment horizon seeking capital growth who are prepared to tolerate large price fluctuations. If investors are uncertain if the fund is suitable for them, they are advised to contact a financial adviser.




Threadneedle Pan European Smaller Companies Fund

Fund aim

The Fund's aim is to invest primarily in the equities of smaller companies domiciled in Continental Europe and the UK or with significant Continental European or UK operations. If desirable, the Fund may further invest in other securities (including fixed interest securities, other equities and money market securities).

Performance

Cumulative Performance Periods to 31 December 2010

	3 months	1 year	3 year	5 years	Since inception (Nov 2005)
Threadneedle Pan European Smaller Companies (Net)	17.1%	41.9%	6.7%	66.7%	74.6%
HSBC Smaller European Companies (Gross)	12.2%	25.6%	-2.6%	21.8%	27.6%
Sector Median² (Net)	14.9%	30.8%	-2.7%	18.2%	23.8%
Quartile ranking²	1st	1st	1st	1st	1 st
Ratings					

Source: Morningstar/Threadneedle/Thomson Financial Datastream

²The Sector Median (Net) and Quartile Ranking are referenced to Morningstar – Offshore and International Funds - Europe Small-Cap Equity. Note: All performance figures relate to the Net Acc Class 1 (Retail) GBP share class (converted into EUR). **Past performance is not a guide to the future.**

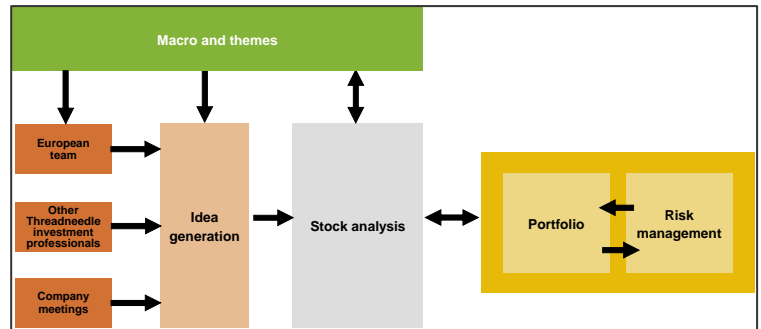
Index returns assume reinvestment of dividends and capital gains and unlike fund returns do not reflect fees or expenses. The index is unmanaged and cannot be invested in directly. The value of investments and any income from them can fall as well as rise. Source performance: Copyright © 2010 Morningstar UK Limited, assumes income is reinvested for a non-UK taxpayer in fund currency, bid to bid (which means performance does not include the effect of any initial charge).

Key selling points

- A well-defined, consistent investment process with a diversified approach that seeks to reduce risk and limit volatility.
- Face-to-face meetings with companies help to ensure a thorough understanding of performance drivers, leading to increased conviction.
- This fundamental, bottom-up approach leads to a focus on quality companies that are likely to outperform over the long term.
- Philip Dicken has managed the Fund since launch in November 2005.
- Well resourced investment team – Philip is supported by 23-strong team of European portfolio managers who operate within Threadneedle's wider team of more than 115 investment professionals.

European Smaller Companies Investment Process

The team has a fundamental stock picking approach, which drives asset allocation and geographic weightings. Our goal is to identify under-researched, under-valued and niche opportunities. Our selection criteria focus on premium business models and companies' pricing power. The chart below summarises our investment process. This is a recurrent process where research contributes to idea generation and vice versa.



Idea generation

A clear understanding of the macroeconomic and thematic background is a vital starting point for building the portfolio. These insights are gained from numerous sources including Threadneedle's regular economic outlook meeting and investment themes meeting where a culture of challenge and debate ensures only the best ideas make it into a portfolio. Views from external economists and strategists help highlight those areas of the market likely to be a good source of stock opportunities.

Stock analysis

This top-down approach is combined with a large number of company meetings where we can understand how a business may develop over the medium-term. The manager uses a variety of analysis to assess the stocks including valuation tools, financial analysis and Porter's Five Forces to ensure he targets quality companies with robust balance sheets and pricing power achieved through strong market positioning.

Portfolio construction and risk management

Once the stock ideas have been thoroughly debated the fund manager is responsible for constructing a balanced portfolio, aware of the need to generate alpha from different directions balancing one stock with another.

The portfolio is monitored constantly by an independent risk team – a process aided by daily risk reports – to ensure that it is structured correctly and that any risks are known, are directionally desirable and are managed.

The rigour that underpins the process allows the team to invest with real conviction.

Fund codes:

Sedol	B0PHJS6
ISIN	GB00B0PHJS66
Bloomberg	TDNPS1A:LN Equity
WKN	A0HMGB
Valoren	2398783

The strategy is available as:

- a) segregated portfolios,
- b) through pooled investment vehicles:
 - i) UK OEIC sub-fund (UCITS)
 - ii) Luxembourg SICAV portfolio (UCITS)

European Range

Threadneedle has a comprehensive European equity range with differing objectives and risk profiles, from core funds to more concentrated high alpha and specialised smaller company funds, our range of European equity funds provide options for investors with differing risk appetites.

For more information please contact Threadneedle or visit threadneedle.com

Key Fund Risks:

MARKET RISK: Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up, and an investor may not get back the amount invested. **SMALLER COMPANIES RISK:** Smaller companies can be more volatile and less liquid than their larger counterparts. **CASH RISK:** Where a fund holds at any one time a substantial proportion of their assets in cash, near cash or money market instruments, it might not, under such circumstances, participate fully in a rise in market values of the asset classes the fund would otherwise invest in. **CURRENCY RISK:** If the investment returns are not denominated in an investor's currency, investors are exposed to fluctuations in exchange rates. Changes in exchange rates may also cause the value of investments to fall as well as rise.

Important Information

Opinions expressed are as at the date of issue, but may be subject to change without notice. Investors should note the "Risk factors" section of the Prospectus in terms of risks applicable to investing in any Fund. Threadneedle Investment Services Limited, 60 St Mary Axe, London EC3A 8JQ, Registered No. 3701768. Authorised and regulated in the UK by the Financial Services Authority. Threadneedle is a brand name, and both the Threadneedle name and logo are trademarks or registered trademarks of the Threadneedle group of companies.

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