

Conference call highlights

European equities

March 2011



Ann Steele
Fund Manager

An eventful first quarter

Following a strong end to 2010, we had expected to witness a degree of volatility in the first quarter of 2011 as markets grappled with high commodity prices, rising inflation, expectations of rising interest rates and ongoing peripheral debt concerns. Indeed, there was a sharp rotation within markets during January as investors took profits in the best performing stocks from 2010 and sought opportunities in oversold areas. However, the factors that we had expected to dominate investors' thinking were soon superseded by unrest in the Middle East and North Africa and the earthquake and tsunami in Japan.

Valuations attractive

These events led to a 10% correction in European equity markets, taking indices back to their November lows. This places the market on a forward PE of just 10.8x, which is well below the long-term average and represents excellent value in the context of healthy double-digit earnings growth. The market is also attractively valued on other measures, with price to cash flow and price to book value ratios that are both below the long-term average and a prospective dividend yield of 3.7%.



Philip Dicken
Fund Manager

Feedback from companies

Meeting companies is at the core of the Threadneedle investment process – we find that it is an important way of gauging operating conditions and testing corporate growth strategies. Recent conversations with management have revealed that companies are performing well. This sentiment is echoed in recent business surveys, with the Ifo at all-time highs and purchasing managers' indices firmly in positive territory. So, despite the acknowledged short-term risks in markets, companies are looking to the future with confidence. We share this optimism.

Positive investment themes

In 2010, sector strategy was the key driver of investment returns but we expect stock selection to return to the fore in 2011. We have identified a number of positive investment themes that are informing our stock selection process. The difference in growth potential between emerging and developed economies has been a core theme for some time, benefiting companies from the heart of Europe that are helping to meet robust Asian demand for luxury goods, cars and other products. With deficit reduction programmes in place in many European economies, this theme has further to run. Moreover, the recent volatility has left many companies with superior growth potential trading on more reasonable valuations. By the same token, however, we are seeing good value among oversold domestically-focused companies. We have started to add selectively to such companies, with UK house builder Persimmon a case in point.

Ageing populations, unhealthy living

Meanwhile, although we remain cautious on large-cap pharmaceutical stocks, we are finding good opportunities among specialist healthcare companies that are helping to address health issues linked to demographic trends. An example would be Novo Nordisk, which provides a range of diabetes products.

Use of cash flows

Companies are generating healthy levels of cash flow and, as confidence grows, the tendency to hoard this cash on the balance sheet is diminishing. At the same time, the cost of raising capital is relatively modest, with interest rates and corporate bond yields at historically low levels. As a result, companies are set to use their excess cash in shareholder-friendly ways. This is likely to include M&A activity, dividend increases and share buybacks. We will be examining all of these uses of cash on a case-by-case basis as part of our stock selection process.

Pricing power is key

Raw materials prices have risen sharply over the past year and an emerging theme is the ability of companies to maintain their margins by passing costs on to their customers. This is especially difficult to achieve in an era in which consumers are under pressure from low real wage growth and rising taxes. Our focus on business models helps us to identify companies with pricing power. Tools such as Porter's Five Forces help us to analyse the relationships between a company and its suppliers, competitors and customers. Considering these issues allows us to identify companies that can generate sustainably higher returns.

Outperformance across the range

Our experienced team of European equity managers runs a broad suite of products, including core and concentrated continental and Pan European funds and dedicated smaller companies portfolios. The philosophy of teamwork that underpins our investment approach has ensured that the idea generation capabilities of the team are brought to bear on all portfolios. The result is a consistently strong performance record across the range. For example, our core Pan European Fund has outperformed its benchmark index by 11.0% over the past 12 months; the 30-stock Pan European Accelerando Fund by 13.5% and the Pan European Smaller Companies Fund by 7.0%. All three funds have also significantly outperformed over three and five years.

Summary

Recent market volatility has left European equities trading at attractive levels. Although the domestic economic backdrop remains challenging in some areas of Europe, our meetings with companies reveal that many businesses are performing well. Following a period in which sector positioning has been a key factor in driving relative performance, we expect stock selection to gain importance in 2011. Given our team's impressive track record in stock selection, this environment should serve us well. We have identified a number of positive investment themes and are finding many companies that are well positioned to benefit. As such, we are confident in our ability to continue to deliver value for European equity investors.

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