

# Viewpoint

Global Equity Income  
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Global Equity Income Fund

**With official interest rates in the developed world still at record lows, investors continue to be attracted by the yields available on equity income funds. Moreover, by selecting a fund that invests on a global rather than regional basis, investors can enhance their prospects of securing a growing income along with the potential for long-term capital growth. Since its launch in June 2007, the Threadneedle Global Equity Income Fund has proved highly successful, substantially outperforming its peer group. Over the three years to the end of February 2011, the fund has recorded top quartile performance in its sector. The fund is managed by Stephen Thornber, a highly regarded member of Threadneedle's global equity team, who has more than 20 years' experience in the investment industry.**

The fund focuses on good quality, high yielding stocks where the company has the ability to grow the dividend. Threadneedle's proven investment process underpins all aspects of stock selection, and in addition to his own in-depth knowledge, the manager is able to draw on the expertise of his colleagues on the global equity desk, as well as the full resources of Threadneedle's team of more than 120 investment professionals.

The fund is able to add value by taking some significant positions against the benchmark in terms of its exposure to individual markets, sectors and stocks. More traditional equity income portfolios tend to have a regional orientation, and a tendency to focus on established higher yielding sectors such as telecoms and utilities. While the Global Equity Income Fund is also overweight in these areas, its global remit enables the manager to access the best opportunities from around the world. Last year, the fund particularly benefited from its above-benchmark exposure to emerging markets, and notable holdings in the telecoms sector currently include KT Corp in Korea, Maxis in Malaysia and Starhub in Singapore.

The chief criterion for stock selection is a dividend yield of at least 4%. By investing globally, the manager is able to select the most attractive opportunities amongst the hundreds of stocks currently offering this level of yield. Consequently, there is ample scope to run a well-diversified portfolio. Historically, a UK equity income fund tended to maintain a significant exposure, not only to telecoms and utilities, but also to banks and oil stocks. However, the financial crisis precipitated a significant erosion of dividend payments in the banking sector, so this is no longer a high yielding area of the market. Even within the oil sector it is important to be selective with BP, one of the UK's largest companies, suspending its dividends last year in the wake of the Deepwater Horizon disaster. Fortunately, the company is on target to resume its dividend payments this year. Three years ago UK equity income funds were therefore more diversified. However, given their income remit, not only has it become more difficult for UK-focused funds to invest in banks, but also many cyclical companies, as these tended to cut their dividends during the recession and it will take time for them to be rebuilt.

## **Better diversification**

The Global Equity Income Fund therefore offers better diversification. For example, while the fund tends to be structurally underweight in the technology sector, due to the low yields typically on offer in this sector, it is still possible to find attractive stock picks. For instance, there are some strong technology stocks in Taiwan on good yields with the prospect of healthy dividend growth. Taiwan currently accounts for around 5% of the portfolio and half of this is invested in two technology companies in the hardware space, namely HTC and Taiwan Semiconductor. HTC is a smartphone manufacturer and has continued to perform well on the back of strong quarterly results and broker upgrades. Taiwan Semiconductor operates in a growth industry and is generating strong cash flows. Overall, recent years have seen Asian

companies adopt more shareholder-friendly policies, including sustainable dividend payments. As a result, a number of Asian stocks offer the very attractive combination of above-average earnings potential and solid dividend growth.

### **Rigorous stock selection**

The fund typically features between 75 and 95 stocks. As well as offering a dividend yield of at least 4%, companies are expected to grow their dividends by a minimum of 5% per annum, with a similar target for earnings growth. All holdings must be able to contribute to the fund's distributions. Additionally, there is a preference for companies with strong free cash flows, which are able to provide good dividend cover (at least 1.25x), and have only modest levels of gearing. Companies with these characteristics should be capable of a sustainable dividend policy.

From an initial universe of 15,000 stocks, these selection criteria result in a list of around 350 companies, which are then assessed on the basis of their business fundamentals, liquidity and ability to grow their dividends. Company meetings are used extensively to test the strength of business models and the management's credibility. The proven ability of Threadneedle's global equity team and the Global Equity Income Fund's performance record has seen it awarded an AA rating by Standard & Poor's.

### **Current positioning**

Stock and sector selection lie at the heart of the investment process, so that the fund's overall market exposure is largely a result of bottom-up stock picking. However, top-down analysis also plays a part, and the fund has no exposure to Japan where there are few high yielding stocks. In contrast, the fund is overweight in Europe, Asia ex Japan, emerging markets and the UK, given the number of attractive higher yielding opportunities. Elsewhere, the portfolio is underweight in the US, which is typically a lower yielding market.

As outlined earlier, the fund is overweight in telecoms and utilities. However, recently the fund has also moved up to overweight in energy and neutral in materials, given the manager's positive view on commodities. Elsewhere, the fund is underweight in industrials, in light of the dividend cuts seen during the economic downturn. Nevertheless, the recovery in the global economy should enable companies to gradually rebuild their dividends, so this position will be monitored.

Healthcare is another big sector, but a number of major pharmaceutical companies are facing pressures such as patent expiration and generic competition. As such, the fund is neutrally positioned.

Last year, analysis by the fund manager revealed that there were no UK-listed technology stocks or mining companies offering a yield of 4% plus. So, if a UK equity income fund manager wished to hold a technology stock, it would be necessary to deliberately forego some yield. Similarly, there were no US or European technology stocks offering a significant dividend yield. Yet on a global basis, it was possible to find 39 technology companies and 51 mining stocks on a yield of 4%. Asia, in particular, offers some strong, high-yielding technology companies.

### **Global opportunities**

Below, we outline some of the international stocks held in the Global Equity Income Fund that help to highlight the advantages of a global portfolio.

The fund's largest holding is BP Prudhoe Bay Royalty Trust, a US energy trust. The Global Equity Income Fund has held the stock for some time and the manager has recently added to this position. The trust collects a royalty payment on the first 90,000 barrels of net oil production per day from the giant Prudhoe Bay oil field and has to distribute over 90% of its revenues as income. Hence, the share price and dividend are geared to the oil price, which has risen sharply over the past two years. The trust has zero debt and the dividend yield is over 8%. There is no comparable entity in the UK, which again highlights the benefits of global diversification.

Canadian energy company Baytex is also highly sensitive to movements in the oil price. Consequently, it has been another beneficiary of the rise in the price of oil. The shares provide a high dividend, payable on a monthly basis.

Leading smartphone manufacturer HTC is well placed to meet the growing demand for this technology. Last year, this Taiwanese company was the top performing stock in the portfolio and is already up 20% over 2011 to date. The shares stand on a yield of 5% and the company is currently growing the dividend at 25%. Over the last five

years, the dividend has risen by 67%. There is no technology stock in the developed world that can offer this level of yield and dividend growth. The holding was top-sliced three times last year and once again in 2011, yet it is still the fourth-largest position in the portfolio.

Mexican Coca-Cola bottler and distributor Grupo Continental is one of the fund's emerging market stock picks. The company is therefore strongly geared to the improving Mexican economy and the increasing domestic demand for consumer products, particularly western brands. The company's product range has been expanding as Coca-Cola continues to diversify into bottled waters and fruit drinks. Grupo Continental's founding family members are majority shareholders and the company has zero debt. Grupo Continental distributes virtually all of its free cash flow by way of dividends and the current yield is 5.6%. Earlier this year, the shares rallied strongly on the announcement of a merger with Embotelladores Arca, the second-biggest Coca-Cola bottler in Mexico.

French-listed international media conglomerate Vivendi is a high quality business that has tended to be overlooked by investors. It is a well-diversified company in a strong financial position, generates high cash flows, and the management is committed to paying a good dividend. The shares stand on a current yield of 7%.

### **Outlook**

Global equities continue to look attractively valued. Looking back over periods of 10 and 20 years, the average global P/E ratio has been around 16-17x. By comparison, the P/E ratio for 2011 is 12.5x. So equities are trading at a very big discount to their historic norms. Moreover, there are a number of companies where the equities offer a higher yield than the corporate bonds; Vodafone being a case in point. Consequently, not only are investors able to receive a higher income by investing in these shares but there is also the potential for future capital growth.

Indeed, bond yields are very low by historical comparison and prices of government and high quality investment grade corporate bonds are likely to be negatively impacted once central banks in the developed world begin the process of normalising interest rates.

For 2011, Threadneedle is forecasting double-digit earnings growth for markets in the UK, US, Europe and Asia. This should feed through to a healthy increase in dividends. The UK is likely to see dividend growth of 11% this year, followed by 10.2% for Asia ex Japan and 8.4% for Europe ex UK. Even the US, a traditionally lower yielding market, is expected to generate a healthy increase in dividends on the back of strong corporate free cash flows.

### **Summary**

The Global Equity Income Fund is invested in quality companies offering high dividend yields. Although in the short term, investor risk appetite has been hurt by recent events in Japan and the unrest in parts of North Africa and the Middle East, the fund should perform well once sentiment begins to recover. Meanwhile, investors are able to benefit from an attractive level of income (the fund is on a historic gross yield of 4.7%), which is considerably above the rates available on bank deposits and high quality bonds. The recent setback in global equity markets should therefore represent an attractive entry point for investors, with the fund offering the potential for future capital appreciation and healthy dividend growth.

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