threadneedle.

# Conference call highlights

## US small cap

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Head of US Equities

### A broad range of products

Threadneedle's highly-regarded US equities team manages a broad range of funds to meet the needs of different investors. This range includes core and more focused multi-cap portfolios, a successful 130/30 strategy, an absolute return UCITS III product and the Threadneedle American Smaller Companies Fund. This fund's name is slightly misleading in that it targets companies up to a market capitalisation of US$5bn at the time of initial investment and its performance benchmark is the S&P Mid Cap Index.

### Consistent stock-picking approach

The fund benefits from the same successful investment approach that underpins our acclaimed American and American Select Funds. The team liaises closely with other equity desks and the company's fixed income department in defining the macro backdrop, and these macro views then help us to target our bottom-up research in the most profitable areas. Rigorous fundamental analysis of companies then allows us to unearth opportunities that may have been overlooked or mis-valued by the market. The result is a portfolio of 50-90 high conviction positions. The number of fund holdings is currently close to the middle of this range.

### Pragmatic style

In common with our other portfolios, the American Smaller Companies Fund takes a "blend" approach over the long term. In other words, we are not wedded to growth or value but will flex the fund's style to suit the prevailing conditions. For example, having had a pronounced bias towards balance sheet strength during the credit crunch, we identified that value stocks had become oversold in early 2009 and tilted the fund in this direction.

### Growth bias

The portfolio is currently invested with a growth bias. This positioning is a result of our macroeconomic analysis, wherein we are forecasting muted economic growth over the coming quarters. In this environment we believe that cyclicals are likely to struggle and that companies with the ability to grow their earnings irrespective of the economic cycle should be rewarded. This ability might come from exposure to a demographic theme such as ageing populations or from another investment theme such as the need to save money and improve efficiency at the state level. It might even come from opportunities arising from weakness in specific companies - a current example of which is Coinstar, a kiosk DVD retailer that is benefiting from the downsizing of Blockbuster post-administration.

### Performance update

The fund underperformed in the first quarter as a number of our holdings that had delivered value in 2010 witnessed profit taking. We took the opportunity to add to some of our positions on weakness. Performance in April was very strong, leaving the fund ahead of its benchmark index over the year to date. It has also outperformed over one, three, five, seven and ten years.

### Valuations versus large caps

Relative valuations between large and small caps have been volatile over the past few years. Having been relatively expensive in 2009, small caps were then significantly de-rated relative to large caps, to a point in 2010 when the relative free cash flow yield was at levels not seen since the late 1970s. This measure of relative valuation has since corrected and is now close to its long-term average. While there is no longer such a compelling valuation argument for small caps versus their larger counterparts, we continue to see good value in US equities as an asset class. Within this, many smaller companies offer robust earnings growth potential.

**Operational gearing**
Small and medium-sized companies were particularly effective at cutting costs as financial and economic conditions deteriorated in the credit crunch, ceasing expenditure virtually overnight as the future became increasingly uncertain. As a result, the operational gearing that has produced such impressive profits growth over the past few quarters has been particularly evident among small and mid-caps.

**Strong quarterly earnings**
Coming into the first-quarter earnings reporting period we were concerned that high raw materials prices could start to impact on corporate margins. While some companies have mentioned indirect effects (McDonald's, for example, suggested that high fuel prices may be deterring some of its customers), there has been limited evidence of direct margin pressure from input prices. This gives us confidence that the US equity market can continue to generate healthy earnings growth in the coming quarters. Our aggregate forecast for 2011 US corporate earnings is 15%.

**Proactive capital management**
Given the muted economic backdrop, we continue to favour companies with low levels of debt and strong free cash flows. However, we believe that hoarding cash is no longer the most efficient strategy and we are looking for companies with a good track record in managing their capital effectively. This might involve returning cash to shareholders through increased dividends or share buybacks; or it might involve earnings-enhancing corporate activity. Alternatively, companies might choose to increase capital expenditure. Indeed, data suggests that this is occurring.

**Capital expenditure recovery**
Nine months ago, when the market was unduly focused on the possibility of a "double-dip" recession, companies quietly began to increase their capital expenditure - a trend that has continued to gather pace ever since. This expenditure is being undertaken because companies believe it is in their best interest as they seek to strengthen their market positions and maximise their growth potential. It also creates opportunities for companies that will help to fulfil these capital projects – for example, increased capex in the oil & gas industry might benefit smaller companies providing specialist logistical or technical services.

**Summary**
The Threadneedle American Smaller Companies Fund is built on the same investment process that powers our successful American and American Select Funds, with fundamental stock-picking directed by a clear macro view. Despite the modest economic growth backdrop, we are positive on the prospects for US mid and small cap stocks. US equity valuations are attractive and we believe that the market will generate double-digit earnings growth this year. Our confidence in the profitability of corporate America is matched by the companies themselves, many of which are increasing capital expenditure in a bid to maximise their growth potential. The portfolio is currently positioned with a growth bias and a preference for companies with low debt, high free cash flows and proactive capital management. We believe that this strategy will help the fund to continue its strong long-term performance record.