

 Threadneedle thinks
Conference call highlights

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Difficult macroeconomic backdrop

The UK economy continues to face significant challenges as the government seeks to reduce the fiscal deficit against a background of weak growth and stubbornly high inflation. These headwinds have been known for some time but the difficulty of the government's task has been illustrated in recent weeks by an upturn in industrial action and a number of high profile corporate failures. As the deleveraging phase continues over the coming years, life is likely to remain difficult for public sector bodies as well as domestic consumer-facing companies. Moreover, deleveraging is not a uniquely UK phenomenon: many other developed economies face similar challenges.

Three ways out of a debt crisis

History shows that there are three ways to get out of a debt crisis – indeed, all three paths are currently being pursued in different countries. The first is to default, which seems the likely eventual outcome in Greece; the second is to print money – the approach favoured to date in the US. The third path of fiscal consolidation has been successfully followed in the past, notably by the UK in the 19th century (admittedly with the tailwind of the industrial revolution) and by Sweden in the 1990s. This is the option currently being pursued in the UK and the initial signs are encouraging. However, we are still in the early stages and the success of the programme ultimately rests on the ability of the economy to grow while costs are being cut. This ability is yet to be proved.

Are equities good value?

Companies were quick to reduce costs during the credit crunch and this cost cutting, combined with a modest recovery in the global economy, has resulted in significant operational gearing in a number of areas. Although 2010 was probably the peak in terms of profit growth, we still expect aggregate earnings to increase by nearly 17% this year. This places the market on 10.2x forward earnings. Meanwhile, the prospective dividend yield is 3.3%, a similar level to 10-year gilts but with the prospect of dividend growth to combat the effects of inflation. So, on a superficial level, equities offer good value compared to history and to other asset classes such as bonds.

Where is the value?

Clearly, however, there is a big divergence in the prospects facing different parts of the market, with companies offering niche engineering solutions or luxury goods to fast-growing international markets likely to continue to offer the best growth potential. In many cases this is already reflected in valuations, while domestically-oriented businesses are typically trading on much lower multiples. As stock pickers, our job is to decide where we are prepared to pay up for growth, and which domestic stocks represent value at these levels. This continues to be the focus of our fundamental research.

Time for defensives

Defensive companies underperformed significantly from the market bottom in March 2009 through to May 2011. They have started to outperform in recent weeks, helped by sector rotation driven by risk aversion on the back of sovereign risk concerns. However, we believe that there is more to this trend than simple risk aversion and that market leadership will continue to broaden. Having identified good value, we have been adding to defensives across the capitalisation scale since Q4 2010 and we continue to hold significant weightings in this part of the market.

Dividend inflection point

Cutting dividends was one way in which companies conserved cash during the recession, with the payout ratio falling below 40%. However, the earnings recovery of the past two years is now being reflected in meaningful dividend increases and the resumption of payments by companies that had previously suspended distributions. This reflects companies' growing confidence in their long-term cash generation potential. We expect this trend to continue, resulting in aggregate dividend growth of 11% this year. We take a flexible and pragmatic approach to UK equity income, in which we focus on income at the portfolio rather than the stock level. This allows our funds to benefit from low yielding companies with good dividend growth potential in addition to traditional high-yielding stocks.

Investment themes

We are pursuing four main themes in our funds at present. The bedrock of the portfolio is made up of strong franchises with good management, high barriers to entry and healthy finances, allowing high and growing dividends. Alongside these companies we are finding opportunities among restructuring and recovery stories. This is a potential source of value throughout the cycle but, in difficult economic times, self-help can be a particularly powerful catalyst. Thirdly, we continue to invest in quality cyclicals and overseas earners, although we acknowledge that valuations are now leaving little room for disappointment in some cases. At the margin, we have therefore been taking profits in this group and adding to oversold domestic companies, with a clear focus on long-term winners.

Extensive income offering

We have built an equity income range that offers a variety of funds to meet investors' needs. In addition to our flagship UK Equity Income and UK Equity Alpha Income Funds, we have UK portfolios that generate monthly distributions, with 11 months smoothed and the twelfth including any surplus built up in the fund. We have also launched Pan European and global income portfolios for investors wishing to take a more geographically diverse approach. Each of these funds has delivered strong long-term performance, underlining Threadneedle's strength in income investing.

Conclusion

Deleveraging is likely to lead to a lacklustre domestic economic background for a number of years, but UK businesses are not reliant on the UK economy and we expect the market to generate double-digit earnings and dividend growth this year. We continue to find good opportunities in our key themes of strong franchises, restructuring and recovery, quality cyclicals and oversold domestic stocks. Our stock selection skills have allowed our funds to deliver impressive performance over the past year and we are confident in our ability to continue to perform well across our extensive income range.

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