

Pan European Equity Dividend Fund – June 2011



Nick Davis
Manager of Threadneedle Pan
European Equity Dividend Fund

The Threadneedle Pan European Equity Dividend Fund has proved successful, substantially outperforming both its IMA and offshore peer groups. Over the five years to 31 May 2011, the fund has recorded top quartile performance in its sector. Income funds provide attractive yields while offering both an inflation hedge and some exposure to any improvement in the macroeconomic outlook – and compare favourably, in our view, to other asset classes. The fund is relatively defensively positioned.

Income investing – good short and long-term positioning

Income funds are typically biased to more defensive sectors that pay higher dividends (for example pharmaceuticals, consumer staples, utilities and telecoms) resulting in lower betas (volatility compared to the market). On a long-term basis this style has clear advantages, if only for the simple statistical reason that over the longest time periods, reinvested dividends boost returns by around 4% per annum.

In the shorter term, there are more reasons why income investing is attractive. With the challenging global growth outlook apparent from recent economic data releases, government debt in many countries running at high levels and an over-indebted consumer under pressure, markets are likely to be volatile. Most of this volatility will come through in fluctuating capital returns, whilst income returns are typically more stable. Over 2010, many investors boosted returns by investing in China and Asia; however in 2011, unrest in certain Middle Eastern countries and tightening monetary policy have reminded investors that growth in emerging markets is unlikely to be in a straight line.

With poor income returns available from most other asset classes, investors will be drawn to equities for income. The European equity index yield of 3.7% (FTSE Europe inc UK) is higher than that on German government bonds of 3.1% and comparable to the 3.7% available from European corporate bonds. Stocks with genuine pricing power and yields comparable to bonds should fare better than bonds in an inflationary world. In fact, the index yield is above the eurozone inflation rate of 2.9% – typically a positive sign for performance.

Of course, companies that have high dividends are not always good investments – a high dividend yield may not be sustainable over the medium term, or worse it may be at risk of being cut. If the fundamentals of a business are likely to deteriorate, a healthy dividend return may not compensate for the risks. The important thing for income investors is to identify not just high yields – but high and growing dividends. This requires considerable skill – a focus on strength of the balance sheet, business model and competitive outlook.

Fund management approach

The fund is run as closely as possible to the core Pan European funds within the constraint of the income target of the fund (110% of the index yield). This target is achieved through a three-speed approach with companies generally in three categories: stocks yielding below the index (where high capital conviction warrants dilution to overall fund yield), in line with the index (typically GARP style stocks – “buy and holds”) and high yielding stocks (with a focus on restructuring, special situations and value).

The fund currently contains around 45 stocks – with the investment process driven by bottom-up analysis of competitive environment, pricing power and sustainability of earnings and dividend growth. A key consideration is the sustainability and accessibility

of cash flows (are optically attractive cash flow yields sustainable, and how confident can investors be that they will get the cash?) – examples of risks are windfall taxes and value destructive M&A to chase growth. Company meetings are a key part of the process to understand the business models and challenge management strategy.

Current positioning

There are several prevailing themes that have driven the current sector weightings. The core of the fund is centred on strong franchises with unique assets: Tesco, Nestlé, Ropak, Sampo, Remy Cointreau. In addition, we look for mature companies at attractive valuations where emerging market exposure can contribute material growth: Diageo, GlaxoSmithKline, Novartis, Bayer and BAT. There are also plays on what we see as medium-term themes: for example, Siemens and Schneider (challenges around energy supply).

We are currently overweight in insurance stocks, reflecting attractive valuations and the fact that (eventually) rising interest rates will improve the profitability of the sector, and in a more uncertain world, ageing populations will drive the increased need for private sector solutions. Other plays on rising inflation and interest rates include United Utilities (regulated water company), Edenred (vouchers business) and Euler Hermes (credit insurance).

Our core underweights are banks (where we remain cautious on the funding outlook), telecoms (where we are worried that cash generation will attract the attention of debt-ridden governments), and oil and gas (which struggle to capture value). Unlike some income funds, we are only broadly neutral in utilities and telecoms given significant near-term political and regulatory risk.

Summary

We continue to see European equity markets as cheap, with the market on 9.5x 2012 earnings, strong balance sheets and valuation support from M&A activity. However, given all the uncertainty around eurozone sovereign debt, Middle East instability and the problems stemming from the Japanese earthquake, it makes sense to take a defensive and prudent stance by focusing on income.

All data as at 31 May 2011. IMA peer group UK Unit Trust/OEICS Europe including UK, performance based on 12pm bid to bid prices, net income reinvested, net of fees. Other peer group data in €, S&P Offshore & International Universe, bid to bid basis, net performance based on 12pm prices, unadjusted income reinvested.

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