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Meeting the fund manager

Threadneedle Investment Conference 2013

Threadneedle Investments is one of the primary fund houses we use across our portfolios. They clearly have an array of excellent investment teams and fund managers. Last year we included the emerging market debt fund in our portfolios in addition to their European and American Smaller Companies funds which have been in the portfolios for a couple of years.

Looking at the markets and the portfolios we have seen a strong rally coming through at the beginning of this year. The argument has been that the markets are cheap and we are starting to see a correction in prices. With such a strong rally the question has to be asked as to whether markets are still cheap and if there are any further opportunities going forward.

We have written about the disconnect between bond returns and gilts, and with this in mind and the murmurings of a bond bubble is it right to consider alternatives to conventional bond investing.

For us this conference was an opportunity to hear from an active fund manager as to how they feel the market will behave this year and going forward both in the world of equities and bonds. We also had an opportunity to have breakout sessions with the fund managers on the European, UK and US desks as well as the emerging market debt desk.

The discussions were interesting and I have broken this update into two sections – firstly a market update and secondly updates from the managers.

Market update

The market update was delivered by three senior individuals at Threadneedle. Mark Burgess (picture to the left) who is the Chief Investment Officer at Threadneedle, Jim Cielinski who is Head of Fixed Income and Leigh Harrison who is Head of Equities.

Going into 2013 the house view is that although there are still a number of uncertainties around the Eurozone, the US and how this may impact on emerging markets there are no additional worries which to some extent makes them more relaxed. They believe that there is a possibility that Greece and others could leave the Euro but this is unlikely to be anytime soon and in reality if this did happen they believe that the Eurozone is now strong enough to deal with any exit.

As we have indicated before the flow to risk assets seems to be the right approach. Threadneedle moved to an overweight in equities in 2012 and remain overweight in equities. Interestingly one area they are overweight in is Japan which is an area we see opportunities. On the bond side emerging markets and high yield are two areas where they see opportunities, but not within government bonds.

The reason behind the flow to risk assets is because interest rates are near zero and they do not feel they will move at least for 2 to 3 years. Liquidity will start to flow into the market and as this happens equities will benefit from this.

Growth does create a worry spot for them. The austerity measures to reduce debt in Europe will restrict growth and this means that they are cautious about the macro outlook for Europe and the potential impact this could have on China.

To give an example of what austerity is doing; in Spain austerity is dragging down GDP by 4.1% and in Italy 2.9% which means they have a battle to balance the books. In the US the fiscal cliff threatened a 4% drop which would have tipped the country into recession. Although some of the main issues have been sorted it is not over yet. However, it is believed the end resolve will create a drag of 1 to 2% in the US but with Growth the US should sit comfortable in positive territory.

In China there has been a drop in GDP growth and this reflects a new government with individuals who have not had to make decisions. This will reverse and the market after three years of underperformance has started to respond to these changes.

So looking at the macro picture although there are challenges it is certainly not gloomy. The resolve in the US is expected and that will be positive and changes in China are starting to be felt in the markets. When we consider the corporate sector they have benefited from this environment.

We have seen good companies getting stronger and in good shape. Many are generating cash and strengthening their balance sheets. We are starting to see well financed companies with low debt levels. Companies are also being cautious with what they do with their cash and it is expected we will see more M&A activity (like Heinz) and buy backs (Dell).

In the fixed interest world the picture is different; yields are at rock bottom for most bond classes. It is mathematically impossible to achieve the same returns as have been received over the last few years.

As an example over the last three years on US bonds the returns would have been 3.94%, assuming the bonds go to zero yield over the next three years this will drop to 0.97%.

Yields will not go up until interest rates go up and it is clear this is not going to happen quickly.

Therefore the real challenge going forward will be the search for yield and where do you achieve this.

There are opportunities within the bond market. Threadneedle like emerging markets because they have low debt and they are in control of their own destiny. They also see opportunities in the high yield.

So if we get a slow growth scenario which is likely gilts would be around 0% return, global high yield 8.4% and emerging market sovereign 7.6%. So the importance is to perhaps rotate away the normal gilt type returns.

Turning to equities the view as I have mentioned before is that interest rates will remain low for sometime to come. The reason is simple, growth in the developed economies is weak, debt is high and the Eurozone crisis rumbles on, anything that knocks that recovery will not be forthcoming in a hurry!

It is felt that printing money is creating an allusion of wealth and as yet there is no evidence that QE is creating jobs, in fact in the US it is estimated that each job created costs $940,000! But there is good news in the equity world.

Clearly P / E ratios are still low and equities are starting to provide better yields than bonds. However investors need to accept that there will not be a normal distribution of returns. Although all indicators are that the long term trend is upwards there will be volatility which will see this move.

There is still no hurry for investors to rotate investments in the US bond inflows were nearly $800 billion in 2012 and equities saw outflows of $600 billion. However this will reverse and the opportunities are there now. There is also evidence that the global economy is growing, slowly.

In summary Threadneedle are optimistic going into 2013 and have an equity bias. Clearly gilts will be low for some time and this means the search for yield becomes more important whether in bonds or in equities. Within equities P / E ratios are low and yields can be higher than bonds however there will be greater volatility although the upward trend is positive. The rotation from bonds to equities will come when confidence comes but this may be at the wrong time!

Meeting the fund manager

Threadneedle Emerging Market Debt

Last year we moved our portfolio holding from UK debt to emerging market debt. We recently heard discussions from First State on whether this was just another bubble or an opportunity to diversify portfolios in the search for yield and less volatility.

We use two funds and one of those funds is the Threadneedle Emerging Market Debt Fund. There are two versions a hard currency and a local currency version. We have taken the hard currency version. This does have the opportunity to take local currency debt and we will cover this further.

The first point of discussion was around the team. There were some changes last year with the lead fund manager leaving. Dr Henry Stipp and John Peta are the Co-Heads of the Emerging Market Debt Team. Henry joined Threadneedle in 2001 and was previously Chief Economist for a Brazilian Bank. John joined in 2012 having previously worked in the US on emerging market debt and with an expertise in local debt.

The key to the team and process is around what has been developed by Henry. The key to their success and I believe generally in emerging market debt is the research process. The models and process they use have been developed over a ten year period and they believe that irrespective of who is at the helm it is this process and research that delivers the returns.

The performance was strong in 2012 and this has continued in to 2013 so we had the opportunity to discuss how the fund is positioned.

The fund we use is the hard currency fund. This has slightly out-performed the local currency fund. The feeling is that there could be flip where the local currency performs better this year but the margins are slight and there is likely to be greater volatility with the local currency. However, the fund can hold up to 20% in local currency to tap into the opportunities and they expect to hold around 5 to 10% to exploit the opportunities.

Some examples of where they see opportunities. Venezuela is an area that offers high yields with low debt. It is likely with or without Chevez his party will win the next election and the new government will continue with their willingness to continue to pay these yields.

In Argentina the opportunity is around local bonds although there are legal issues around defaulted debt. It is not that they don't want pay back the debt they just don't want to do it in one go. However, the local bonds are not impacted by these issues.

They also like Chile and Malaysia however the spreads are too tight at the moment so they are avoiding these areas. Areas of concern are Lebanon, Jordan and Egypt because of the geo political situation and South Africa where the expected reforms have not been put in place and there are concerns over the labour force.

In summary with emerging market debt you want a team which can exploit the opportunities without taking undue risk. Clearly the team they have in place looks to achieve this. There are areas in emerging markets which will benefit so global growth is key as this is the largest single factor affecting EM currencies and will support currency appreciation. With EM you are also looking at environments where debt is low and growth is greater than the developed world. On a corporate level we are starting to see stronger balance sheets and low costs when it comes to funding.

It is not risk free but in a world where we need to dig deeper to seek opportunities clearly we still believe that EM debt is an alternative to the normal routes of delivering fixed interest investments.

Threadneedle European Companies

We have met Dave Dudding previously. He is the manager of the European Select Fund and was up to the end of last year the manager of the European Smaller Companies fund before he passed the reigns over to focus on a new global offering. He has managed the smaller companies fund since 2001 and the euro select fund since 2008.
Dave is optimistic going into 2013 however he is not optimistic for growth in the Eurozone, i.e. the problems in the likes of Greece and Cyprus have not gone away. The key for him is that there are great companies out there with attractive valuations.

As we have heard before bonds are overpriced but equities remain cheap and are a great place to be. In the first two weeks of January the European market reflected this rising over 10% before pegging back slightly.

Interestingly we discussed the rotation from bonds to equities which Dave believes will happen. This is important because this will create demand for equities which will push up prices. However in Europe they have the same view on bonds as we do on property. It is a mind-set based on what has happened in the past and therefore because Europeans have always held bonds they continue to do so. As yields depress there will be a search for yields and slowly (not immediately) there could be a rotation in mind-set to equities. This has started slowly to happen in the US.

So cheap valuations are important and the potential for demand for shares will also be key but this is a longer term play. We discussed some of the potential within the fund. We talked about L'Oreal. The company has a great deal of cash on its books. Because it is not earning a great deal on this money it is being encouraged to do M&A activity as it could earn more money through this. L'Oreal is cheap relative to history and has been de-rated over the last ten years. Nestle is another company that is cheap relative to history and it has cut dividends for 55 years.

David likes BMW, this is the only car company he holds. Renault could have a good year but this is short term. The likes of VW and Peugeot are fighting out the middle ground. BMW on the other hand is making inroads in China, the US and taking market share in Europe. It is making money in the US and takes around 50% of its profits from China. So it is less likely to suffer from a downturn in Europe but more a global downturn.

Another company is Ryan Air which consistently delivers. Although it has recently increased fares by 8% these are still cheap in comparison to other companies.

David is looking for long term winners, he knows he can buy companies that will deliver an instant return but he wants to produce steady long term performance which will outperform the market over the long term. This means there will be periods where he underperforms the market. When looking for these companies he likes companies which have a diversified market, where pricing is sticky (so he was using the example of chocolate where you pay whatever the price is and companies that can innovate and produce goods at a higher margin to the ones they are replacing).

In summary for David the problems in Greece and Cyprus are still there, Spain and Italy may have bottomed but France still presents problems however just because the macro picture is uncertain it doesn't mean there aren't good global companies in Europe. With the search for Income and the rotation from bonds to to equities this will also add to the value of equities over the long term.

Threadneedle UK Equities

Simon Brazier is Head of UK Equities at Threadneedle. We have met him before and have been impressed with his style of management. However, the UK space has some exceptional fund managers and currently we believe we are investing with the best managers.

Having said all of that Simon is someone we follow and trust what he is saying. His team managers over £15 billion across all products and turnover on the funds is relatively low at 11%. Fundamentally they are looking for good ideas and looking to hold for the long term.

A consistent message coming out of the discussions we had was how cheap the markets are. The market is up 90% from the bottom and only now are people starting to feel positive about investing. Just because we have seen this growth it doesn't mean there is more to play out.

The problem is that the markets are inefficient. An example would be Tesco's which because of short term thinking devalued the price and by exploiting this weakness has seen a 25% return. So for Simon it is about looking to exploit the market inefficiencies.

Looking back over history, and if history only partially repeats itself and even with the increases we have seen we could be facing a bull market. After the Second World War we experienced a bull run from around 1948 to 1970. What followed was geo political issues and we had a bear market to the the end of the seventies. Then a bear market from the eighties through to the nineties. We then had the crash in 1999 / 2000 and although a recovery came back the financial crisis ended that. We are just starting to see signs of another bull market.

But with a 90% jump since the bottom is the bear market coming to an end? Simon thinks not, the average P / E ratio in the UK is below 12% with a dividend of nearly 4% so prices are still cheap. The difference is that unlike the eighties and nineties where we saw a virtual straight line it will be more volatile and therefore investors will need to be longer term stock pickers.

Due to the volatility Simon feels that you don't want to be in an index tracker in these markets. With £15 billion under management they are aware that people have aspirations for that money whether it is retirement income or to provide for education. 75% of the money is invested in strong franchises. In theory you could buy into the company and go away for five years and you will have had a good return.

The rest of the money looks to exploit opportunities. So in 2011 they opted for contrarian views like Tesco's and the Daily Mail Group. So these are good businesses which are out of favour. In 2012 they moved towards defensive growth stocks like Reckitt Benckiser and Diageo. These are global franchises which have high cash yields / dividends.

We talked about some companies they have or are investing in. BP is a favourite. In 2010 it was trading at a 60% discount, even now it is trading at a 35 to 40% discount and a P / E ratio of 11 x earnings. They have invested in Easy Jet but this is a cyclical stock and therefore the holding is restricted to protect the fund. A company they may be interested in is Royal Mail which will be listed this year, the management has changed and could be a good long term story once it is out of government control.

Summarising Simon pushed the opportunities in the UK with global businesses offering low P / E ratios and attractive dividends combined with excellent corporate governance. There are also opportunities with family businesses like for example Schroders which tend to do better because there is a vested interest and they want to pass it down the generations. The fund Simon manages holds 50% in the FTSE 100 and a maximum of 10% in small cap.

Threadneedle US Equities

We currently invest in the American Smaller Companies Fund and unfortunately we were unable to meet the fund manager however we do have a telephone conference with the team booked in.

Threadneedle are one of the largest US equity managers in London. They are stock pickers and look to attend nearly 1,000 meetings a year.

The message is similar across all equity fields and that is that now is a good time to be invested. Stephen Moore manages a number of specialist US funds for Threadneedle. GDP growth in the US is around 1.5 – 2% including the 2% fiscal drag. Other factors which make this attractive include the housing market which is improving, agriculture, oil combined with a monetary policy which is supportive of the markets as well as a better banking sector.

Stephen went onto to explain why this is important. The housing market is coming off a very stressed level. Housing affordability has greatly improved. Those who struggled to get work in the down market were people with no degree or high school degree. These people tend to be in construction, manufacturing etc so a resurgence in the housing market and building will directly help these people.

A company called Airgas makes packaged gas for the likes of welders, this again will benefit from a growth in the construction industry.

As people start to feel more confident with their jobs those who have held onto old cars will start to buy new cars and the US is starting to see an improvement in this area. AutoNation is a company which could potentially benefit from this.

Cheap natural gas impacts on manufacturing as an example it is used in the making of plastics and one company they invest in imports plastic to China.

Like the global view equities in the US have been out of favour with low returns and massive outflows. However, as people start to see changes they will come back into the market and it is likely large cap companies will benefit initially.

In summary there are many positives in the US and like the UK (and globally) it is cheap. This means there are long term opportunities.

Conclusion

Clearly Threadneedle will do a “sales job” however the indicators are good and clearly equities are cheap. However, the rotation from bonds to equities will take time even though equities can deliver better yields and growth prospects but the added volatility leaves people with a trusted formula.

The source of information in this note has been provided by Threadneedle and is correct as at 13 February. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase this fund. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise.