COLUMBIA THREADNEEDLE INVESTMENTS

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FUND COMMENTARY – Q3 2023

Threadneedle (Lux) UK Equity Income

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Fund Manager
Since: 18/11/2022

Fund Information

You are investing in a fund that is actively managed in reference to the benchmark below. Please refer to the Prospectus and KIID for the Fund objective.

Fund Benchmark: FTSE All-Share Index

Inception Date: 05/10/2016

Fund Currency: GBP

Fund Domicile: Luxembourg

Summary

- The FTSE All-Share index returned 1.9% in sterling.
- Gross of fees, the fund performed in line with the FTSE All-Share.
- At a stock level, key contributors included Centrica and Marks & Spencer; the zero weight in Diageo was also beneficial.
- Detractors included the zero weights in Shell and BP, along with the holding in Oxford Instruments.
- We initiated positions in FirstGroup, International Distributions Services and Victrex; we also sold out of Melrose Industries and Pennon.

Market Background

The FTSE All-Share returned 1.9% for the quarter.

Globally, sentiment was impacted by concerns about sticky inflation and central banks' attempts to contain it without causing recession. While headline inflation continued to ease in the UK, the US and the eurozone, core inflation (which excludes volatile components such as food and energy prices) remained elevated and labour markets remained tight. The Federal Reserve, European Central Bank and Bank of England all signalled that, while interest rates might not rise much further, they would likely take longer to come back down. This weighed on equities, particularly shares of growth-oriented companies. Investors were also unsettled by China's faltering economic recovery and the country's indebted property sector, although Beijing announced further stimulus measures.

Despite these negative factors, UK equities bounced back from their underperformance earlier in the year to outperform global markets over the third quarter (Q3). The UK stock market benefited from a weaker pound given its sizeable exposure to overseas earners. The UK's value bias was also advantageous as growth stocks underperformed due to the 'higher for longer' interest-rate narrative. Given its sizeable exposure to the energy sector, the UK index also benefited from surging oil prices after Saudi Arabia and Russia announced further extensions to supply cuts.

The pound fell amid optimism that UK interest rates may have peaked as the inflation story finally appeared to take a positive turn. According to the Office for National Statistics, headline consumer price inflation eased to an annual rate of 6.7% in August. Core inflation (excluding energy, fuel, food and tobacco prices), which hit a 31-year high in May, also fell in August, to 5.9%. This most likely influenced the Bank of England's unexpected decision in September to leave interest rates unchanged for the first time in almost two years.

Meanwhile, the UK's Q2 GDP print proved stronger than expected, while the Q1 figure was revised higher. Wage growth in Q2 reached the highest level since comparable records began in 2001, and falling inflation helped consumer confidence improve over the period. Less positively, the composite purchasing managers' index slipped below the threshold of 50 that separates expansion from contraction in August and fell further in September, as the strong momentum in the services sector faded while manufacturing output continued to decline.

At the sector level, energy stocks were the top performers by far in Q3 due to the strength of oil prices. Materials and industrials were the only other sectors to outperform. In materials, shares of major mining companies were boosted by hopes of further Chinese stimulus. The utilities sector was weakest due to Thames Water's difficulties and resulting fears about other indebted firms. Consumer discretionary and technology also underperformed.

Performance

12M Rolling Period Return in (GBP) - as at 30 September 2023

	09/22-09/23	09/21-09/22	09/20-09/21	09/19-09/20	09/18-09/19	09/17-09/18
Fund (Gross) %	18.49	-8.16	29.96	-11.69	0.69	4.71
Index (Gross) %	13.84	-4.00	27.89	-16.59	2.68	5.87

Source: Columbia Threadneedle Investments as at 30/09/2023. Gross of fee fund returns are time-weighted rates of return net of commissions transactions costs and non-reclaimable taxes on dividends interest and capital gains using pricing of investments which is either the last traded price or a bid basis. Cash flows are factored as of the end of the day and exclude entry and exit charges. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it. The return of your investment may change as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation. Past performance does not predict future returns and future returns are not guaranteed.

For detailed information on Fund Changes please see Significant Events - Threadneedle (Lux) Funds PDF available on www.columbiathreadneedle.com/en/changes

Gross of fees, the fund performed in line with the FTSE All-Share over the quarter, and remained ahead of the index over the year to date.

The outperformance over the quarter was due to favourable stock selection, especially in utilities, financials and the consumer sectors, although picks in technology detracted. However, sector allocation detracted, mainly due to the zero weight in energy, although there were modest positive contributions from the underweight in financials and overweight in materials.

At a stock level, key contributors included Centrica and Marks & Spencer.

Centrica, one of our longstanding contrarian holdings, announced an increase in profits for the first half of 2023 thanks to higher gas and electricity prices. The firm also reported an uptick in free cashflow and hiked dividends. With a strong cash position, we feel Centrica is well placed to take market share from failed rivals.

Marks & Spencer outperformed after releasing a positive trading update, which showed an 11% increase in food sales and a 6% increase in its home and clothing business over the first 19 weeks of its financial year, with increased market-share gains across both categories. The company also said that it expects a significant improvement on the forecasts unveiled with its interim results, with annual profit growth likely to turn positive.

The lack of exposure to Diageo was also beneficial. Shares in the beverage firm declined amid fears that higher-for-longer interest rates might dampen consumer spending. The economic uncertainty around China, one of the firm’s key markets, was also a headwind.

Key detractors included the zero weights in Shell and BP. While both companies’ Q2 earnings underwhelmed, the shares were boosted by the surge in oil prices.

The holding in Oxford Instruments was also unfavourable. The stock succumbed to profit-taking amid a rotation away from companies perceived to be vulnerable to an extended period of higher interest rates. Shares were also impacted by concerns about China’s economy; the country accounts for about 25% of the company’s revenues. However, we retain conviction in the stock. Oxford Instruments is mitigating the effects of higher costs and reported increased profits for its recent financial year. Revenues were also higher as supply-chain bottlenecks eased. Moreover, the firm boasts a high return on capital and strong average cash conversion; the latter should be further enhanced once the company’s defined benefit pension scheme comes to an end. Oxford Instruments also has an effective research and development strategy, along with a broad customer base. The firm additionally stands to benefit from exposure to the semiconductor and battery industries, where its atomic force microscopes are used.

Activity

We initiated positions in FirstGroup, International Distributions Services (IDS) and Victrex.

Following the sale of its overseas subsidiaries and with a new chief executive at the helm, transport operator FirstGroup has vastly improved its balance sheet and leadership team. Having navigated successfully through Covid, the regional bus business is now making good progress in improving margins. The firm’s rail division generates surplus cash and has the opportunity to continue doing so over the long term through contract extensions. The net cash position provides options to enhance returns through a progressive dividend policy, share buybacks and bolt-on acquisitions. In addition, as FirstGroup boasts the largest electric bus fleet in the UK – which it continues to expand – the company’s structural change offers an opportunity for it to pursue further cost reductions and additional revenue opportunities.

Shares of IDS have underperformed significantly over the last three years, resulting in a deeply discounted valuation. The group comprises one of the best parcel businesses in Europe – GLS – and Royal Mail in the UK. Structural change in demand for letters and parcels has generated an opportunity for Royal Mail to create significant value through automation and changes to working practices. The probability of success has increased following the recent agreement with its largest union, the Communication Workers Union, which has yet to be reflected in the value of the shares.

Victrex is a polymer solutions company that provides products with positive environmental and social impacts for a variety of end markets. In our view, the shares have been excessively penalised by concerns about slowing demand. In addition, the firm is managing costs well and has increased prices for customers. Victrex also stands to benefit from increased demand for its polymers, which are replacing metals in cars and planes; the resulting reduction in weight helps cut fuel use and carbon emissions.

We also topped up some existing holdings, notably Land Securities and SSE.

Melrose Industries was sold as we felt that the shares had fully priced in the benefits of the company's internal restructuring efforts and the wider cyclical recovery in aerospace demand. We also exited Pennon; the stock's rating has been pressured by the company's poor environmental performance. We took some profits in BAE Systems and 3i as both have outperformed over the year to date.

Outlook

UK equities are still trading at very attractive valuations relative to global peers. Consequently, the shares of UK-listed global firms remain deeply discounted compared to their overseas counterparts. This should continue to support inbound M&A bids and stoke interest from private-equity firms.

Inflation in the UK is slowing as input prices have fallen back to levels last seen before the pandemic. We expect wage inflation to follow and therefore feel that interest rates in the UK have likely peaked. Meanwhile, consumer spending has been holding up well so far as UK households are now much less indebted than at the start of the Covid pandemic, with higher aggregate savings. While we are mindful of the impact of a modest fall in house prices, we still feel that much of the gloom overhanging the UK economy is overdone. Additionally, our role in investing in companies goes beyond valuations; we feel that engagement is key and see ourselves as owners and not renters of businesses. Our ongoing constructive engagement approach enables us to take a contrarian, long-term view.

As patient conviction investors, we will continue to avoid whipsaw momentum trades and concentrate on company fundamentals to target strong risk-adjusted returns..

Key Risks

The value of investments can fall as well as rise and investors might not get back the sum originally invested.

Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments.

The investment policy of the fund allows it to invest in derivatives for the purposes of reducing risk or minimising the cost of transactions.

The fund typically carries a risk of high volatility due to its portfolio composition or the portfolio management techniques used. This means that the fund's value is likely to fall and rise more frequently and this could be more pronounced than with other funds.

The risks currently identified as applying to the fund are set out in the "Risk Factors" section of the prospectus. Please read the Key Investor Information Document and the Fund Prospectus if considering investing.