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FUND COMMENTARY
THREADNEEDLE UK EXTENDED ALPHA FUND

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Summary

- UK equities fell sharply in March as concerns over the coronavirus escalated.
- Gross of fees, the fund underperformed the FTSE All-Share.
- Detraction from the long book outweighed the gain from the short book.
- In the long book, we initiated new positions in Rentokil and BHP.

Market Background

The FTSE All-Share lost 15.1% in March. UK and global equities experienced the worst sell-off since the financial crisis, and volatility spiked as the Covid-19 pandemic worsened in Europe and the US. As lockdowns were imposed across the world to tackle the outbreak, fears mounted about the ensuing demand shock and disruption to supply chains. Corporate cash flows have been particularly impacted, and many firms have announced several cash conservation measures, such as dividend cuts. The market turbulence was heightened by a further collapse in oil prices, triggered by a Saudi-Russia price war. This was a further headwind for the UK market, due to its significant energy exposure.

Central banks in the UK and elsewhere responded to the virus with a wave of emergency interest-rate cuts and liquidity injections, while governments unveiled fiscal stimulus plans accompanied by ‘whatever it takes’ rhetoric. While these measures were not seen as ‘silver bullets’, equities did respond favourably to the US government’s fiscal stimulus package towards the end of March. Sentiment was also buoyed as China’s officially compiled manufacturing purchasing managers’ index (PMI) suggested that the sector unexpectedly returned to growth in March, following a sharp contraction in February caused by lockdowns.

The UK’s manufacturing and services PMIs indicated that activity contracted in March. The reading for the dominant services sector was the weakest since records began, suggesting GDP growth is set to contract in the first quarter.

Amid the heightened volatility, correlations in markets increased: most sectors and firms were impacted, particularly those with high debt levels. The consumer discretionary sector was the worst performer in the FTSE All-Share. Travel, leisure and retail stocks have been severely hurt by the virtual halt to tourism and footfall at stores. Industrials lagged too, on concerns about the disruption to supply chains. Healthcare, consumer staples and utilities held up relatively well, as investors sought defensives. Healthcare stocks were further buoyed by an upswing in interest amid a race for tests, drugs and vaccinations for the virus.

Performance

Gross of fees, the fund was down 16.9% in March and lagged the FTSE All-Share.

The underperformance was due to the long book, which fell 16.7% and detracted 227 basis points (bps) in relative terms.

Returns were hampered by the outperformance of AstraZeneca, which the fund does not hold, and by detraction from our travel- and events-related names such as SSP, easyJet and ITV. Additionally, selected financial names underperformed owing to heightened volatility and the pressure in credit markets.

Weir was another detractor, amid concerns over faltering industrial demand, and disruptions to the company's factories as a result of the lockdowns. We believe that Weir's shares have been excessively penalised, and that the firm's business model is resilient.

Positive contributors included defensives such as Tesco and Reckitt Benckiser. Both stocks also benefited from the expected boost to revenues from consumers stockpiling groceries and other essential goods as a result of the pandemic. Reckitt Benckiser is exposed to some of the faster-growing categories in the household personal-care sector and boasts strong brands with robust market positions. Following the firm's significant reinvestments, we feel that operational performance can improve, and that growth and margins can rebound faster than expected. A new management team brings prospects of a more clearly delineated strategy.

Rio Tinto also outperformed, rallying towards the end of the month following news of the US fiscal stimulus and as South Africa's announcement of a three-week lockdown eased earlier concerns about supply outstripping demand.

The short book was down 17.8%. It underperformed the FTSE All-Share, and hence contributed positively to relative performance (+41 bps). The positions in a maker of hazard-detection products and a speciality-chemicals firm were particularly disadvantageous. However, our shorts in an aerospace components manufacturer and an online rail-ticketing platform added value, given the virtual halt to travel and tourism.

Activity

We added pesticides manufacturer Rentokil to the long book. We are positive about the firm's moves to mitigate the impact of lower demand for its products from the hotel industry. These measures include reducing wage costs and putting acquisitions temporarily on hold. At the same time, increased sales of hygiene products should be beneficial. We are also optimistic about Rentokil's strengthening position in several expanding markets.

BHP was another new holding, as part of our move to increase exposure to potential beneficiaries of fiscal and monetary stimulus. Similarly, we also topped up our holdings in CRH and Berkeley.

We rotated the fund's consumer exposure by exiting Carnival – we felt that the firm's financial risk is now greater – and by topping up holdings in staples such as Tesco and British American Tobacco.

We initiated a short in a supplier of assurance and testing services. We closed our positions in the aforementioned rail-ticketing platform, a sports-fashion retailer, a variety retailer and a bookmaker.

Outlook

The coronavirus has delivered a clear jolt to the world economy, which we feel cannot be entirely offset by the substantial monetary and fiscal stimulus measures currently in train. That said, the magnitude of stock market falls means that this is already being factored in to some degree.

While the situation is evolving rapidly, the dislocation should create opportunities for us to capture value through our robust process and active management.

We expect a wave of refinancing to sweep the market as companies seek to shore up liquidity and, just as in 2009, this can be a fantastic opportunity for long-term, bottom-up investors. The key is to identify decent businesses unduly caught up in the crunch – and, of course, to avoid throwing good money after bad. Elsewhere, the prospects for selected domestic cyclicals appear interesting as, before the virus emerged, these stocks had already suffered from a 'Brexit malaise' since the EU referendum.

We are confident that a well-constructed and balanced portfolio with a diversified set of exposures, coupled with accurate and disciplined active management, can navigate the market's vagaries.