January 2015

M&G Global Dividend Fund

Reviewing 2014: an open letter to investors

Fund manager – Stuart Rhodes

Dear investors,

2014 has been a difficult year for the M&G Global Dividend Fund. The purpose of this letter is to review the major issues that have affected performance throughout the year and ask ourselves some very blunt and direct questions to make sure the fund is on its best possible footing for the future.

1) Where have we been proven wrong? Where has the investment case been disproven and the share price reaction been warranted, resulting in permanent loss?
2) Where have there been shorter-term issues causing weakness but the longer-term fundamentals and investment case remain robust?
3) Where has there been genuine mispricing not explained by fundamentals?
4) What have we learned and what can we do better in the future?

We believe answering these questions honestly is important as it will lead us towards those issues within the fund that offer the best opportunities. Answering these questions honestly will ultimately determine how we can return to winning ways and claw back the underperformance of 2014. Stubbornness is a common investor character trait when it comes to assessing underperformance. Open admission of failure in this industry is rare. This leads to the vast majority of performance issues being addressed in questions 2 and 3. Self-denial and anchoring can clearly be very damaging. I hope as you read the rest of the review, you will not detect any of these attributes in our assessment of the key issues in 2014. But you will have to be the judge.

Issue number 1 – Oil price

This has been the biggest issue of 2014, accounting for approximately 5% of the fund's underperformance. The scale and speed of the decline in the oil price has caught us, as well as the wider investment community, by surprise. Whilst our direct exposure to energy within the portfolio was not a significant overweight, the recent high correlation of Gibson Energy and Methanex (and TransCanada to a much smaller degree) to the energy sector has caused us problems. They have ceased to perform in the same way as the utility-like operation and chemicals business of the past. We discuss these two companies in detail below.

Assessing the impact can be split into two parts. The first part involves the companies that operationally have been significantly affected by these events and this has impinged on the dividend outlook for the firms. The resulting share price reactions have been very painful but justified and deserved. We are not claiming otherwise.

The second part involves the businesses that have sold off very significantly despite their limited exposure to the underlying commodity price. Some of these share price falls have been more severe than that of the oil producers themselves and hence we believe are irrational and causing some genuine mispricing. We are getting excited about this area and are adding to our positions in reasonable size.

1) Deserved

There are four companies that have hit the fund hard and for very justifiable reasons. The first is Fugro, which has now been sold. The business was already struggling before the collapse in the oil price and we lost faith in the company's controls and ability to make a reasonable margin. We exited the position in July and it cost us 51 basis points (bps) over the year.

The other three companies are different in that we don't believe they have suffered permanent loss, but they are heavily dependent on a rally in the oil price. They will not recover without it. We can understand the share price reactions and believe they are rational. The companies remain industry leaders and will be well positioned in any recovery. Prosafe and Seadrill are heavily exposed to the deepwater drilling market where demand is declining. Both businesses have the best assets in their respective markets, but have too much financial leverage to continue paying their historic dividends. Our error here was to underestimate the sensitivities in such extreme price changes. As a result, we have moved both companies to the 'sale-at-right-price' bucket as they have failed our dividend sustainability requirements. However, as the stocks are trading at such extreme discounts to asset value, we will not be selling them at this price. These two companies alone have cost us 2.3% in underperformance. Any recovery in the deepwater drilling market (which we believe is inevitable over the medium term) should result in significant outperformance and the clawing back of some of the value lost.

Nokian Tyres has been affected by the situation unfolding in Russia. Firstly, events in Ukraine have severely reduced demand; second, the oil price decline has, and will, hit the overall Russian economy hard. Nokian has a sizeable business in Russia. Its cashflow has declined and a decent chunk of its long-term growth outlook has been damaged. The resulting share price reaction is very understandable and a reflection of its current profitability. However, with a very solid balance sheet, robust market shares in all the geographies it operates in and its highly competitive products, we believe the long-term outlook for Nokian still looks attractive should there be a rebound in the oil prices or sustained progress in resolving the situation in Ukraine. This holding cost us 56 bps in 2014.

2) Mispricing

The three companies that we believe do not warrant their share price collapses are Gibson Energy, Methanex and HollyFrontier. These three companies alone account for 2% of the fund's underperformance. We have been adding meaningfully to these businesses in the past few months. Whilst all three businesses are connected to the underlying commodity price, the scale of over-reaction has been fairly extreme.

The clearest example of this has been in Gibson Energy. Most of its business is contractual on take-or-pay contracts with only limited direct exposure to oil in minor divisions. We and the company remain highly confident in steady growth in cashflow and dividend for the foreseeable future. We believe that the share price fall, which has been more severe than for the oil producers, is genuine mispricing. We have added to the holding to maintain it as one of our largest positions.

Methanex has been a holding since inception and a company we know very well. Underlying methanol demand is partially linked to the oil price as some end uses are energy-related. However, methanol is not oil and over 60% of global demand has nothing to do with energy (ie, plastics). So again, we believe the resulting share price fall, which has been way more extreme than for most oil producers, is unjustified and producing a unique opportunity. We have been adding to the holding and it is also one of our largest positions.

HollyFrontier is a US refiner that is currently offering real asset value as well. It is much more exposed to the spreads between different oils rather than the absolute oil price level. The stock is now trading at a valuation far below that of the oil producers and services segments alongside a very healthy dividend. We have been adding to the holding.

Issue number 2 – US outperformance

Country allocation has accounted for approximately 1% of underperformance in 2014, with the underweight in the US and the commensurate overweight positions in Europe and the UK being the key factor.

The fund has always had a healthy allocation towards the US and it has consistently represented the largest geography. However, the fund has been slightly underweight for the last couple of years and this has made a negative contribution due to the size of the outperformance of the market. Since the fund's inception, we have had considerable success with stockpicking within the US; it has been our most successful region by a long distance, and so we feel that letting the fund drift into an underweight position has been a mistake, that is, not playing to our strengths.

Valuations of other regions do look attractive, but they also lack the fundamental strength of the US and therefore we don't believe the valuation differential is extreme. We will only go meaningfully underweight the US again where there are extreme valuation differentials or a real dearth of investment ideas. Not owning Apple in 2014 has also resulted in 50 bps of underperformance. Apple has continued to increase its dividend since its first payout over two years ago, and the stock is under consideration as an investable candidate.

Issue number 3 – Shifting gradually from quality too early

This is partly correlated to issue number 2. It is also much more difficult to measure the contribution of underperformance accurately. Gut instinct tells me it probably represents around 50 to 100 bps. We have monitored our selling track record closely since inception and it has been a considerable strength in previous years. 2014 was less successful in this regard. We sold a cluster of quality holdings in the first half of the year for valuation reasons – Reynolds American, Reckitt Benckiser, Chubb and Compass. All of these companies were operating well and we had no concerns about the fundamentals. These companies have continued to perform well with sustained momentum and to grow into their valuations. Reflecting on this has caused us to think a little bit more carefully regarding selling within the quality bucket. We will be adopting a more staggered approach to selling down positions and will be using position sizes to reflect valuation rather than outright sells. Quality companies will still be sold when valuations reach extreme levels. However, these levels were not reached in 2014 in our opinion and hence the regret in selling the full positions.

Issue number 4 – Macau

Las Vegas Sands and Sands China accounted for approximately 1.2% of underperformance in 2014. We are shareholders in these businesses as we are strong believers in the development of the mass gambling market within Macau. The level of infrastructure spend is expected to lead to further increases in visitor numbers to the area; they have been rising in a robust fashion.

The higher end of the gambling market (VIP) has struggled badly in 2014 due to a focused effort on clamping down on corruption, coupled with possible credit and collateral issues. This segment of the market has been declining for some time and has never been a focal point of our investment case. Whilst clearly not ideal for reported profits in the short term, the structural investment case of developing a huge mass-gambling market in the region remains intact. This should lead to consistent, reliable and sizeable cashflows, which potentially will all be returned to the shareholder. Both companies have already demonstrated shareholder-friendly capital allocation policies. Therefore, we believe that we are being presented with an excellent opportunity to increase our position size and will benefit from the longer term development profile of the company. The stocks' underperformance in 2014 is not irrational as developments recently have not been positive, but investors with a reasonable time horizon are being presented with an attractive entry point.

Summary

So what is our conclusion from all of this? We have made some mistakes in 2014. Drifting away from the US, a core area of strength, was an error we will not repeat unless the circumstances are really extreme. Managing weights down rather than the complete sale of quality businesses is also an area for improvement going forward. Sudden changes in correlations on specific stocks are hard to forecast and any risk model will struggle to overcome this issue. Upon reflection, there may well have been some complacency around the number of companies where oil plays a role regardless of the actual economic effect. Certainly, our sensitivity analysis around our two deepwater companies could have been more robust. We will certainly look to learn and improve from these lessons.

Despite this, we are very excited about the fund's future. There have been areas of mispricing which we are confident will lead to significant outperformance over the medium term. Coupled with this, there are also some companies that are offering highly attractive entry points for those with a sensible investment horizon and therefore we must be brave and buy into the short-term weakness. This period reminds me a little of early 2009 where we had a very difficult three to four months, underperforming by approximately 5%; the actions we took during that period were responsible for the long period of outperformance that followed. There is no change to the underlying process. There is no change to the types of companies that we look for. The ability for the fund to generate significant distribution growth remains. Bring on 2015.

Stuart Rhodes

M&G
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Source of all performance attribution: Factset, preliminary data, as at 31 December 2014, in sterling, gross of fees.