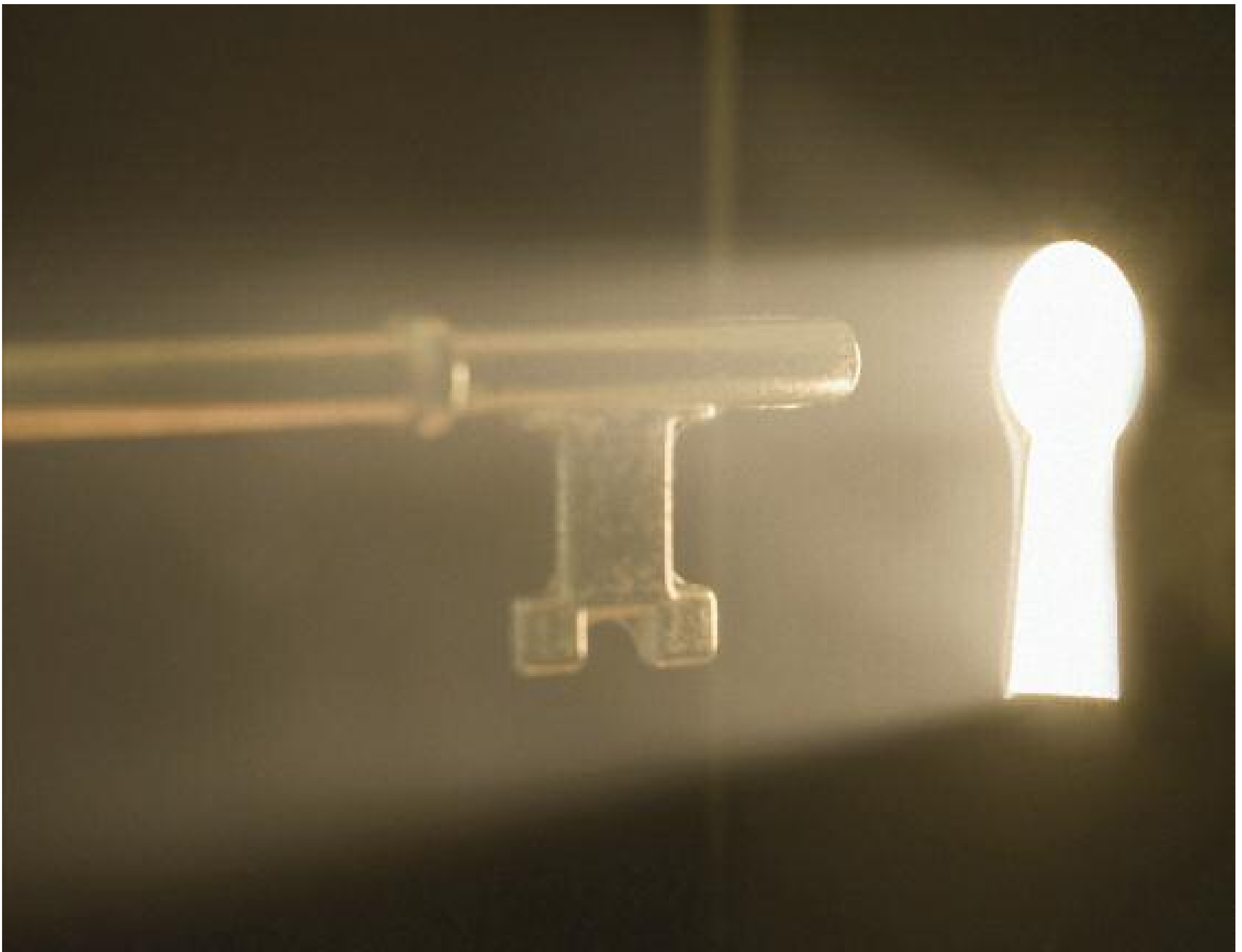
Securing the future

Newton's investment briefing
November 2009

➢ A BNY MELLON COMPANY℠

NEWTON
The Power of Ideas



Performance

Newton exists primarily to increase the wealth of its clients
by delivering strong and transparent investment performance

Perspective

Newton uses a distinctive global, thematic approach to maintain
perspective and to generate strong and durable investment ideas

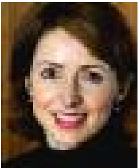
Teamwork

Newton is successful in varied market conditions by using a coherent,
collaborative and enduring team-based investment approach

Consistency

Newton seeks to achieve consistent and stable growth in its business
by maintaining strong investment performance and managing portfolios
that are appropriate to the fulfilment of clients' objectives

Securing the future



Helena Morrissey
Chief executive officer

SECURITY

At our 2009 investment briefing in London in November, we explored a number of topics in relation to the theme of *Securing the future*. Over the last two years, investors have experienced considerable insecurity about the outlook for economies and financial markets. At the briefing, we reflected upon the events of those two years, we considered the lessons that might be learned from the economic and financial-market turmoil that we have witnessed and we explored how investors might secure their futures most successfully.

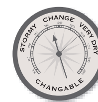
We covered the performance of our various strategies, with a particular focus upon the importance of managing portfolio risk as well as seeking returns. We explained how we are using our evolving investment themes to understand how the world is changing and, in particular, we looked in some detail at our *security* theme and the investment opportunities that it helps us to identify. We also debated the respective merits of real-return and benchmark-aware approaches in seeking to secure investors' futures.

If you joined us in November, I hope that you will find this report a useful précis of the presentations you heard. If you were not able to be there, I hope that you enjoy reading about the topics that we covered. All of the presentations were videoed and are available to view at www.newton.co.uk/securingthefuture

Helena Morrissey

The topic of *Securing the future* is of great importance to all of us. Our focus is (and was at our investment briefing) predominantly upon financial security, but the theme has a number of facets in relation to both financial and non-financial areas, including national security, physical security, identity security, the security of the environment and the security of energy supplies.

All of Newton's themes are to some extent about change. Our global thematic framework is, in effect, our interpretation of the key forces that are driving change in the world, driving how we live our lives and ultimately, therefore, driving changes in asset prices. In 2008, we introduced our overriding *all change* theme, which captured our conviction that the world would adjust, in a rather painful way we anticipated, from an era during which there was a colossal increase in borrowing to one characterised by rather painful 'deleveraging' (repayment of debt).



All Change!

We must acknowledge that, in the short term, the enormous injection of liquidity by authorities around the world has counter-balanced to some extent the deleveraging trend - certainly as far as financial markets are concerned. That liquidity has fuelled a rally in markets (and particularly in lower-quality stocks). In this 'dash for trash', as we might term it, Newton's relative performance has lagged somewhat. Later in this report, we review Jeff Munroe's and Iain Stewart's presentations, in which they expanded on our investment performance and discussed our outlook and the composition of the portfolios we manage.

Developments at Newton

Before handing over to Jeff and Iain, Helena spent a few minutes explaining what the *all change* theme means for her own role. That role is essentially to secure the future of Newton's business, not because that is a worthy objective in its own right, but because our financial security allows us to keep on investing in the talent and resources that we need to perform well for our clients and to develop fruitful, long-term partnerships with them.

In running our business, we are faithful to our investment philosophy and our prevailing views about the economic and financial-market backdrop. Last year, Helena highlighted that *all change* reinforced the importance of perspective, flexibility and focus; and those three elements are very much influencing how we run our business at Newton at the moment. *All change* does not mean that we're jeopardising the essential aspects of how we built our business. In life and in business, we believe that it is critically important to have a strong inner compass, to know where you are going, to know what you are good at and not to be buffeted by the winds of short-term changes; we believe it is inappropriate, for example, to launch new investment products simply because they will sell well.

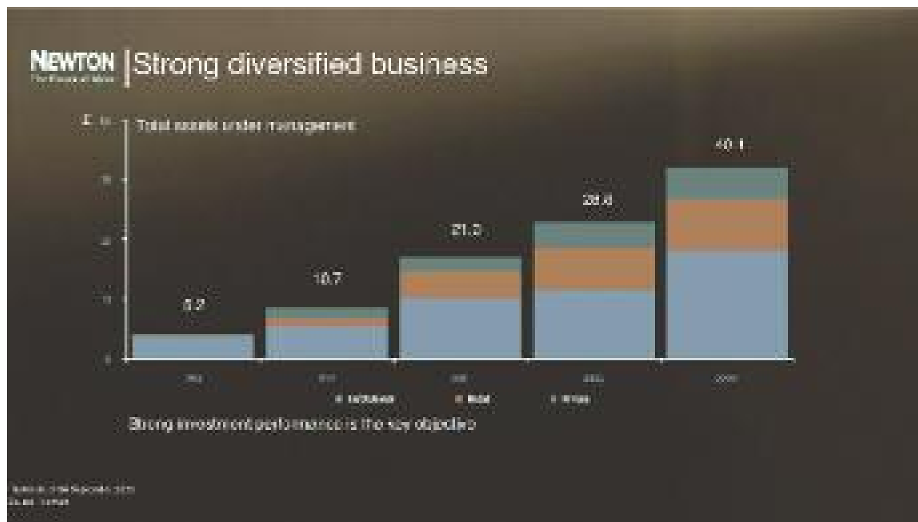
Helena explained that we have not changed our committed, active approach to running global portfolios. That approach will remain at the heart of everything that we do, and the performance of the portfolios that we manage is the yardstick against which our clients should measure us. We continue to believe strongly too that we should align our interests with our clients wherever possible through the use of performance fees (not the now-discredited sort of 'two-and-twenty' model, but rather an arrangement with a low base fee and a performance fee element, which means that we are only rewarded fully when we perform well).

We are not going to change our core investment philosophy of building holistic global portfolios, whether they be multi-asset, equity or bond portfolios, or our process, by which a strong research team and the application of ideas drive the construction of portfolios. Over the past five or six years, we have developed our strategies to offer a number of new solutions to clients' requirements, including 'absolute' or real-return versions of multi-asset funds and less constrained strategies. In these areas we do not have to pay so much attention to benchmarks, and we can invest in securities about which we have strong conviction. We have also expanded our range of equity-income funds.

Some areas at Newton have changed a little more radically, although they represent the evolution of our business rather than any revolution within it. First, we have been diversifying the geographic spread of our business. A few years ago, we made a conscious effort to attract US and Canadian clients, and the development of our North American business is going well, with over half of Newton's institutional business this year being sourced from North America. We have also won a number of large pension funds in the Asian markets, an area in which our themes tend to point to above-average growth potential. We would emphasise that we are not simply rushing around the globe seeking to gather assets, but we are highly encouraged that clients and prospects have recognised both our long-term performance records and the integrity of our philosophy and process.

Our performance culture means that our business performs better if we outperform for existing clients than if we grow assets for our own sake. However, it is preferable that we grow assets rather than lose assets, not least because it is a sign in currently uncertain financial times that our business can thrive and that we can continue to invest in the resources that will help us to perform well for our clients.

We now manage about £40 billion of assets, a total that has grown gradually over the last 16 years or so. The chart below illustrates the respective shares of these assets that are attributable to institutions, retail clients and our private investment management business (incorporating private clients and charities).



We have always applied the same investment philosophy to each of our clients, whether a client is a private client, a charity client, a retail client or an institutional client. This approach is quite unusual in today's world; often a particular business area, such as private client fund management, is 'hived off' and investment managers within such a business may not have the same resources as, say, their institutionally focused counterparts. Newton's private client investment managers use the same investment resources that are applied to the largest institutional portfolios that we manage, including all the output of our career industrial research analysts. We have, perhaps, hidden the light of our private investment management area under a bushel and, to reinforce our commitment to that area of our business, we recently appointed Simon Pryke as head of private investment management. Simon joined us in 1996 as a graduate trainee and, until recently, was leader of our research team and was one of our financials analysts.

Finally, another step we have taken over the last year, in response to some of the feedback that we had received from our clients, has been to publish more of what we describe as 'white papers' or 'thought-leadership pieces' on major investment-related issues, for example the debate that has been raging all year about active versus passive investing. All such written material is available on our website (www.newton.co.uk) and we would encourage you to visit our trustee training centre on the website too. (www.newton.co.uk/trusteetraining)

Helena said that she had hoped there would be progress in the aftermath of the financial-market traumas of 2008 (when there was an even greater degree of uncertainty than there is today) towards a greater degree of partnership between our clients, their consultants and us. She acknowledged that there had been some progress in fostering this spirit of partnership but she suggested that there was still great scope for more fruitful collaboration. In this vein, she reiterated that we would encourage our clients to ask us our view about particular issues and to ask us to write papers on such issues where such input would be helpful. We are committed to helping clients to secure their financial futures and we will do whatever is appropriate to ensure that we do so.

Agenda for the investment briefing

Before handing over to Jeff Munroe for his presentation on managing risk and return, Helena set out the agenda for the rest of the investment briefing as follows:

Managing risk and return – a performance update
Jeff Munroe, Chief investment officer

Understanding how the world is changing – using themes to secure the future (1)
Iain Stewart, Investment manager, multi-asset funds

Understanding how the world is changing – using themes to secure the future (2)
Simon Laing, Investment manager, US funds

Security – investment opportunities arising from this Newton theme
Jeremy Stuber, Global analyst, industrials
Simon Pryke, Head, private investment management

Using themes to manage risk
Rob Stewart, Investment manager, global funds

The respective merits of real-return and benchmark-aware investing
Paul Brain, Leader, fixed income portfolios
Raj Shant, Investment manager, European funds
James Harries, Investment manager, global funds

Managing risk and return – a performance update

Jeff set the scene by discussing the financial-market backdrop. He reviewed the performance of some of Newton's principal strategies during 2009 and over the longer term, and he explained Newton's investment outlook.

Jeff Munroe
Chief investment officer

Market backdrop

Achieving returns by investing in 'risky' assets has been very challenging over the last two years. We have talked to our clients at great length over that period about the volatility evident in the global financial system and we have explained how we see the future taking shape, in terms of both economics and prospective financial-market returns.

The large-scale sell-off in risky assets up to March 2009 was essentially a feature of investors' desire for liquidity. Government bonds and cash found favour, but investors sold riskier assets such as property and equities, with the MSCI World Index (of equities) falling by about 40% from its peak in 2007 to March 2009. Economic and government authorities reacted dramatically, by taking a wide range of measures, including cutting interest rates and reducing taxes.

Equity markets, in common with other risky asset classes, have rallied sharply since their March lows. Non-government bonds have also performed well, a degree of confidence has been restored in credit markets and commercial property markets have also stabilised. The authorities have been highly effective in trying to restore some order in financial markets but, as investors, we must consider where financial markets go from here. This is where history may offer a useful guide, with previous market experience providing some useful lessons.

The US equity market, for example, has a well-documented history and it is instructive to compare the equity-market rally of 2009 with some of the more traumatic periods in US stock-market history. The 1929 rally, for example, lasted 106 trading days and entailed a return of +48.0%, but it was eclipsed by the rally that began in the spring of 1938, which lasted 153 trading days and delivered a return of +59.8%.

The rally in 2009 has been even more significant than anything investors have witnessed before, lasting for 173 days and generating a return of +62.4%. We experienced not only some of the largest falls in markets in 2007 and 2008, but in the wake of those falls we have seen enormous stimulus by authorities around the world, both in terms of scale and in terms of breadth; and so, perhaps it is not a great surprise that we have seen one of the largest equity-market rallies of all time. In short, financial markets have been extremely volatile over the last two years and that volatility has been highly challenging for investors.

Sectoral performance in equity markets during 2009 was particularly changeable. In the first quarter of the year, leadership in markets was concentrated in some of the more stable, defensive areas, and the financial sector came under continued pressure amid persistent concerns about financial solvency and viability. In the second and third quarters, however, there was almost a complete reversal of fortunes with the financial sector, having been the worst-performing sector up until the first quarter, being the best performing area as insolvency risk was greatly diminished. In this context, the shares of companies in the financials, basic materials, industrials and technology sectors (namely the more cyclical areas of the market) performed most strongly.

Performance of Newton strategies

Against that backdrop, a number of our strategies have performed very well over the last year, and some have lagged benchmark returns a little. Over one year, three years and five years, our balanced composite has performed very well in relation to its benchmark. The Real Return strategy[1], which we launched a little over five years ago, and whose objective is to outperform Libor plus 4% over what we call a market cycle (a three- or four-year period), has also generated strong returns over each of those periods.

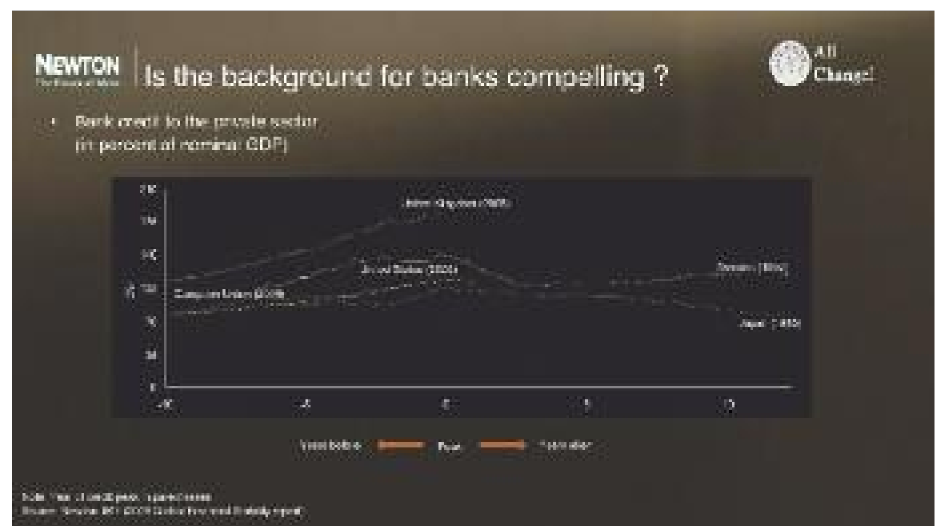
In the UK Opportunities strategy, performance over the last year has been a little disappointing, owing principally to the concentrated nature of UK equity market performance over the year. However, the longer-term returns (over three and five years) have been very strong indeed. Our global strategies have performed well over longer time periods and, despite the highly volatile backdrop in equity markets, our Asia ex Japan and European strategies have also delivered attractive long-term returns.

Our global dynamic bond strategy, which is invested with the intention of generating attractive absolute returns, has done well since its inception in 2006. In the strategy, we seek to take advantage of opportunities in a broad range of bond markets rather then being pigeon-holed either in sovereign or corporate debt, and we believe that the flexibility of this approach is going to be very important in achieving attractive fixed-income returns in the years ahead.

1 Please see back page for composite definitions

The background for banks

In recent years, we have been cautious not only about the economic background as a whole, but also about the outlook for the financial sector, given our concerns about both the over-borrowed nature of the consumer in the West, and also the way in which many financial companies have been very aggressively managed. However, it is prudent to keep this stance under review and to ask whether we should be featuring banks more prominently in our clients' portfolios and whether we should temper our concerns in particular about the prospects for Western banks.



As displayed in the above chart, Jeff discussed the build-up of private-sector debt in the US, Europe and the UK up to 2008 with reference to the inflating of previous debt 'bubbles' in Japan (1993) and Sweden (1992). In Japan, there was an enormous expansion of credit to the private sector in the years preceding the peak in borrowing (as a percentage of GDP) in 1993, after which credit to the private sector fell significantly as the banking sector deleveraged. In the wake of that reduction in credit and financial-sector deleveraging, banks performed very poorly and the Japanese economy remained sluggish. In Sweden, the peak in private-sector credit in 1992 was followed by a number of years of retrenchment by banks.

The expansion of credit in the US and Europe in recent years has not been quite as extreme as that which occurred in Sweden prior to 1992 but, nonetheless, private-sector credit in both regions now exceeds 100% of GDP, and it seems there is some way to go before US and European banks have made the necessary adjustments in the aftermath of the credit crunch. The situation in the UK is even more extreme and the banking sector, which is very large in relation to the size of the economy, has much work to do to repair its balance sheets.

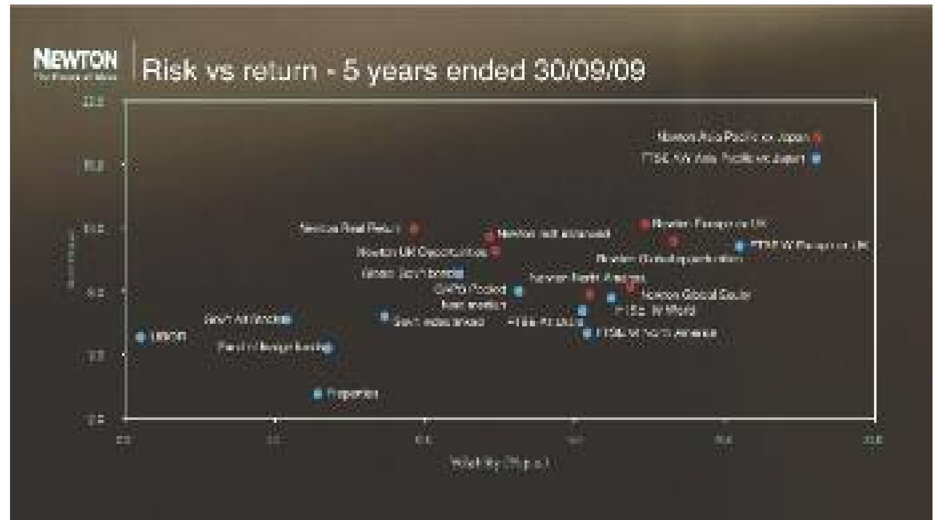
The experiences of Japan and Sweden illustrate that deleveraging is inevitable following the bursting of credit bubbles, with growth in lending in the aftermath of credit crises generally being weak for years and bank margins typically remaining under pressure (especially when interest rates are low). We suggest that the Western economies are likely to undergo quite a protracted 'bad debt' cycle and we continue to believe, therefore, that there are better investment opportunities than exist in the banking sector. In most cases, therefore, exposure in clients' portfolios to the developed-world banks remains quite light. However, portfolios do have plenty of banking exposure in the Asian and the emerging-market areas, where we think prospects are generally much better.

Longer-term perspective

The last ten years in equity markets have not been all that encouraging, and some investors have been asking whether they should be looking to invest away from equities; and investors have embraced a range of 'alternative' investment classes in recent years. In the 1980s and 1990s, simply investing in line with equity indices was a profitable and cost-effective thing to do. Today, we continue to regard equities as highly attractive to long-term investors, but we believe that one must be very selective and disciplined in one's approach to equity investment. Over some periods, it is likely that the returns from equity investors' portfolios will diverge (perhaps significantly) from the returns of benchmarks, but we believe it is vital for investors to maintain perspective and focus in seeking to meet their long-term objectives.

Risk versus return

Over the long term, it is critical to consider returns in the context of the risks taken to achieve them. Over the last five years, we have seen pronounced volatility in financial markets, with share prices rising significantly between 2005 and 2007, falling until March 2009 and rising sharply thereafter. In the chart over the page, we show the performance of a range of our strategies against the performance of a number of relevant indices and cash (1-month Libor). Libor has 'returned' 3.8% per annum over this five-year period and of course it appears as the least risky place to be because cash is not a volatile instrument. Over five years, the markets of the Asia-Pacific region have been the strongest of the major regions, with about an 18% return, but those markets have been the most volatile. To the extent that investors are willing to 'buy' volatility, they have been well-rewarded by the return from Asian equities.



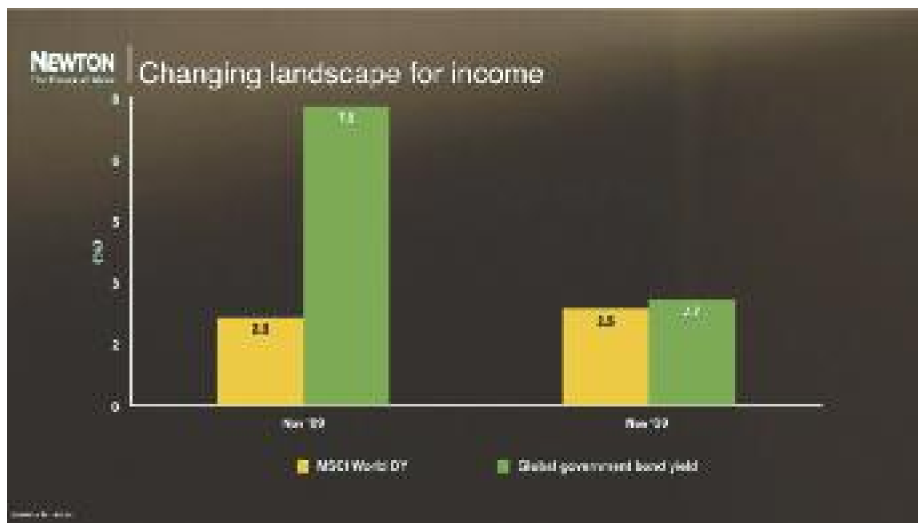
Pension fund investors are likely to have different attitudes towards volatility, depending on whether their scheme is a defined-benefit scheme (and depending, in turn, on the maturity profile of such a scheme) or a defined-contribution scheme. Newton's oldest strategy, the balanced strategy which features the Newton Exempt Fund, seeks to achieve a compromise between risk and return. The strategy has achieved a strong return over the last five years with less volatility than has been exhibited by its benchmark, the Caps Pooled Fund median.

Our newer strategy, the Newton Real Return strategy, which is less benchmark-focused and seeks to obtain a return versus cash, has done even better. It has returned more and has been even less volatile than the balanced strategy over the five-year period. We think that real-return strategies should be quite appealing to investors in the years ahead and we are continuing to develop our range of services in this area. We recently launched a global real return strategy in the US and we are looking at other opportunities in real-return investing.

The chart shows also the returns and volatility readings of a number of our other strategies, including global equities, UK Opportunities and North American, European and Asia-Pacific equities. In summary, over the last five years, which have been particularly challenging in markets, we have in most disciplines achieved excess returns, often with better than market levels of volatility.

The importance of dividends

We are asked frequently where, against a backdrop of great uncertainty in economies and financial markets (and following the significant bounce in asset prices), clients should invest their funds. At the investment briefing, Jeff considered some of the basic building blocks of investment in seeking to address this question, with a particular focus on yield. He began by looking at the dividend yields available on a range of asset classes and noted that in November 1989, 20 years ago, the yield on the world (equity) index was about 2.3%, compared with a 7.8% yield on global government bonds. Owning government bonds over the last 20 years has indeed been beneficial as the economic background has been relatively benign, inflation has stayed low and interest rates have declined.



Today, the MSCI World Index of equities is yielding about 2.5%, little different from that which it yielded 20 years ago. The big difference, however, is that global government bond yields are now yielding only about 2.7% in aggregate. That figure does include Japan and, as investors are generally aware, Japanese government bonds are very low-yielding; if one removes the Japanese component of the global bond index, the average yield from a basket of global government bonds is about 3.5%. Nevertheless, investors are receiving little more yield from government bonds than they are from equities. The future is inevitably uncertain (arguably more so now than usual) in terms of the prospects, for example, for economic growth and inflation. However, equities are a 'real' asset class, and over time they should provide investors with some kind of protection from the threat of inflation.

We have been focused for a number of years upon running equity-income-oriented investment strategies. Our Global Higher Income Fund, investing (as its name suggests) in equities around the world, yields about 4.7% currently. It holds high-quality companies, which are thoroughly researched and which accord with a number of our investment themes. Our Asian Income Fund, which gives investors exposure to one of the world's most dynamic regions, yields about 5%; and our European Higher Income strategy also yields about 5%. Our UK Higher Income strategy, owing to the dividend-paying propensities of UK companies, currently yields about 7%. Each of these strategies provides investors with an attractive opportunity, we believe, to harness dividends in the pursuit of attractive total returns from equities.

One of the notable features of the recent market environment is that many of the sectors that have led the equity-market rally do not have very attractive dividend yields. Many of the highly cyclical sectors, in fact some of the areas in which dividends have actually been cut, have been among the strongest performers during 2009. As a consequence of the less ebullient performance of some of the very stable growth companies, those companies are offering very attractive dividend yields in the context of the last 20 years as a whole.

Identifying opportunities via our global thematic approach

In conclusion, Jeff argued that, despite the fact that we have witnessed one of the strongest stock-market rallies in history since March 2009, equities remain an attractive asset class, particularly in relation to areas in which dividend yields are appealing. During the market volatility of recent times, the performance of Newton's strategies has not been as outstanding as we might have hoped in the short run, but we believe we are very well-placed to continue to perform well on behalf of our clients in the longer run. There are some excellent opportunities in financial markets, but it will be imperative for us to maintain a discerning approach, via our disciplined, global thematic philosophy and process, in order to identify those opportunities to good effect on behalf of our clients.

Understanding how the world is changing – using themes to secure the future – part 1

Iain explained how we use investment themes to identify the opportunities to which Jeff alluded and to secure the future by meeting our client's investment objectives.

Iain Stewart
Investment manager – multi-asset funds

Using themes to identify opportunities

The financial world, as everybody knows, is subject to a great deal of 'noise'. We believe that there is generally far too much emphasis on what is happening right now, this minute, for example in relation to companies' earnings figures and economic data. In reality, it is the long-term, underlying trends in economies, markets and industries that are important for pension schemes and other long-term savers.

Traditional approaches to investment tend to revolve around making forecasts. At Newton, we have tended to avoid making forecasts because we believe that forecasting is rather unreliable. Perhaps we are just not that good at it, but we

are not necessarily sure that anyone else is good at it either. Another favoured method of active investment management has been to build models of the past and to extrapolate their findings into the future. Clearly, if the future does mirror the past, such models may work effectively, but at points at which the characteristics of economies or financial markets change radically, as they have over the last few years, those models are prone to fail. The key facet of our themes is that they are themselves dynamic, and they should ensure therefore that we are not taken by surprise by changes in the world.

Our themes also allow us to narrow the universe of investible securities. There is a large amount of information available to investors about economics, financial markets, industrial sectors and so on. However, the key benefit of our themes is that they allow us to make sense of that information and to take the perspective necessary to identify the specific stocks that allow us to generate returns in the long run.

Together, the themes produce a kind of roadmap of where we, as investors, are going, and Iain turned next to an overview of what we think that roadmap is telling us at present.

Each theme highlights areas of risk and areas of opportunity. Among the most influential ideas in the longer term are those captured by our *population dynamics* theme. Although demographics change, and vary between different economies, the world as a whole will be beginning to age at some point during the next decade. Japan may well be showing the way for what happens to economies when the working population starts to decline as a proportion of the total population, particularly in Western economies that have a significant emphasis upon 'pay-as-you-go' systems for areas such as healthcare, social security and pension provision.

A major realignment in world activity is underway at the moment, as highlighted by exchanges at the latest G20 meetings. We call this idea *global realignment*, and among the key trends that we observe within it is the requirement of the developing world to consume more and to be less reliant on trade for economic growth. The developed world, by contrast, must consume less and save more. As this realignment takes place, there are clearly implications for supply constraints in natural resources, particularly in relation to the use of fossil fuels, and for environmental concerns more broadly. Clearly, these implications are going to give rise to challenges for both policymakers and investors in the years ahead.

Among the key themes that have been affecting our investment management in the short run has been *all change*. This theme sounds like rather a radical idea, but we believe actually that it is a fairly reasonable one. We contend that the credit crisis was probably telling the Western world that it had tested the limits of credit-fuelled activity. Both the supply of, and the demand for, credit are likely to have peaked for the foreseeable future, and we expect savings to increase in relation to consumption in the developing world which, in turn, should lead to slower growth. Importantly, we view these changes as amounting to a structural adjustment, rather than as a normal cyclical event, and we anticipate that the adjustment will take place over quite a protracted period.

One notable consequence of this adjustment to an *all change* world has been an increase in the levels of government intervention in economies (in the context of what was becoming already a more managed global economy); and there are important implications associated with this greater intervention. The greater role of governments is almost certainly going to prove to be costly and we are seeing that clearly in relation to fiscal policy, particularly in the UK. Intervention is likely also to lead to distortions, to mixed signals within the economy, potentially to volatility in economies and financial markets, and possibly to the misallocation of capital. Certainly there will be unintended consequences of policy decisions, and such consequences are key ideas that are captured in our *more government* and *uneconomic growth* themes. Another unintended consequence of the state's greater involvement in economic activity could well be inflation. We do not necessarily see inflation pressures in the near term, but printing money makes inflation likelier in the long run.

Given the challenges that exist in the Western-world economies, global growth as a whole is likely to be suppressed because, notwithstanding the strength evident in parts of the developing world such as China, the bulk of global demand still derives from the Western economies. A slower-growth world, characterised by greater volatility should, in simple terms at least, mean that investors have a greater appetite both for areas, rather obviously, in which growth is apparent, and also, perhaps, for stability in returns, cash flows and dividends.

There is a range of areas in which we can see growth in the world, for example technological areas that relate to networking and the internet, and medical technology, in which phenomenal products continue to be developed. The most obvious area of growth is the developing world, and we have maintained our *developing economies* theme for a number of years. We are highly focused on the beneficiaries of domestic consumption in the developing parts of the world, on infrastructure, the attractions of which are identified in our *construction & reconstruction* theme, and also on developing-market financial companies. Clearly, however, these ideas are not lost on markets, as illustrated by the very sharp moves that we have seen in markets during 2009. Developing-world equity markets have performed extraordinarily well in recent months and it may well be a feature of loose policy globally that bubbles develop and speculation intensifies in those markets. We need therefore to be very selective about the particular stocks that we own.

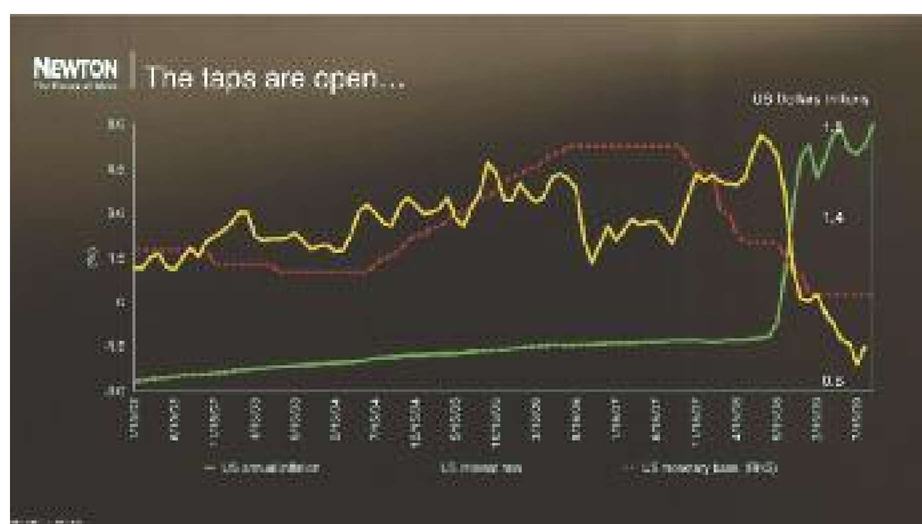
In the context of subdued developed-world consumption, we are favouring currently the beneficiaries of 'lower-end' consumer activity and companies with exposure to less discretionary spending; Simon Laing discussed the ideas associated with our *low-end spend* in more detail later in the briefing. Elsewhere, we see security-related sectors potentially as areas of stable cash flows, and we like a number of industries in what was considered to be the old economy.

Low-End Spend

More generally, we are drawn to the attractions of large companies and we have framed these attractions in our *large-cap laggards* theme. There are some significant opportunities for investment in larger companies that offer strong cash flows, high returns, strong market positions and historically attractive valuations, but which have failed to keep pace with the broader appreciation of share prices. We believe that, if markets continue to rally and should investors be motivated to move out of cash and into ‘risk assets’, it is likely that large-cap stocks will begin to perform better in relation to the market as a whole.

Our outlook

In the near term, it seems clear that the economic backdrop, and the fiscal and monetary policy responses that are being made against that backdrop, are dominating events in financial markets. In the wake of the recession in the world’s major economies, inflation has collapsed and, although authorities in those economies have lowered interest rates substantially, they have had to resort also to other measures. Among these measures has been an enormous enlargement of central banks’ balance sheets. In the US, this process of balance-sheet expansion is referred to as ‘credit-easing’ and in the UK it is termed ‘quantitative easing’; but effectively it amounts, whatever the parlance, to the printing of money and the expansion of the amount of ‘raw money’ in the financial system. It was deemed necessary because the ‘shadow banking system’, which previously had been very adept in creating credit, had collapsed.



The point of these policies was principally to provide liquidity and to ‘un-gum’ the financial system, and that goal seems to have been realised relatively effectively. Policymakers wanted to improve confidence, to improve risk appetite and importantly, more latterly, to ensure that credit influenced economic activity directly on the basis that economies do not grow when credit is contracting. It is questionable whether policymakers’ initiatives have had a substantial impact on the amount of credit available in the economy, but what we have certainly witnessed is the effect of increased liquidity in financial markets, and in ‘risk assets’ in particular.

The correlation matrix below shows the correlations of a range of assets - equities, government bonds, high-yield debt, emerging-market bonds, property (UK real estate investment trusts), industrial metals, gold and oil. The blue boxes show that correlations since 9 March 2009 (when equity markets reached their low points) have been broadly positive and high, indicating that just about every asset class has been rising in tandem. This is not a coincidence; the key factor in the simultaneous rise in the prices of diverse assets has been liquidity. For those who have been running multi-asset portfolios during 2009, there really have not been many benefits in being well-diversified; government bonds have been the only major asset class to have provided negative correlation with other types of asset.

Interestingly, the correlation between risk assets and the US dollar has been very strong; as the prices of risk assets have risen, the US dollar has fallen. Very low US interest rates have allowed investors to borrow dollars and to secure a higher yield by buying just about any other asset. As a result, a ‘carry trade’ developed rapidly in the aftermath of the credit crisis towards the end of 2008, which seems remarkable but appears to be testament to the success of policymakers’ actions to increase investors’ risk appetite.

Amid this greater risk appetite, lower-quality stocks have tended to do better than higher-quality ones. The chart below shows the returns from US equities during 2009 (up until our investment briefing), with returns arranged by Standard & Poor’s ratings of companies’ earnings quality. The stocks of companies with the highest-quality earnings are shown on the left, and those with the lowest quality are shown on the right; and it can be seen that the returns from lower-quality companies (indeed for those that were previously the closest to bankruptcy), have been very strong. Better-quality companies have participated in the market rally to a much lesser extent.

Clearly, improving confidence is good for investors' fortunes, but we would suggest that this sort of pattern has moved beyond simply an extreme bounce from highly 'oversold' levels. What we had begun to see at the time of our investment briefing were signs that investors were becoming more confident that economies were 'fixed' and that they expected a return to a more normal cycle.

A 'normal' cycle is one in which both consumption and capital expenditure rise and in which leverage (borrowing) increases. However, such a pattern is at odds with the ideas inherent in our *all change* theme, and it is important therefore for us to keep reviewing our ideas in order to check that we have not got *all change* all wrong. In reviewing this question, Iain argued that improved liquidity, risk appetite and confidence are not sufficient alone to put economies back on an even keel. There remain some obvious headwinds to economic expansion, not least the existence of an enormous debt 'mountain' in some of the Western economies. Iain showed the chart below, which dates back to 1870 and illustrates the enormous growth of total debt (of the private sector and the government combined) in the US economy in recent years as a proportion of US GDP.

We are not suggesting that there will be a repeat of the 1930s, in which the US economy entered its Depression, but the prevailing indebtedness of the US economy is extreme in nature. By cutting interest rates to ultra-low levels, the authorities have been able to engineer a reduction in the burden that the servicing of this debt causes, but the debt has not gone away. Importantly, if the accumulation of debt implies the bringing forward of consumption (and if saving implies the deferment of consumption), it can be argued that there has been more consumption, and perhaps higher asset prices, in Western economies than there 'should' have been. We do not believe there is sufficient pent-up demand to bring about another debt-driven cycle and we anticipate at this stage therefore that a conventional leverage-driven cycle is implausible.

The chart on the left [below], which shows the level of total domestic borrowing in the US economy, as well as changes in private-sector, financial and governmental borrowing, supports the idea that there is little pent-up demand for debt. It illustrates that stimulus policies are serving really just to counteract the inexorable deleveraging of the financial and household sectors. The chart covers the period up to the end of the second quarter of 2009, which was the most recent period for which official data was available at the time of our investment briefing, but more recent data confirmed that this credit contraction was continuing. Meanwhile, personal savings rates had begun to rise, as illustrated, for example, in the chart on the right [below] of the situation in the UK. We anticipate that these savings rates will continue to rise during 2010.

In short, an adjustment in borrowing and saving does appear to be taking place in the consumer-driven Western economies, and the types of policies that the authorities have put in place have really only been able to slow that adjustment rather than to prevent it altogether. Slower borrowing activity and rising savings do not provide a particularly promising backdrop for those Western economies.

Investment strategy

In terms of investment strategy, we suggest there are some strong headwinds to economic activity and that interest rates are likely to stay low for a protracted period. We think that talk of 'exit strategies' from highly accommodative policies by the world's major central banks is probably premature, despite the fact that investors are talking about them following an improvement in confidence and the strong appreciation of asset prices. Investors are likely to continue to search for yield and for return against a backdrop of very low interest rates and, on that basis, risk assets can continue to perform well, albeit that the prices of the very riskiest assets are unlikely continue to rise as they have hitherto.

As to the prospects for financial-sector investment in particular, we think it is unlikely that the banks will be as profitable as they have been in the past; after all, deleveraging (the repayment of debt) is set to continue, banks are likely to require further equity in order to recapitalise sufficiently, and the banking industry might well be heavily regulated in the years ahead. We do, however, favour financial companies selectively in some parts of the world, particularly in some of the developing economies.

In general, we favour large-cap businesses in stable areas that exhibit strong cash-flows and attractive dividend yields. As Jeff indicated in his presentation, there are some very appealing high-yielding investment opportunities at present and we believe that stocks with strong yield characteristics could perform very well as returns from equity markets 'broaden'. We continue to favour exposure to the developing world, but it is important to be selective in investing in developing markets. In China's equity market, it is possible that investors are driving the largest asset-price bubble that has ever been seen. China-related investment has its merits, but we need to be discerning in trying to identify those merits. We do not need necessarily to invest in China directly; there are many ways to take advantage of Chinese growth by investing via the beneficiaries of that growth elsewhere in the world.

Similarly, in commodity markets, we would make comparable observations. There are clearly some strong drivers for higher commodity prices, including supply constraints, strong demand and environmental-related changes. Indeed, given the policies that are being pursued by authorities in the major economic regions, including very low interest rates, competitive devaluations and monetary debasement, investors are likely to continue to commit capital to real assets including commodities. Again, however, we are selective about the areas in which we invest; we like particular parts of the energy sector, we like agriculture, and we have some exposure to gold. Existing trends can continue to support each of those areas, but we are mindful too of the risks that exist in relation to them.

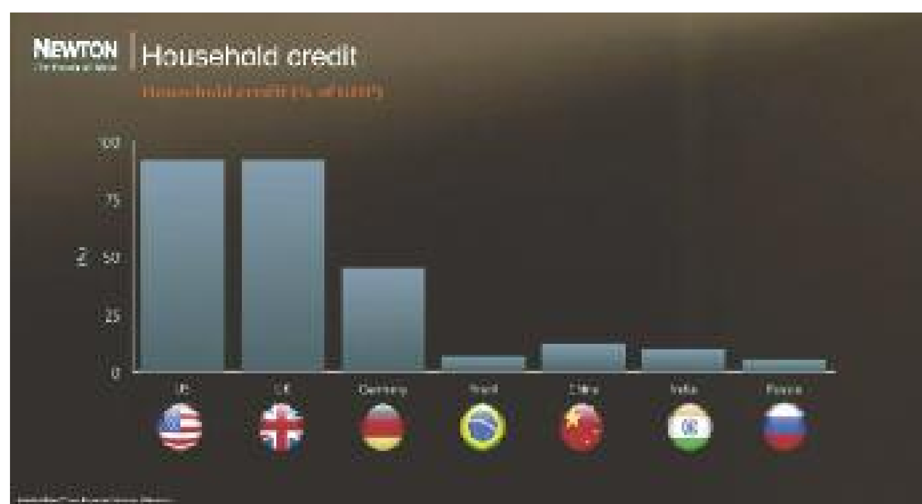
Understanding how the world is changing – using themes to secure the future – part 2

Simon expanded on Iain's presentation about our use of investment themes by discussing two of those themes in more detail: *low-end spend* and *developing economies.*

Simon Laing
Investment manager – US funds

Low-end spend

We introduced our *low-end spend* theme in 2009. It came about as we thought about the implications of the large increase in consumer debt in the West, as well as the consequences of the growing income disparities that we see between high earners and low earners around the world. The credit crisis has been the catalyst for consumers to take responsibility for their finances, or in some cases, for their banks to take responsibility for their finances, but it has also been the catalyst for governments to address this large earnings 'gap' that has opened up. The chart below is a snapshot of household credit in the US, the UK and Germany versus that in some their emerging-market counterparts (Brazil, China, India and Russia) as a percentage of GDP. It shows that, as consumers in the US and UK have embraced debt-financed spending at the sacrifice of their savings, credit in those countries has reached highly elevated levels; meanwhile, the situation in emerging markets is much less extreme.



Simultaneously, savings ratios (the percentages of disposable income that households save each year) in developed economies have generally fallen. The US savings ratio, for example, has fallen since 1960 from a range of about 8% to 12% to 2% in 2008. The picture is similar in the UK and in several countries in Europe. We anticipate that household debt levels will 'normalise' at some point and that savings ratios will start to rise towards 8% or 10% at some point, and this is going to have significant implications for patterns of spending. In short, consumers are going to be ever-more thoughtful about each penny that they spend.

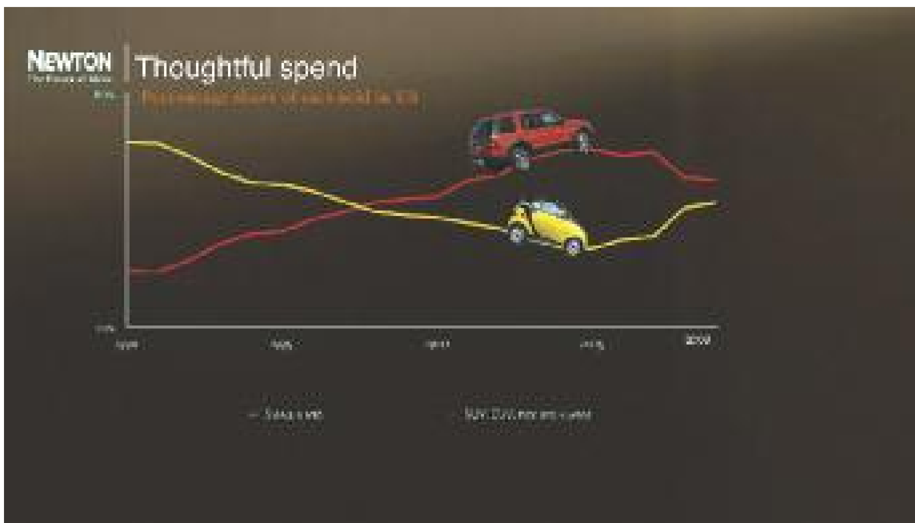
Another area of 'excess' that has grown in recent years has been income disparity. In the US, for example, the average lowest-quartile salary has risen only moderately over the last 40 or 50 years. By contrast the mean of the top 5% of salaries in the US has grown by considerably more. In fact the ratio between those two income groups now stands at an all-time high of seven times. In other words, 'high' earners earn seven times more than 'low' earners, and that is something that has been very sensitive politically.

We expect to see a stepping-up of political measures aimed at reducing the income 'gap'. In the US, we have already seen the rolling-out of a number of programmes which are intended to bolster low-end incomes. The Obama administration has introduced, for example, an $8,000 tax credit for first-time homebuyers in the US, and the US 'food stamps' programme has been extended significantly. In the UK, the government has sought to close the income gap principally via higher taxes on higher earners, and the top rate of income tax has been increased to 50%.

The accumulation of high levels of debt has been principally a Western phenomenon, but income disparities are, nonetheless, global issues. This was evident, for example, in the food riots that took place during 2008 in a number of developing economies, including India, Bangladesh, and Egypt as lower earners struggled to meet the costs of everyday staple food. Amid rising global food prices, a number of governments took steps to contain the extent of price rises, with China, for example, introducing tariffs on rice exports to trying to control the price of its base commodity food for poorer parts of the population.

These trends, as debt levels are normalised and as income disparities are addressed, are going to have profound implications for patterns of consumption. One of our consumer analysts coined the phrase 'thoughtful spend', which captures the notion that, in general, unnecessary spending is going to be curtailed. With households committed to paying down their debts and increasing their savings, they will have to prioritise how they deploy their disposable income. We believe that we will see a cultural shift towards frugality and we are starting to see examples of that shift already.

The chart below is a snapshot of the US car market since 1990. The red line shows the market share of large vehicles, including sports utility vehicles ('SUVs') and large pickup trucks. During the 'glory days' of spending, the increase in market share of these large vehicles came very much at the expense of small and mid-sized cars, whose market share fell sharply. Over the last two years, however, the pattern has begun to reverse. Most people can no longer afford to drive 'gas-guzzlers' and, perhaps more importantly, people no longer want to be seen to do so.



Simon discussed next a number of trends in household spending and suggested that 'going out is out; eating in is in'. In the US, grocery store sales have been outpacing restaurant sales for 15 consecutive months - the longest period on record. This trend is consistent with our idea that consumers are prioritising (and will continue to prioritise) their expenditure. Households are recognising the areas in which they need to cut back and companies are reacting accordingly. Among UK companies, M&S and Waitrose, for example, are running promotions aimed exactly at meeting consumers' more budgetary requirements. Similarly, Lovefilm, which specialises in DVD rentals by post, is doing well at present; in the mobile phone market, prepaid mobile phone subscriber trends are much stronger than monthly contract spends; and Ebay's gross listings are starting to accelerate once again. More laterally, the trend towards frugality is arguably showing up in rising rates of shoplifting. According to an article in the Times in November, UK shoplifting is up 20% on a year ago to a total of £5 billon over the year.

While the *low-end spend* theme has already started to emerge, we believe that it has much further to run. The scale of debt evident in a number of Western economies will not be reduced in a matter of months; the process of 'deleveraging' is likely to take many years. Furthermore, consumers' propensity to spend is likely to be lowered by the imposition of higher tax rates around the world, and unemployment is high and likely to remain so for the next few years. Capacity utilisation in the economy is low, meaning that there is likely to be little pressure on employers to raise wages; and we think there is a good chance that food and energy price inflation will start to escalate, which would be a further thorn in the side of consumers.

As investment managers seeking to capitalise on this trend, we are looking for the beneficiaries of these changing patterns of household spending. The areas that we want to avoid are those in which consumers are most likely to cut back, for example mid-tier department stores, restaurants, some hotel stocks, and leisure areas such as gyms in the Western economies; at one gym in the City of London, we understand that membership has fallen from a peak of 8,500 to just 5,500 in November. In this challenging environment, some companies will thrive, and consumers will continue to spend in a number of areas. In addition, we need to take account of the intervention of authorities who are intent on supporting lower-end earners, for example in the form of subsidies. Companies like WalMart, Aldi and Primark, for example, are doing extraordinarily well. In the US, Netflix, which is the publicly listed equivalent of Lovefilm, is also thriving.

One stock in the US that we like in particular is Kroger, one of the largest supermarket operators in the US. Their 'traffic' data, the number of people passing through their doors, has already started to increase dramatically. We look at Kroger, as we do all our investments, in the context of its global peer group and there are a number of reasons why we favour the stock in particular at the moment.

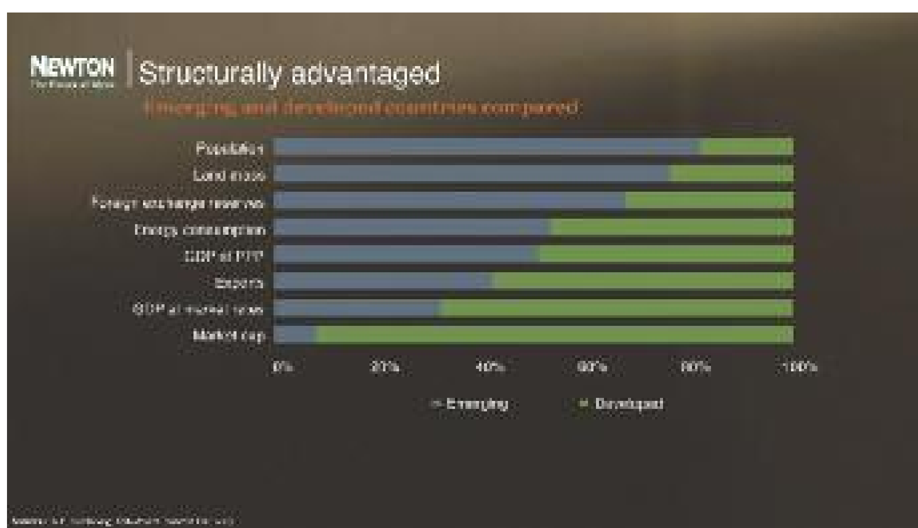
Kroger's own-brand products account for about 25% to 30% of its total sales. At Tesco (whose own brand is 'Tesco Value') and Sainsbury's (who sell 'Taste the Difference'), by contrast, the penetration of own-brand products is more like 50% to 55%. We think that, as consumers start to recognise value in own-brand products in the US, penetration rates at Kroger can improve. Own-brand products provide much higher profit margins than typical third-party products, meaning that the benefits of increased penetration fall effectively to the 'bottom line' (profits) of the supermarket operator. Kroger should also benefit from the increased issuance of food stamps in the US. About 11% of the US population are now on food stamps, a proportion that seems quite remarkable, and the food stamps programme, previously worth $35 billion, is being expanded by $20 billion under the Obama stimulus plan. There are not many stores in which the stamps can actually be redeemed, but supermarkets are among those in which they can, and this should be to Kroger's benefit.

Valuation is also important in weighing up the merits of investment opportunities. Kroger is trading on a price-to-earnings ratio of 11, which compares favourably with its global counterparts including, for example, Carrefour, Metro and Sainsbury's, all of which trade at about 14 to 15 times their earnings. In summary, Kroger is well-exposed to a theme that we think highlights great opportunities and, when we compare the company to its global peers, it is very attractively valued.

Developing economies

The second theme that Simon talked about was our *developing economies* theme, which has been in place at Newton for several years. At the investment briefing last year we talked at length about the structural opportunities in both Brazil and China, and on a show of hands the audience voted that Brazil was marginally the more attractive investment opportunity at that time. The structural opportunities in those markets are still very strong.

In the chart below we compare emerging and developed countries in the context of a range of different factors, including population, land mass, foreign-exchange reserves, energy consumption, output, exports and stock-market capitalisation. The developing economies have, for example, about 80% of the world's population and approximately 75% of the world's land mass, and they account for roughly 50% of global GDP at purchasing-power parity. Perhaps the greatest opportunity in developing markets relates to market capitalisation; developing economies still account for only 15% of the world's total market capitalisation.



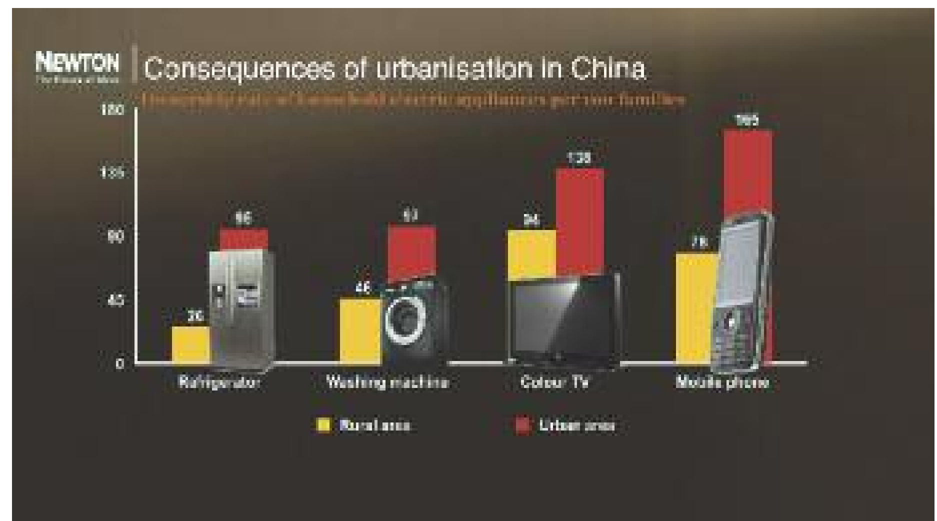
These opportunities have not been lost on investors. Whereas in November 2008, the world was in the midst of a global credit crisis and 'risk asset' markets had weakened significantly, risk appetites have returned with a vengeance in 2009, with investors pouring money into developing markets. As a result, while developing markets such as the US, the UK and Europe had risen by about 18% to 20% during the year (to the time of the investment briefing), 'BRIC' markets had generated much stronger returns. China and Brazil, for example, were up by 75% to 80%.

The appeal of developing-market equities has led to their valuations rising strongly. In terms of global price-to-book ratios, for example, investors have 'bid up' developing markets to valuations that actually exceed those of many Western markets; not often has that been the case historically.

It is at times such as these that investors need to tread carefully; we think that it is imperative that we select stocks, rather than markets, in seeking to meet our clients' investment objectives, and this is where our themes and our research really come into their own. We use our themes to guide our analysts as to where to try to identify stock-specific opportunities. For example, our global consumer staples analyst, Tracey Dominick, has recently been in China, where she has been seeking ideas that might be slightly 'off the beaten track'. By that, we do not mean small, illiquid stocks, but rather opportunities that may have been misunderstood or overlooked by other investors and in which we believe we can add value.

In relation to China, we are all aware of the very powerful position that the country is in demographically at present. China has an enormous population which is undergoing considerable 'urbanisation' as vast numbers of people move from rural communities into the cities.

Many investors obtain exposure to China's urbanisation through investing in infrastructure and construction-related companies, but we prefer to look at the wider implications of urbanisation. As populations urbanise and incomes increase and, as people move to cities, they gain access to goods and services that previously they are likely never to have had; with rising incomes, urban consumers tend to buy 'white goods' for their apartments.



Rates of ownership of refrigerators, for example, are much higher in Chinese cities (where 'penetration' is 95%) than in rural areas (where it is 26%). In turn, when consumers have a refrigerator, they start to consume fresh food; previously they had no storage capability to do so. Specifically, when people move from rural areas and their incomes increase, they start to consume more fresh protein as part of their diet.

One company that Tracey is particularly excited about is Shenguan Holdings, a sausage-casing company that is a significant beneficiary therefore of consumers' greater preference for fresh meat. Compared with its global peer group, Shenguan is attractively valued, being priced at a clear discount to many of its competitors elsewhere in the world.

In summary, it seems to have become a consensus opinion that developing economies offer some very attractive opportunities to investors. While we concur with that opinion, we believe it is essential for investors to be discerning and to select specific, well-researched stocks rather than rely on the attractions of markets as a whole. Our global thematic approach and our fundamental, proprietary research are invaluable in allowing us to identify those specific opportunities, and thereby to meet the investment objectives of our clients.

Security – investment opportunities arising from this Newton theme

Simon explained how Newton's analysts work to generate the ideas to which Iain Stewart and Simon Laing referred in their presentations; and in a pre-recorded film Jeremy Stuber explained how he identifies investment opportunities in the aerospace and defence, automotive and industrial sectors by meeting companies.

Simon Pryke
Head, private investment management

Jeremy Stuber
Global analyst, industrials

For the 11 days prior to the investment briefing, Simon had been head of private investment management at Newton, but he spoke about Newton's global research process in the context of having led the global research team for the previous six years.

The role of the analyst at Newton

At Newton, we have 18 global industrial sector analysts and they constitute the 'ideas engine' of our business. The task of our analysts is to generate the best stock ideas, wherever they might be in the world. We use our global themes to make sense of how the world is changing and to focus our research in appropriate areas, the kind of areas in which we think we can identify 'winning' ideas.

The role of our research analysts, who conduct their research on a global basis, distinguishes us from a number of other investment management companies. One of our key strengths is our ability, through the work of our global analysts, to conduct proprietary research across global sectors, and not simply within the narrow confines of geographic borders. Instead of being organised by country, mandate or benchmark type, our analysts carry out research in the sector(s) to which they are assigned.

Owing to continuing technological improvements, information has never been so abundantly available to investors, but we believe that investment management success is much less attributable to the amount of information gathered than to the quality and interpretation of that information. The ability of our analysts to analyse information intelligently in a global thematic context enables them to identify investment ideas effectively. The single location of our investment team is a powerful factor in enabling us to work as a focused group; we work locally, but we think globally.

Identifying opportunities in the context of our *security* theme

Our global industrials analyst, Jeremy Stuber, researches and recommends stocks in the aerospace and defence, automotive and industrial sectors. There are hundreds of stocks in these sectors and his role is to reduce this number to just a handful of investible opportunities. The *security* theme helps him to do this.

Jeremy explained that, as part of his research, he meets the senior management of a range of companies to discuss their results and their strategies for the future. Visiting facilities and talking to operational management helps him to gain perspective on what is really happening in the industries he researches, by ascertaining, for example, whether a plant is running efficiently and whether projects are being managed to schedule. In addition, he meets senior government officials to understand the political priorities associated with those industries and how these are evolving over time. In tandem with detailed financial modelling, he uses all of this information in trying to gauge the prospects for companies.

Jeremy observed that the very word 'defence' conjures up powerful images. However, he pointed out that the operations of defence companies are very diverse. They include, for example, data security and domestic security, both of which are high-growth areas.

Increasing amounts of data need to be collected and transferred between satellites, aircraft, ships and land vehicles. The advent of broadband for the battle space entails an increased demand for communication systems which are both secure and reliable. As a result, defence electronics make up an ever-increasing proportion of defence budgets.

Cobham is a leading UK defence company in which we invest, and it was very early to identify the growth of enhanced data security. Since the 1990s, Cobham has successfully diversified into defence electronics and now 70% of its revenues are derived from this area. As a result of its strategy, the company has grown significantly faster than most other companies in the sector.

The internet has changed all of our daily lives, but it has also created vulnerabilities at a national security level. For example, last year, when Russia entered Georgia, its move appeared to be a traditional show of military might. However, the manoeuvre was actually preceded by a series of cyber attacks, which effectively disabled Georgia's communication systems. In addition to military targets, attacks on critical public infrastructure could be just as devastating; just imagine, for instance, what could happen if someone were able to hack in to a nuclear power station's control system.

Such threats give rise to enormous demand for skilled information-technology professionals with experience in the defence and security sectors. However, such individuals are in short supply, especially those with the requisite security clearances to perform such tasks. Jeremy looks for companies that employ such experts because those companies have the capacity to grow. Cobham, following its recent acquisitions, is just such a company.

The other growth area that Jeremy discussed in his video was domestic security. He noted that, since September 11, 2001, there has been an enormous shift in priorities. The US now spends $50 billion per year on homeland security (about the same size as the entire UK defence budget). Domestic security means many different things, including aviation security, border patrol and the identification and monitoring of terrorist cells.

FLIR, a company in which we invest, is one of the beneficiaries of the increase in homeland security spending. It is a US company that specialises in thermal-imaging equipment, and its technology is used to monitor borders at night. What makes FLIR such an interesting investment prospect is the sheer range of areas in which it has the potential to develop solutions. An engineer working on a national grid, for example, can use FLIR's technology to decide whether a transformer needs to be replaced by measuring heat loss; a surveyor can use its technology to establish the energy efficiency of a house; and, one day, we may all use its technology as a night-vision system in our cars to help us drive more safely.

Our analysts do not simply stay in the office in London analysing balance sheets. They go out into 'the field' to meet companies and experts in their sectors in order to unearth the information that will allow them to generate investment ideas against the backdrop of our global themes. Jeremy Stuber visits a large number of companies in his sectors each year and, in his video, he explained two such companies he has visited in relation to our *security* theme.

QinetiQ

Jeremy had visited Nigel Jackson, the director of security at QinetiQ in Farnborough to research the work the company does in the security field.

QinetiQ used to be known as the Defence Evaluations and Research Agency, until it was floated on the stock market about ten years ago. It has an impressive heritage of innovation and Mr Jackson discussed with Jeremy a number of areas in which QinetiQ provides security solutions.

Among these areas are cyber-related threats, which range from the bringing down of websites to the accessing of computers or systems via the insertion of some form of 'Trojan horse' to extract information. QinetiQ has expertise in developing counter-measures to such attacks and in providing solutions that allow organisations to keep their systems running.

Mr Jackson discussed how technology had changed during his career. He explained that, when he first started in the security intelligence business, most data was gathered through human intelligence. While human intelligence remains extremely useful, technological support is now highly developed, for example in the field of unmanned vehicles. QinetiQ is a world leader, for example, in the provision of robots in Iraq and Afghanistan, which are used in a range of activities from explosive ordinance to supporting military operations.

Mr Jackson also talked about the overlap between military and commercial security issues, and in particular about QinetiQ's ability to transfer military-related expertise to commercial applications. Among challenges to which the company has sought to provide solutions has been piracy on commercial shipping off the coast of Somalia. QinetiQ has a number of technology solutions, several of which had been devised in the military arena, which it was able to apply in a commercial context.

Jeremy brought the discussion to a close by asking Mr Jackson about QinetiQ's growth prospects. Mr Jackson suggested that globalisation had heightened vulnerability around the world and that no one could be immune from threats to security. He suggested that we were now witnessing extraordinary terrorist attacks that we could never have imagined in the past. It would be a very unwise government, he argued, that 'took its foot off the accelerator' in terms of trying to secure the security of its nation.

Smiths Group

Jeremy had also been to Watford to visit Stephen Phipson, head of detection at Smiths Group.

Mr Phipson explained that the security market in general is very fragmented and is worth about $150 billion a year; it ranges from the provision of guard dogs and fences to the types of equipment and bomb detectors that Smiths Group provides. Specifically, Smiths Group operates in a £3.5 billion, government-regulated segment of the total market, known as 'CBRNE' (chemical, biological, radiological, nuclear and explosive sensor security).

Jeremy asked Mr Phipson about the future of aviation security. Passengers are familiar with checkpoint security, but Mr Phipson explained that there is an equal amount of equipment beneath airports for screening baggage, as well as perimeter screening for staff. Until recently, the majority of checkpoint equipment had comprised simple x-ray machines to screen passengers' bags and metal detectors to detect whether people were carrying weapons on to aircraft. However, Smiths Group has also developed trace-detection systems in the wake of the 9/11 terrorist attacks. These systems analyse swabs which are taken from bags and can detect very small amounts, even molecules, of explosive materials.

Mr Phipson explained that Smiths Group was now concentrating on how to improve the throughput of passengers through checkpoints while maintaining high security. The company is trialling, for example, systems which are able automatically to detect explosives attached to laptops in bags, which will enable more people to pass more quickly through security checkpoints. In addition, equipment is becoming more sophisticated, with better screen resolution for example that allows operators to see more detail of the contents of passengers' luggage. There is also considerable interest in non-radiating, whole-body imaging, which will be able to detect ceramic, as well as metallic, weapons.

Among opportunities for growth at Smiths Group, Mr Phipson also discussed the ports and borders market, in which very large machines are able to scan whole seagoing containers. In the US, an amendment to the 9/11 act requires that, by 2012, all seagoing freight is screened before it reaches American borders; at present only about 8% of freight is screened. Smiths Group is also involved in integrated projects for the remote monitoring of borders. The US government, for example, has installed scanning equipment at a port in Pakistan that enables it, in Washington DC, to view everything from the licence plate of a vehicle to CCTV and x-ray images of seagoing containers before they are loaded on to ships.

Mr Phipson was very positive about the outlook for growth at Smiths Group. He suggested that the ports and borders business would grow by at least 10% per annum over the next few years. This, combined with the growth of new technology at airports, meant that the prospects for Smiths Group's detection business were attractive, and Mr Phipson argued that the business was very well-placed to take advantage of those opportunities in the coming years.

Using themes to manage risk

In a number of earlier sessions, presenters had discussed how we use themes to identify attractive areas of opportunity for investment. In his presentation, Rob explained how we use themes to manage risk in our clients' portfolios.

Rob Stewart
Investment manager – global funds

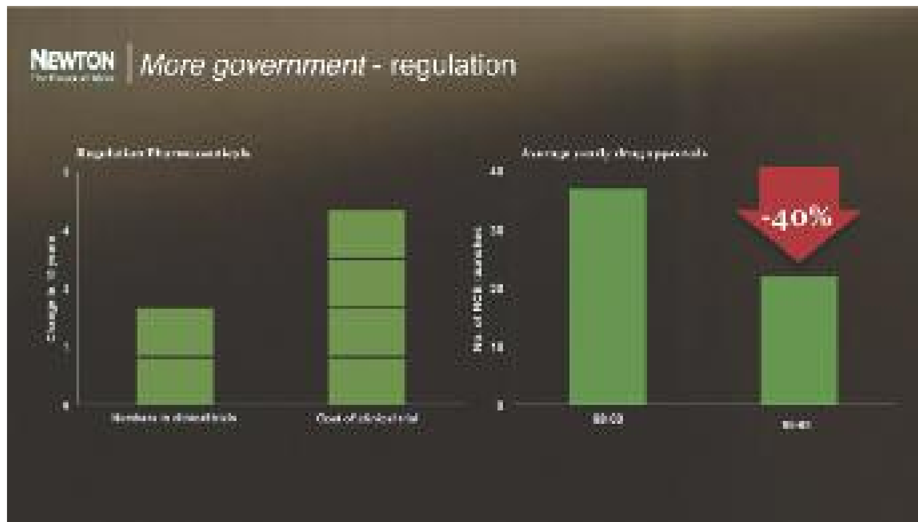
Rob began by explaining that he would be talking about how our themes shape our investment approach to risk and how the use of themes to manage risk is integrated at all stages of our investment process. We have a range of themes and Rob concentrated on two of these themes, *more government* and *fire risks*, in particular. Our *more government* theme explores the ways in which governments are becoming more influential in all aspects of economies and society; and our *fire risks* theme looks at the potential for inflation to pick up in the future.

Fire Risks

More government

The increasing role of governments can be seen in a number of guises, for example in the increased regulation of the financial sector. Government 'ownership' is also growing, not simply through the physical ownership of businesses or assets, but also through the increasing influence of governments upon industries. Car scrappage schemes in the US (where the Obama administration introduced the 'cash for clunkers' scheme) and in the UK are examples of such measures that influence or distort markets. Further obvious elements of more government are heightened public spending and the associated changes in taxation that are being introduced to fund such spending.

Almost all aspects of economic activity are now affected in one way or another by regulation. There has been a great deal of attention in recent times on financial regulation, but Rob talked also about the impact of regulation in the pharmaceutical sector and in relation to the environment.



We would all probably agree that, for safety reasons, it is a good idea that pharmaceuticals are regulated. In the last ten or 15 years, there has been a significant increase in this regulation, and that has led to a doubling in the number of patients that are required to be involved in the clinical trials of new drugs. That doubling has lead to a quadrupling in the costs of running a clinical trial. For pharmaceutical companies, such an escalation of costs is highly significant and is one reason why the average number of yearly drug approvals has fallen sharply over the last decade. As investors, we like the attributes of the pharmaceutical sector, but the lower rate of overall drug approvals focuses our attention on identifying which companies can innovate against a background of more onerous regulation.

Another area of regulation that is much in the news relates to the environment. In preparing his presentation, Rob had been to visit Robert Canepa-Anson, one of our global industrial research analysts with responsibility for the resources and utilities sectors. Rob had asked Robert: “have you got a good, simple chart that I can use in my conference presentation?” Robert had replied: “I’ve got just the thing for you Rob - a timeline of regulation in US coal-fired power stations”. Rob had checked that this was the simple version and Robert had replied that, indeed, it was. The chart is shown over the page.

Rob suggested that there were two lessons to learn from the chart. First, one should never ask an analyst for a simple answer. The second and more serious point, however, that emerges from looking at the chart is the sheer scale and complexity of the regulation facing the coal-fired power industry. We think that this trend of more complex regulation is here to stay in relation to a number of different industries.

Rob spoke next about the trend towards greater government ownership. Such ownership is most obvious in the financials sector, but it is also highly relevant in the oil sector. Recent estimates indicate that 90% of the world's oil is now controlled by national oil companies, which are controlled in turn by national governments. This represents a dramatic shift in power away from the big oil companies like Shell and Exxon that used to be called the 'Seven Sisters' to these national oil companies.

In the financial sector authorities have had to deploy enormous sums in support of their banking sectors. In the UK, it seems staggering that the government has had to commit a sum greater than half of national income to support ailing banks. The figure is equivalent to the next 18 years of proposed defence spending in the UK and entails UK taxpayers now owning 84% of Royal Bank of Scotland and 43% of Lloyds Banking Group.

Given that the US was felt to be at the epicentre of difficulties in financial markets, it is noteworthy that the UK's commitment to the banking sector is twice the relative commitment which has had to be made in the US. That is the case because the UK economy is, compared with the US economy, relatively small but has a very large banking sector. In the years ahead, we believe that is going to be challenging.

Government spending has risen fast, not simply as a consequence of the crisis in credit markets and the associated recession of the world's leading economies, but also in the decade preceding the crisis. The corollary of higher spending is higher taxation. In the UK, there has been much focus on likely changes in taxation, but higher taxes are a global phenomenon and we are seeing this across the world. In Greece, for example, the government has introduced a 'one-off' tax on companies of between 5% and 10% of corporate profits in an attempt to ease its financial constraints; and we anticipate that we will see many more such measures around the world in the period ahead.

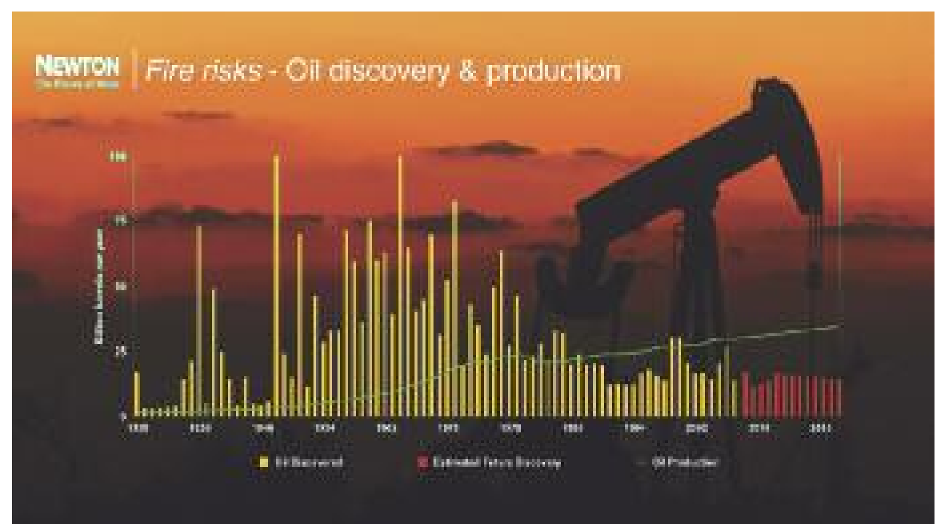
Fire risks

The second theme that Rob discussed was *fire risks*, which relates to the potential for inflation to rise. Rob touched upon two elements of the theme: first the printing of money by governments and, secondly, related risks to commodity prices. Historically, there have been a number of cases in which governments' printing of money has led to inflation; Germany in the 1920s, the UK in the 1970s, Hungary in the 1950s and Zimbabwe at the moment are all good examples. At Newton, we are mindful of the risk that higher inflation may once again reappear in the global economy.

It is instructive to look back at the last decade in the United States. At the beginning of the decade the Federal Reserve pumped just over $50 billion into the US money supply because it was concerned about what might happen over the Millennium; and, following the terrorist attacks of September 11, 2001, the federal authorities in the US pumped $42 billion into the financial system. In response to the financial crisis, US authorities have implemented the same 'cure', but the scale of the liquidity they have provided has dwarfed that which they made available earlier in the decade.

US authorities' injections in the aftermath of the credit crisis amount to $1.1 trillion, equivalent to 20 times the scale of the previous two examples of monetary expansion. In the two prior periods the authorities increased money supply by around 8%, but in the present situation they have more than doubled base money supply. It is not certain that policymakers' actions will stoke inflation, but we believe nonetheless that those actions give reason for investors to be watchful.

The other area of interest in relation to our *fire risks* theme is commodity prices, and Rob turned next to an analysis of oil discovery and production. The scale of oil discoveries has been declining over recent decades, with the largest discoveries occurring between the end of the Second World War and the end of the 1970s. The red bars in the chart below represent forecasts of what is likely to be found in the years ahead, and they show that discoveries are likely to remain modest. Simultaneously, oil demand will continue to rise and there will be a tension between these two trends.

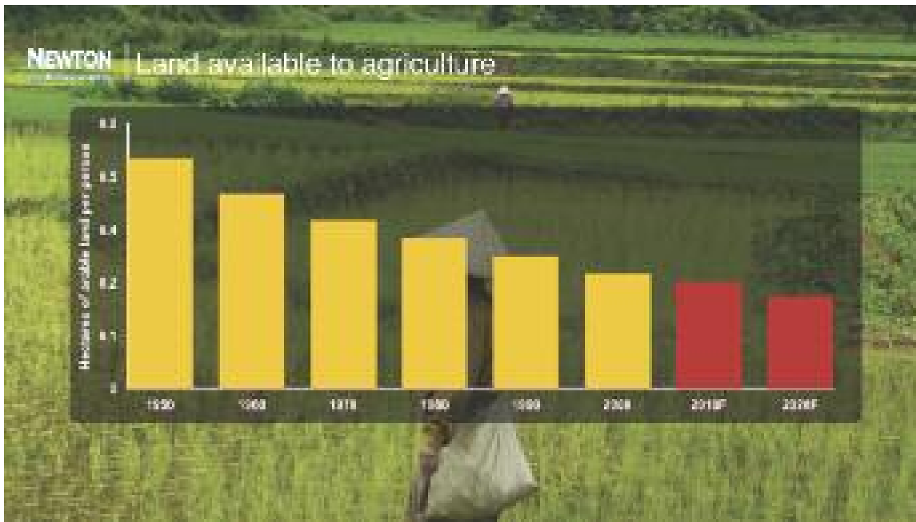


Furthermore, it is becoming more and more challenging to extract oil from the ground. The latest significant finds of oil have taken place in sub-salt off the coast of Brazil. In order to reach that oil, producers will have to go two kilometres down to the seabed, drill through one kilometre of solid rock and, finally, drill through two kilometres of salt. However, the salt moves from side to side, which makes reaching the oil even more challenging than it might have been. The implications of these challenges are fairly clear: oil-production costs are rising.

Rob talked next about another commodity area, food, which is a global commodity and which is particularly important to those economies in which incomes are lower (because it represents a larger proportion of overall spending there).

With rising populations, increased urbanisation and climate change, there has been greater pressure on arable land. The amount of land available for agriculture has fallen markedly over the last 60 years and it is forecast to continue to decline over the next decade. There has been a lack of investment in agriculture in recent decades, and

changing diets in developing economies have also exacerbated the shortage of agricultural land in relation to global demand for agricultural commodities.



As economies develop, populations consume more meat, and meat is very grain-intensive; to produce one kilogramme of beef, for example, a farmer has to feed a cow eight kilogrammes of grain. At Newton, we are optimistic that the world can tackle its agriculture-related challenges, but in order to do so there will be a requirement, among other things, for improved seed technology and for the greater use of fertilisers. All such developments are likely to push up the price of food.

We have identified a number of investment opportunities that arise in the context of these observations about agricultural trends. Not least, opportunities are likely to be spawned by the extraordinary lengths to which governments will go to try to protect their agricultural industries; feeding a population is almost certainly the main concern on any government's list of priorities. Recently, the Chinese have been struggling with a serious drought in the north-east of their country, which historically has been a key agricultural area. China has been willing to go to almost any lengths to tackle that drought, including using anti-aircraft guns to fire silver iodide (which induces snowfall) up into the clouds above its arable land.

Effectively, China's actions can be seen to amount to the appropriation of somebody else's water. Those actions are relevant in the context of our *fire risks* theme, and China's attempt to try to control the weather equates also to a prime example of *more government*.

Applying themes to portfolio construction

Having given an introduction to the *fire risks* and *more government* themes, Rob explained in more detail how they influence portfolio managers at Newton. He began by explaining how the themes are identifying risks in the oil sector and how they are shaping our investments in the oil companies. With oil becoming harder to find, we want to invest in companies with strong reserves and to avoid investing in those that lack them. We want also to avoid companies that may become involved in conflicts with governments. Politics is becoming more important in resource allocation, and we are highly cautious therefore about competition with 'national champions'; those outline preferences lead us to be cautious in particular about exposure to the large oil 'majors'. They are generally excellent, well-managed companies, but we have concerns about their long-term exposure.

Instead, we favour exposure to companies whose interests are aligned with those of governments, and which are operating in countries with stable regulation. It would be imprudent to think that governments will not tax the oil sector, but we are focused upon companies that operate in a framework which is stable, and which allows investors to achieve returns in a stable and comprehensible fashion. Examples of such companies are Petrobras, the Brazilian oil company, which will be drilling in the Brazilian sub-salt to which Rob had referred earlier in his presentation. Petrobras has strong reserves and it is a national champion (meaning that its interests are aligned with the Brazilian government). The government does tax the oil industry quite heavily, but it does so in a very steady fashion and we have been impressed by that.

Other examples include Santos in Australia and Suncor Energy in Canada. However, we are mindful of *fire risks* (the risk of inflation) in relation to the oil sector, and particularly in terms of the cost of extracting oil from the ground. In seeking to manage that risk, we are looking at companies that we believe are going to benefit from rising costs. Among the likely beneficiaries of rising costs are the oil service companies, the companies that help producers extract oil; examples include Subsea 7, the world's leading deep-sea engineer, Transocean, which owns various types of oil rigs around the globe, and Denbury Resources, which has particular expertise in squeezing the last oil from mature oil wells.

Our *fire risks* theme also entails our preference for exposure to gold. We gain such exposure via investing in mining companies (which is where the proprietary work of our global industrial research analysts is so valuable) and gold exchange-traded funds.

In conclusion, our thematic approach provides the perspective that allows our portfolio managers, in conjunction with our research analysts, to select the securities that are appropriate in seeking to meet our clients' investment objectives. We believe those themes are highly effective, both in terms of identifying areas in which we want to invest and in highlighting areas of risk.

The respective merits of real-return and benchmark-aware investing

Paul, Raj and James explored the nature of real-return and benchmark-aware investing and the pros and cons of each approach.

Paul Brain
Leader, fixed-income portfolios

Raj Shant
Investment manager, European funds

James Harries
Investment manager, global funds

Introduction

During this session, Paul, Raj and James posed a number of questions in relation to the respective merits of real-return and benchmark-aware investing: Does the favoured approach depend upon an investor's time horizon? Does one have to be a 'bull' or a 'bear' of markets? Is a bear investor usually an absolute-return investor? Should the decision as to which approach is preferable be driven by how an investor judges their portfolio manager? Does the argument in favour of one or other approach rest on considerations of transparency and accountability? Can both strategies be managed successfully in the same investment management company? Is there a 'right' way to manage each approach?

Benchmark-aware investing is, as its name suggests, the management of an investment portfolio against an industry-standard benchmark; a benchmark-aware approach can be suitable for long-term investors who have a very broad, diversified portfolio and who have the ability to weather the falls which inevitably occur when markets move and gyrate around. Real-return investing, by contrast, is the management of investments to achieve an absolute return or a cash-related target, and it may be more suitable for those investment portfolios that have a shorter-term horizon.

The debate in a bond market context

Being leader of fixed-income portfolios at Newton, Paul approached the topic from a bond-investing perspective. The chart below shows the 10-year US Treasury yield over the last 30 years. During this period, in which US Treasuries have been in a 'bull market', yields have declined steadily as inflation has fallen. A benchmark-aware (relative-return-orientated) investor would have made a return of more than 500% by investing in US government debt during that period. Within the overall trend of declining yields, however, there have also been some significant periods of negative returns, during which yields have risen, principally as investors have worried about rising economic growth and mounting inflation.

Paul explained that government bond yields can not decline (or prices rise) indefinitely; indeed, as they fall closer to zero, the greater the chance is that they stop declining. During the 20 years before the bull market in government bonds began, yields rose dramatically against a backdrop of rising inflation, strong growth and the authorities' loss of control of money supply. That period would have been a very good time to be an absolute-return or real-return investor.

Paul went on to discuss how investors should approach bond investing in the years ahead. At Newton, we manage both benchmark-aware and real-return bond funds, and the objectives associated with each approach are usually broadly the same: to maximise the total return from income and capital growth. The indices or benchmarks against which the respective types of funds are compared are different, but the objectives of those funds are the same. We believe that both benchmark-aware and real-return strategies can be managed by the same investment management company because, from a fixed-income point of view at least, those strategies seek to achieve the same objective, albeit with slightly different nuances.

We believe that capital preservation should be a key objective in relation to all bond portfolios, particularly during periods when yields are falling. However, some real-return-orientated funds have failed to meet investors' expectations in recent times. Paul cited one example of a bond fund that was created in 2005 to extract value from credit markets and to hedge some interest-rate volatility by using a technique known as 'relative-value arbitrage'; the technique was extremely popular prior to the credit crunch. In the three years preceding the credit crunch, the technique brought about gradual appreciation of the fund's unit price over time. However, the construction of these types of portfolios was based on historical relationships and did not adequately protect investors from large changes in liquidity conditions. When the credit crunch occurred, credit markets became dysfunctional and illiquid and the managers of funds such as the one to which Paul referred were metaphorically 'picking up the pennies in front of a steam roller' and their investors lost significant capital sums.

Paul explained that, at Newton, we believe the appropriate way to manage both benchmark-aware and real-return strategies is to found the investment decisions within them upon sound judgment and theme-based investing. In our real-return bond strategy, we harness the same global thematic approach that we employ in all of our investment strategies, we invest in a range of different asset classes and we allocate funds dynamically between those asset classes to smooth volatility; we do not rely upon historical relationships and models to try to hedge risk. Combining diverse bond asset classes in one portfolio – particularly corporate bonds (both high-yield and investment-grade) and emerging-market bonds – can also provide a very attractive level of income, not least in comparison with the very low rates available on cash savings.

At the time of our investment briefing, we had begun to accumulate some downside protection in the US government bond market in our real-return bond strategy as a precaution amid the uncertainty associated with fiscal and monetary policymaking. In particular, we have been concerned that sharp increases in money supply might stoke inflation, to which government bond markets would be vulnerable. We do not believe that rising government bond yields represent the most likely outcome in the near term; Paul explained that government bonds continued to offer significant value. However, pronounced volatility in government bond markets is possible given the large scale shifts that are occurring in the policymaking of governments and central banks.

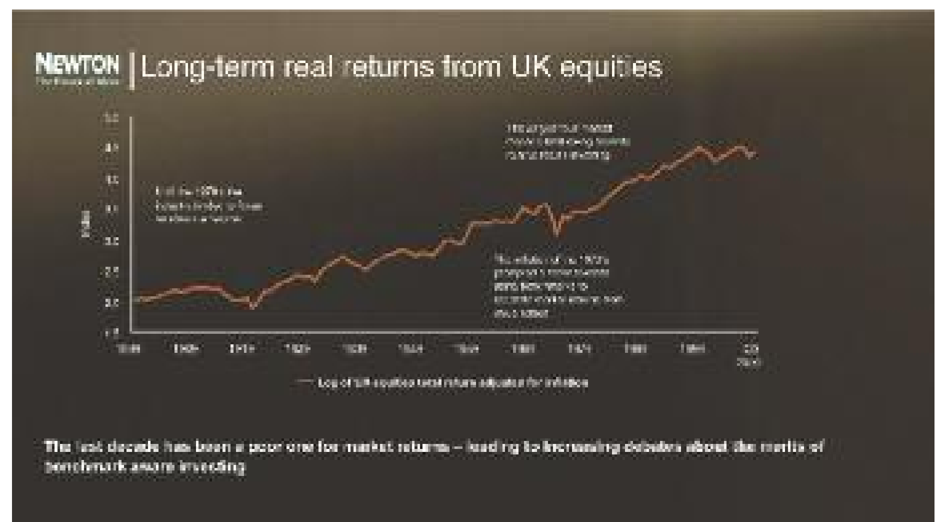
Paul handed over next to Raj and James, who discussed the different investment approaches from an equity perspective.

The debate in an equity market context

Raj began by explaining that he and James would look at the pros and cons of benchmark-aware investing and real return investing, but that they would not seek to persuade the audience that one approach was intrinsically better than the other. By considering the respective approaches in relation to five key aspects of decision-making (time, transparency, accountability and risk, specialisation versus concentration and macro-environmental considerations), their aim was to offer a framework to help investors decide which approach, or which combination of the two approaches, was most suited to respective pension schemes.

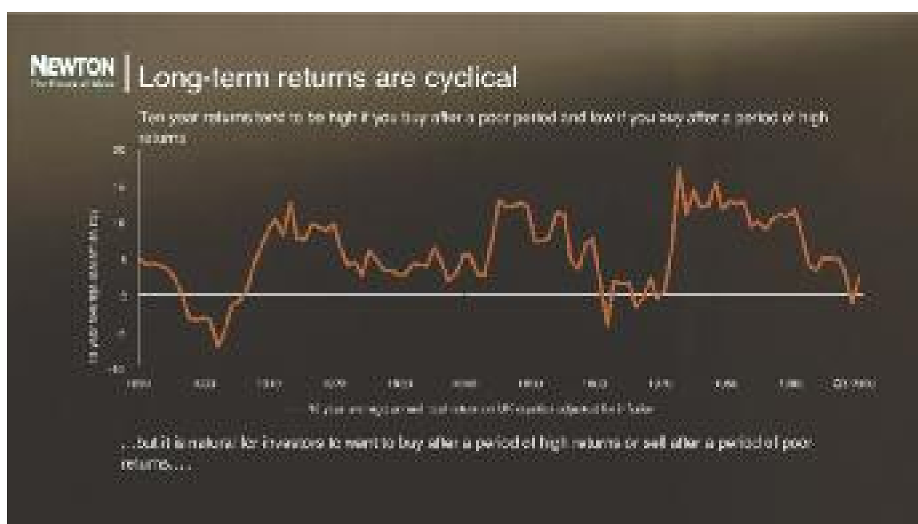
Time horizons

The first factor they considered was investors' time horizons and Raj provided some perspective on long-term returns from equities by showing the chart below of the last hundred years of returns from the UK equity market. The chart shows total returns (including the reinvestment of dividends) on a log scale and it is adjusted for inflation. Raj noted that, until the 1970s, everyone was an absolute-return investor; only when inflation started to rise in the 1970s did investors start to introduce benchmarks in order to differentiate between the returns that came simply from the asset class or market in which they were invested and the value added to those returns by their investment managers.



The 20-year bull market which began in the early 1980s cemented the role of benchmark-aware or 'relative' investing as the central approach of the investment industry. However, the last decade has been a highly challenging time for investors and, following disappointing returns from markets, the debate about the movement from benchmark-aware investing towards absolute-return investing has intensified.

Raj showed next a chart of the returns that an investor would have achieved over successive 10-year periods over the last 100 years. In investment-management jargon, one would observe that real returns from markets have been 'negatively serially correlated', which amounts to saying that if one buys equities following a long period of higher returns, one is likely to generate poorer returns in a subsequent period (and vice versa). Arguably, therefore, the time at which the debate about moving away from benchmark-aware investing towards absolute-return investing should have been at its most powerful was in the aftermath of a period of above-average returns (such as in 1999), rather than following a long period of poor returns (such as now).



James went on to ask whether an equity-biased, relative-return portfolio is what investors should favour, and suggested that perhaps it was not. Time allows investors to take risks; it affords them the opportunity to recoup the losses they may incur in a volatile portfolio. The challenge is, of course, that investors may not be prepared to take such risks because they imply that they are prepared to lose substantial amounts of their capital over short periods of time. It may be that investors are simply not prepared to suffer such losses, either because the maturity of their scheme is such that funds are going to be required soon, or perhaps because, in any event, investors' risk appetites do not allow them to withstand large short-term losses. Trustees may also be concerned about their ability to adhere to their long-term strategy in the teeth of capital losses; if they feel unduly threatened in seeking to do so, it may be appropriate for them to pursue a real-return-orientated strategy.

Transparency

The second factor that Raj and James considered in the context of which approach investors might follow was transparency; they focused on transparency in relation to the assets in an investor's portfolio rather than the transparency of performance measurement and risk measurement.

Investors who follow a benchmark-aware approach will have a very clear reference point of the kind of assets that are held in their portfolios. An index-based, relative-return strategy has the benefit of having a degree of clarity about both what the manager is seeking to achieve and how they are seeking to achieve it, and there is a simplicity about measuring its returns as well.

However, James queried whether such clarity and simplicity is what investors should strive to achieve when they set investment managers their objectives. He suggested that investors might be binding the hands of their investment managers by telling them not just what they want them to achieve, but also how they want them to achieve it. James suggested also that the objective of a fund should be more closely aligned with the benchmark of the fund. If, for example, the assets of a pension scheme are growing at, say, Libor plus 4%, it is arguable that that is precisely what the benchmark for the fund should be.

Accountability and risk

The third key factor that we believe investors should consider is accountability and risk, which relates to transparency. In looking at the returns from a benchmark-aware portfolio, it is easy to assess the risks that were taken to achieve those returns. In relation to real-return funds, the assessment of risk may appear to be less straightforward. Investors need to decide what the appropriate comparison is for a real return fund; sometimes it is seen to be cash, but it is questionable whether the use of a cash benchmark amounts to a comparison of 'apples with apples'.

James suggested that investors should ask what 'risk' is in this context and added that it might be defined as the risk of losing money. He observed that the central tenets of finance theory have tended to treat investment as a science, in which movements in markets can be described in the same way as movements in the planets. Finance theory has tended to be grounded in a conviction that the modelling and quantifying of market movements allows investors to gauge risk. We would argue, however, that such theory is not really sufficient to assess risk. Greed and fear, for example, do not reside in simple mathematical equations.

Much of this theory has permeated the investment management industry such that, when an investment manager refers to risk, he or she is actually talking often about risk in relation to a benchmark. However, in order to think about risk in that way, one needs to make the logical leap that the index or the benchmark itself is risk-free, or that it embodies risk that investors should be happy to take (regardless of the composition or valuation of that index or benchmark).

Another trend in finance theory about which we are sceptical has been the construction of portfolios which would have performed well in the past and which, via the extrapolation of returns, are expected to perform well in the future. The difficulty with this approach is that it assumes the past looks like the future. If conditions change, and at Newton we believe that they have changed, such models tend to fail.

James proposed that investors might want to charge their investment managers with the task of generating a real return, which will encourage those managers to keep at least one eye on capital preservation. It may well be beneficial for investors to set clear objectives and allow investment managers the leeway to rely on their judgement to achieve those objectives.

Specialisation versus concentration

The fourth key consideration that James and Raj discussed was the extent to which investors require concentration rather than specialisation in their investment-management arrangements. Over the last few decades, the investment industry has moved towards having many specialised portfolio managers working on different parts of a scheme. That has happened principally because many investment houses have been unable to show strong competence across a range of asset classes or the ability to allocate dynamically between those asset classes.

Having several managers can reduce an investor's manager-selection risk, but this is where another beguiling theory has somewhat obscured longer-term investment objectives. One theory suggests that, if an investor achieves the best possible return in each of the asset classes in which they invest, they will optimise their overall investment return. However, the flaw in that theory is that it ignores the fact that switching between asset classes can be as important as the returns achieved within each asset class to the generation of an attractive overall return.

We think, therefore, that what investors gain in specialisation, they may lose in flexibility, and that 'real-time' asset allocation is likely to be carried out best by a single portfolio manager who understands all the risks within a portfolio and can switch between asset classes. The ability to invest across the capital structure may be a key benefit that allows investors to achieve better returns over time. Furthermore, investors need not put all their eggs in one basket by pursuing a real-return strategy; they may choose to appoint several managers, each of whom is charged with trying to produce an absolute return for the investor.

Macro environment

The fifth and final factor that James and Raj touched upon in evaluating the respective merits of benchmark-aware and real-return investing was the macroeconomic environment. In relation to benchmark-aware strategies, investors should be mindful of the risk of inflation. We are not saying that the risk is imminent, but it is salient to recognise its existence nonetheless; higher inflation might also render cash-plus strategies less useful. Another major concern for pension scheme trustees is wage inflation, which historically has outstripped generalised inflation for long periods.

The most powerful consideration, however, is that of generally rising markets. As Raj had explained previously, markets do generate strong real returns in the long run. The last 100 years provide evidence of this fact, and that period included two world wars, the adoption and abandoning of various fixed exchange-rate regimes, oil crises, as well as times of great social upheaval. Markets can, and do, overcome a great deal, and it is important to keep that in mind following periods such as the last (challenging) decade in equity markets.

James acknowledged that equities have produced very strong returns in the long term and that, following a decade of poor returns, it would seem like an attractive time to be investing in a relative-return, equity-biased portfolio. The difficulty with this conclusion, however, is that the backdrop to equity investment remains highly challenging.

Growth is typically the 'magic bullet' that allows economies to resolve their difficulties, debt burdens to be reduced and public spending to be sustained. However, James identified two factors that cast doubt on the scope for economies to grow significantly henceforth. The first factor, known as 'Ricardian Equivalence', identifies that individuals are able to see governments spending a great deal of money on their behalves and that, knowing this money will have to be repaid, those individuals decide to spend less. Put simply, therefore, the efficacy of public spending to boost demand may not actually be as strong as is commonly supposed. The second factor is that government largesse is fraught with risk; as governments spend more in pursuit of economic growth and in order to resolve economic and financial-market woes, economic conditions may actually worsen.

We would argue that the fundamental attributes of many of the developed-world economies actually remain rather weak. Although financial markets do not seem too perturbed at present by the challenges that remain in those economies, we believe it remains imperative for investors to adopt strategies that take account of risks as well as the pursuit of returns (and particularly strategies that allow investment managers to harness value across a company's capital structure).

Summary

Paul summarised the debate by returning to the questions he posed at the outset. As to whether an investor's preference for a benchmark-relative or real-return approach depends on time horizon, he concluded that it does; but it is also dependent, clearly, on that investor's risk appetite. In terms of whether the preference depends on whether an investor is a 'bull' or a 'bear' of markets, with perfect foresight, yes, it does.

As to whether the choice should be driven by how an investor judges their manager, using a market universe does indeed lead to ease of comparison and analysis, but investors need to make sure that that market universe is relevant to them.

Can both approaches be managed by the same investment management company? We believe that the approaches are complementary and that they can be managed by the same investment house (not least because both approaches harness the same investment process). As to whether there is a 'right way' and a 'wrong way' to manage each approach, we contend that achieving perspective through the use of long-term themes, and using judgement rather than historical models, can help investors navigate their way through challenging financial-market conditions.

Save the date

The investment briefing dates for 2010 are:

12 November - London
17 November - Leeds
18 November - Edinburgh

For more information please email
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