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Thematic investing – an update

At Newton, we use a well-established thematic investment approach to gain long-term perspective on global financial markets and economies. Our themes represent our ideas about the likely forces of change in the world and they provide the perspective that allows our analysts and investment managers to identify areas of opportunity and risk around the world. In this article, we review how our themes are evolving and we explain our introduction of a new theme called ***low-end spend***.

Backdrop – the importance of themes

The last two years have been particularly challenging for investors, with a global credit 'crunch' giving rise to significant financial-market and economic woes, but 2009 bringing a strong recovery in equity markets. Since March this year, share prices have been buoyed by evidence of better economic and credit conditions and improving corporate earnings results. The share prices of many of the companies that had appeared to be most distressed as the credit crisis intensified in 2008 have strengthened the most in 2009.

Our view remains that a robust economic recovery is unlikely to be sustained until the underlying debt-related challenges inherent in the Western economies are resolved. In recent months, there have been clear signs that the efforts of governments and central banks to ease economic and financial conditions via 'loose policy' have found some success; the rebuilding of depleted inventories by previously very downbeat companies also appears to have boosted near-term activity. However, such trends may be short-lived and uncertainty about the effects of the monetary and fiscal stimulus being deployed is likely to cause sustained volatility in both financial markets and economies.

Heightened volatility is likely to be accompanied by considerable market 'noise', and in such an environment maintaining perspective is crucial to longer-term investment success. We continue to believe that our thematic framework provides that perspective and that it allows us to distinguish between what is happening in the short term and the more important underlying, longer-term trends in economies, markets and industries.

All change

We have captured in our all change theme some of the important changes that we foresee in economies and financial markets in the years ahead. We observed when we introduced the theme in 2008 that the bursting of the credit 'bubble' in 2007, which brought to an end an era in which private sector debt in the developed world had grown rapidly, had important consequences in a wide range of areas.

In developing our ***all change*** theme, we recognized that there was scope for policy stimulus around the world to have significant positive implications for asset prices in the short term, but the extent to which financial markets have benefited from such stimulus this year has been remarkable. It is questionable whether the transmission mechanism by which liquidity is intended by central banks to support 'real' economic activity has worked. However, with banks preferring to use funds made available to them by central banks to buy assets (rather than, as policymakers hoped, to increase their lending to consumers and businesses), liquidity appears to have seeped into financial markets, to have increased investors' confidence and to have driven the prices of (theoretically disparate) assets higher.

In the aftermath of the credit crisis, our conviction remains that the debt 'overhang' to which consumers and companies are exposed, the structural impairment of the global financial system and the growth of regulation aimed at reducing the risk of future financial crises will constrict both the supply of, and the demand for, credit in the developed world. Notwithstanding the recent improvements we have witnessed in economies and financial markets, we continue to believe that this constriction will have significant implications for consumer-driven economies, and for all asset classes and investment strategies.

All change does not equate simply to a one-dimensional 'bet' on the fate of credit markets or on the likelihood of an economic recovery. It touches upon a broad range of investment-related areas, for example in the prospect of greater government involvement in economies and financial markets. It emphasizes, too, some of the investment opportunities in emerging markets; and it has consequences also for the 'low-end' consumer, as set out in our most recent theme, ***low-end spend***.

Introducing *low-end spend*

Low-End Spend

Our ***low-end spend*** theme identifies the fact that low-income groups struggled to keep up with the overall increase in incomes during the 'credit bubble years', and it highlights the likelihood that the relative standing of these groups will improve in the aftermath of the credit crisis. With property markets having weakened and employment conditions becoming more challenging, politicians have moved increasingly towards 'populist' measures that have wide voter appeal in preference to those that are necessarily beneficial to the long-term health of economies. Meanwhile, households in the highly indebted Western economies are likely to adopt more frugal practices, which suggests that a 'trading down' in average spending patterns is likely to take place.

In the near term, falling wages and rising unemployment may affect the spending propensities of consumers, but 'low-end' spending should be relatively resilient to such factors and the ***low-end spend*** theme highlights a number of areas of associated investment opportunity. Among such possible opportunities are producers of consumer 'staples', discounters and 'value' retailers; and straitened times may favour domestic producers over importers. Conversely, there may be risks in relation to luxury brand manufacturers who targeted an unsustainably broad range of consumers.

The nature of investment returns

Our themes evolve constantly, even if their names do not change. Low-end spend represents the only new theme that we have introduced this year, but we have reviewed all of our themes and there have been some important changes of emphasis in relation to several themes, among them being:

Fire Risks

Fire risks: Fears about inflation have shifted from the immediate risk of inflation in economies such as China's to the threat of monetary 'debasement' over the longer term, chiefly as a consequence of the highly stimulative monetary and fiscal stimulus being implemented by authorities around the world. In order to combat the deflationary effects of the global recession, governments and monetary authorities have embarked on unprecedented policy measures. However, the impairment of financial systems and the trend towards continued debt repayment by companies and consumers may continue to undermine the effectiveness of official stimulus. This may prompt authorities to redouble their efforts and give rise to the risk of higher future inflation, particularly if improvement in financial conditions leads to a higher 'credit multiplier' (by which central bank liquidity flows more effectively to corporate and household borrowers). The timing of the risk is highly uncertain, but we believe it is appropriate to take account of it in portfolio construction.

GLOBAL REALIGNMENT

Global realignment: Western industrialized nations still dominate the world's economic output, wealth, consumption and market capitalization, and they consume the lion's share of natural resources. The increasing economic influence of the developing world is challenging this position progressively. The way in which 'realignment' takes place will be crucially important to the longer-term fate of global economies and markets. Increasingly, the rebalancing of the global economy requires developing nations to address their previous 'over-exporting' by focusing upon greater domestic activity.

More Government

More government: The increasing participation of governments in economies and financial markets, for example in the dramatic widening of budget deficits and in supporting commercial banks, lends significant unpredictability to the destiny of those economies and markets. State intervention and forms of managed capitalism hold sway over an increasing proportion of global output owing to the growth of both the developing world and resource-rich economies. As a consequence, historical relationships, such as those between growth, inflation and interest rates, may be altered. The unpredictable nature of state intervention is increasing the risks associated with all asset classes.

Identifying growth opportunities in an uncertain world

Although we are cautious about the prospects for economic growth in general, our themes should allow us nonetheless to identify particular sources of potential growth. There remain good underlying opportunities in some established areas and we continue to find many new investment ideas with the benefit of our evolving thematic framework.

We believe, particularly over the long term, that financial markets are 'inefficient' and that they afford attractive opportunities to active investment managers. In employing a global, thematic approach, we seek to establish the long-term strategic trends that will allow us to unearth such opportunities on behalf of our clients. Our themes are valuable too in seeking to manage risk. We believe fervently that the proper management of investment risk requires some form of qualitative assessment; it cannot be carried out merely by slavish adherence to mathematical models whose assumptions are grounded in the past performance of markets.

Our themes are not intended to provide significant tactical value in identifying, for example, near-term changes in economies, markets or industries. Our investment managers may, through other means, identify successfully such changes but, in using our themes, we seek generally to overcome the unhelpful short-range 'noise' that can impede the fulfillment of investors' objectives.

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