



January 2010

Investment comment

Economic and market background

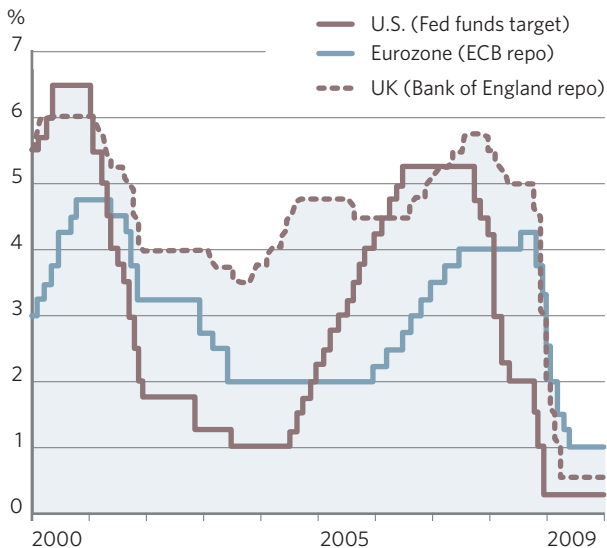
It was only fitting that equity markets should continue to be fortified in the final quarter of a turbulent decade by the ultra-loose policies of the world's leading central banks. During the decade, monetary policymakers cut interest rates aggressively at times to tackle successive economic and financial-market crises, and they provided succor to most investors in doing so (albeit that 'developed world' equity markets made only small advances over the ten-year period). Despite the emergence of incipient concerns in the autumn about the implementation of 'exit strategies' from currently loose policies, fuelled initially by the Reserve Bank of Australia's surprise decision in October to increase the cost of borrowing, central bank-supplied liquidity appeared to sustain equity-market strength in most major regions during the closing months of 2009.

While stock markets extended their gains of the previous six months in a generally measured manner, there were whiffs of excess elsewhere

during the quarter. The fifteen-fold rise in the wholesale price of garlic (thought by some to be effective in warding off swine flu) in China's large cities in the nine months to December was likened by some commentators to the Dutch tulip mania of the seventeenth century; and the sale of Andy Warhol's 1962 painting *200 One Dollar Bills* for \$43.8 million suggested that the contemporary art market was buoyant.

There were stark reminders, too, of the consequences of previous excess, not least in Dubai's request for a (euphemistically described) debt 'standstill' at Dubai World, the flagship holding company that has developed some of the United Arab Emirates' most extravagant real estate projects. Events in Dubai reignited fears about the impact of the debt 'overhang' on the financial sector around the world, but a \$10 billion bail-out in December by the government of neighboring Abu Dhabi eased those fears.

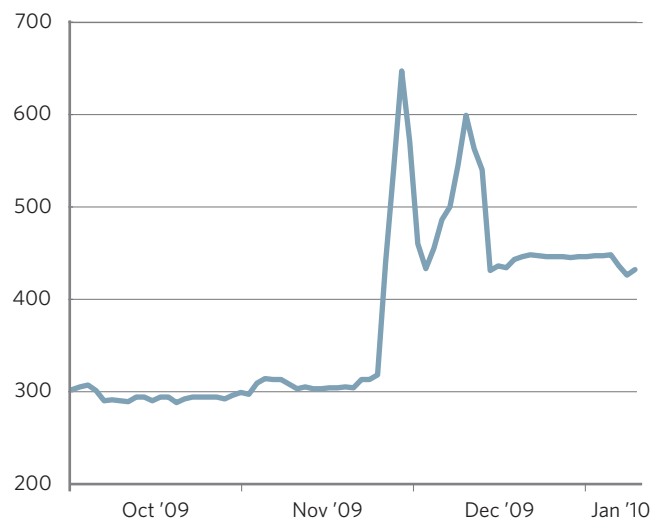
CENTRAL BANK POLICY RATES



Source: Thomson Reuters Datastream, January 2010.

DUBAI DEBT

FIVE-YEAR CREDIT DEFAULT SWAP SPREAD (BPS)



Source: Thomson Reuters Datastream, January 2010.

Elsewhere, concerns mounted about the escalation of sovereign default risk in the periphery of Europe, notably in Greece where the state of the government's finances has become especially parlous. There were other sources of discomfort, including the efforts by a number of authorities in export-focused economies to suppress the strength of their currencies; Brazil sought to slow capital inflows by imposing a tax on foreign portfolio investment and Taiwan banned foreigners from holding fixed-term deposits. The filing for bankruptcy by CIT, the U.S. commercial lender, and the enforced separation of ING's banking and insurance operations by the European Commission served as reminders of the financial sector's frailty.

Despite those events, measures of financial-market volatility fell to levels last seen before the collapse of Lehman Brothers in September 2008 and investors' appetite for 'risk' appeared to remain reasonably hearty during the quarter. Support came from companies' ability to continue to exceed investors' modest expectations of their earnings, and concerns about higher interest rates were defused by the Federal Reserve's renewed conviction that economic conditions were "likely to warrant exceptionally low levels of the federal funds rate for an extended period". Investors were encouraged too by further signs that the activism of governments and central banks has been successful in steadying economies around the world; with few notable exceptions, producers of goods across Asia, Europe and the U.S. reported rising output and healthier order books, and employment conditions worsened less sharply than before.

Against a sustained backdrop of 'easy money', **equity markets** generally made further progress and cemented strong gains for the year as a whole. To the U.S.-based investor, the UK led the way among the principal 'developed' regions during the final three months, with a total return of +7.0% (for a 12-month return of +43.4%). North America, overshadowed in previous quarters by the stronger performance of markets elsewhere, posted a healthy quarterly return of +6.0% (+29.3% over the year), the markets of the Pacific ex Japan region returned +5.2% in dollar terms (+73.0% over 12 months) and Continental Europe returned +3.3% (+36.8% over the year). Emerging markets generated an aggregate return of +8.6% over three months (to take their tally for 2009 to +79.0%). Japan posted a quarterly return of -2.8%, for a relatively disappointing 12-month return of +6.4% stood out like a sore thumb against the far stronger hands declared elsewhere.

In **bond markets**, the strength of the previous quarter gave way to a period of weakness, with higher yields attributable, perhaps, to unease about the implications for the value of fixed-income securities of loose monetary and fiscal policy around the world or possibly to investors' expectations of stronger economic conditions ahead. JP Morgan Global Government Bond Index returned -1.9% in dollar terms (+1.9% over the year). With credit spreads (the yield premia

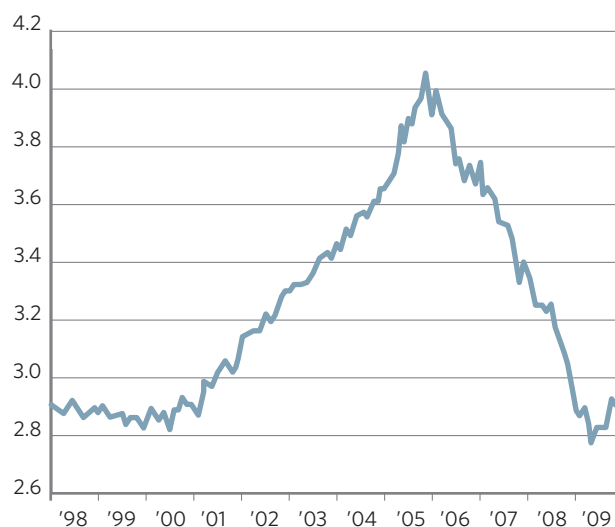
available over government bond equivalents) remaining steady, higher-quality corporate bonds were sensitive to the weakness of government issues.

Elsewhere, the dollar price of **gold** continued to rise sharply, belying seemingly the appetite for 'risk' in other areas of the financial markets. The strength of the gold price seems to have owed as much to its growing fashion as a reserve 'currency' (in the face of the perceived debasement of the world's leading 'paper' currencies) as to any 'safe-haven' characteristics it may bestow. During the final quarter of 2009, India, for example, bought 200 tons of gold for \$6.7 billion (equivalent to 8% of annual global production) from the International Monetary Fund, with Pranab Mukherjee, the country's finance minister, suggesting, in the context of India's reallocation of reserves, that the economies of the United States and Europe had 'collapsed'.

News that the **U.S. economy** had returned to growth in the third quarter of 2009, following the longest period of economic contraction since the Great Depression, made Mr. Mukherjee's pronouncement seem rather belated. However, without the impact of the 'cash-for-clunkers' scheme (which subsidized consumers' purchases of new cars) and the rebuilding of depleted inventories, the expansion would have taken place at a rate of just 1% on an annualized basis (rather than the 3.5% that was reported). More recent data has scarcely pointed to an entrenched recovery in activity and, in a country that has more amusement park attendants than engineers and more waiters than laborers, the recent deterioration in

U.S. HOUSING

HOUSE PRICE TO FAMILY INCOME MULTIPLE



Source: Thomson Reuters Datastream, December 2009.

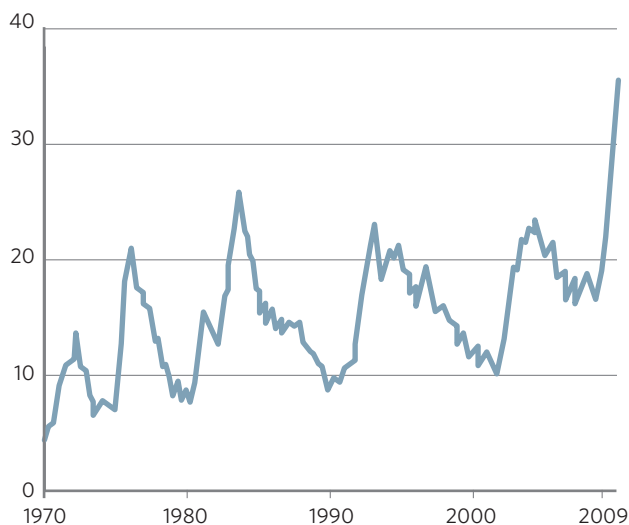
the Institute of Supply Management's non-manufacturing index is a particularly disappointing portent of near-term economic prospects.

Those prospects continue to rest to a large extent on the fortunes of the U.S. employment and housing markets, weakness in both of which has caused consumer confidence to remain depressed by historical standards. With 10% of the workforce now unemployed, the notion of economic recovery may amount to no more than an abstraction of statisticians' work; jobs and wages dominate most people's perceptions of economic wellbeing and continued weakness in both may prevent recovery from taking root. In the housing market, activity has been bolstered by the tax credits that the government has made available to first-time buyers, and further price falls have been made less likely by the average house-price-to-income multiple having fallen significantly over the last three years. However, with one in seven borrowers now in arrears on their mortgage payments or facing foreclosure (the highest rate since records began in 1972), there is scope for housing market conditions to continue to cast a shadow over the consumer-orientated U.S. economy.

The Federal Reserve was notably more upbeat about financial-market and economic conditions in December than previously, but concern about its proclivity to begin raising interest rates may be premature. In 1982, the Federal Reserve waited until four million jobs had been created before raising rates; despite recent improvement in the rate of job losses, the U.S. economy has not achieved any net job creation during the current recovery and the number of people classified as 'long-term unemployed' is already significantly higher than in the 1980s.

U.S. UNEMPLOYMENT

UNEMPLOYED FOR MORE THAN SIX MONTHS AS % OF ALL UNEMPLOYED



Source: Thomson Reuters Datastream, December 2009.

In the UK, the economy was reported to have shrunk unexpectedly in the third quarter of 2009, entailing thereby a sixth successive quarter of contraction for the first time since 1955 and bracketing the UK with Spain and Ireland as the only large economies yet to return to growth. Over the last decade as a whole, the UK economy has suffered its weakest ten-year expansion since the 1940s. There have been some signs of encouragement in more recent data, with industrial production recovering, retail sales proving to be relatively resilient and personal savings rates already having been increased substantially, but there remain significant challenges inherent in the debt-heavy composition of the UK economy.

Conditions in credit markets, notionally at least, have improved, with inter-bank borrowing rates having fallen over the last year to levels that are consistent with their long-term average. However, banks' reluctance to lend means that credit markets resemble Soviet-era shops, in which price lists bear little relation to the products actually available on shelves; despite falling inter-bank rates, the actual rates at which most businesses were able to borrow during 2009 rose and corporate lending by UK financial institutions fell sharply. British households are replete with debt and, while recession has been a boon for fast-food operators (the number of whose outlets has increased by 8.2% in the largest ten UK cities over the last year), the still-bloated nature of domestic balance sheets appears to be a significant impediment to a wider consumer-driven recovery.

Notwithstanding that it subsequently delivered in December its rosiest forecast of UK economic growth since being granted

UK CORPORATE LENDING BY FINANCIAL INSTITUTIONS

QUARTERLY YEAR-ON-YEAR CHANGE (£BN)



Sources: Bank of England, ONS, November 2009.

independence in 1997, the Bank of England saw fit to expand its quantitative-easing programme in November (by £25 billion to a total of £200 billion) on the grounds that the effects of the programme to date had fallen short of those desired. The Bank acknowledged that its operations had helped to boost asset prices and improve access to capital markets but, in loosening monetary policy further, it drew a sharp contrast between changes in economic activity (improving) and the absolute level of that activity (diminished by recession and leaving a significant margin of spare capacity in the economy).

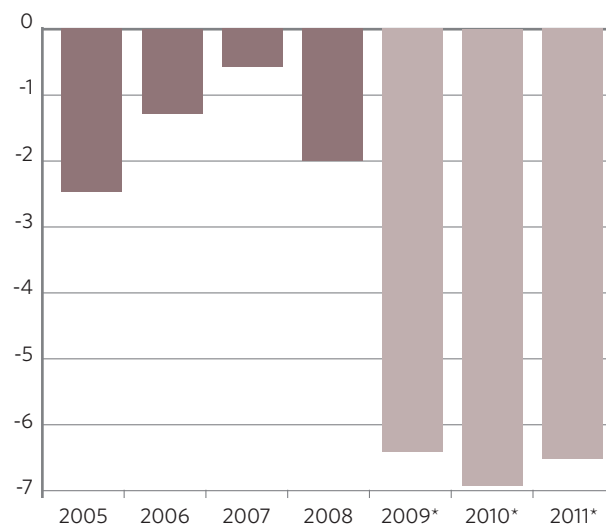
The government, meanwhile, began seemingly to confront the implications of its earlier largesse. Having sold the nation's gold reserves previously, the Prime Minister announced plans for a number of asset sales (including those of the Tote bookmakers and the Channel Tunnel rail link – not so much the family's silver as its scrap metal), oblivious apparently to the Governor of the Bank of England's warning that the UK's credit rating might be at risk unless the government established a "credible" plan to tackle the public-sector deficit. The subsequent Queen's speech outlined the government's legislative plans for the period ahead, but had the look of a bowl of reheated porridge in restating existing measures; and the credibility of proposals for public spending cuts outlined by the Chancellor of the Exchequer in his pre-budget report was undermined by a lack of detail as to precisely where those cuts would occur.

Recovery in the **European economy** has been stronger than was generally anticipated at the beginning of 2009 and appeared to continue during the final quarter of the year, aided by revival in the major regions with which Europe trades, and in no small measure by expansionary fiscal and monetary policy stimulus.

Governmental policies (both new measures and existing welfare 'safety nets') have been a significant factor in Europe's avoidance of a deep and protracted recession, but there is growing concern about how the imbalances engendered by those policies will be tackled. Despite the requirement for existing and aspiring European Union members to maintain budget deficits equivalent to 3% or less of their GDP, none of the eurozone's 16 member countries is on course to meet this stipulation in either 2010 or 2011; the European Commission projects that the aggregate budget deficit of those countries will, in fact, amount to 6.9% of eurozone output in 2010. There is particular unease about the scale of public-sector indebtedness in Greece, and concerns are mounting about the lack of fiscal restraint in Spain and Ireland as well.

EUROZONE BUDGET DEFICIT

% OF GDP



Source: European Commission, November 2009.

* European Commission estimates.

The European Central Bank has provided significant support, by implementing exceptional liquidity-related measures to support the eurozone financial system and to try to avert economic crisis. The ECB indicated recently that it would continue to conduct such operations as appropriate, but that it was seeking to achieve a "progressive, timely, gradual phasing out" of the emergency measures that it has taken.

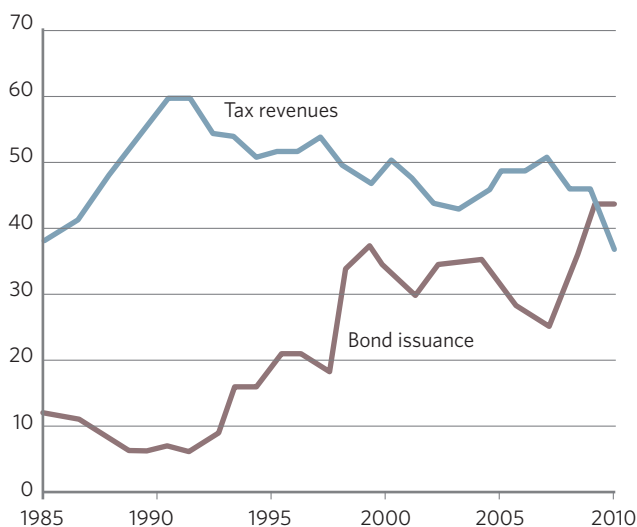
Governments and monetary policymakers have acted determinedly in pursuit of Europe's economic and financial-market stability. The shift to a more Spartan environment may be some way off; indeed fiscal stimulus measures are likely to have a greater impact on growth in 2010 than they did in 2009. However, the adjustment to tighter policy is likely to be a significant challenge to domestically fragile economies such as those of Greece, Spain and Ireland.

Nowhere does hope seem to be dashed more repetitively than in **Japan**, with good news being followed frequently by bad. Preliminary statistics had pointed to strong economic growth in the third quarter of 2009, but revised data was much weaker, with a previously reported recovery in business investment proving to have been an illusion. The counting of investment that did not actually exist represented a twist on the past practices of the Japanese government, whose investment existed but, as in the building of 'bridges to nowhere' for example, did not always 'count'.

Notwithstanding the Bank of Japan's recently announced plans to pump the equivalent of an additional \$110 billion into the country's commercial banks, tension between the BoJ and the newly elected Democratic Party of Japan government, which has portrayed the central bank as overly upbeat about the economic outlook, has grown. The DPJ has pledged to achieve the kind of economic 'rebalancing' that has eluded Japanese governments since the 1980s, chiefly by attempting to spark a recovery in household spending; but, with debt issuance outstripping tax revenues in 2009 for the first time since 1946 and with public-sector debt now equivalent to about 200% of GDP, its room for maneuver seems limited. With 95% of Japan's bond market being owned within the country (only 5% by overseas investors), the government must be careful not to bring about too rapid a drawdown of the household savings that provide vital stability in the country's financial system.

JAPANESE FISCAL POSITION

¥'000BN



Sources: Ministry of Finance, Thomson Reuters Datastream, December 2009.

The economies of the **Asia-Pacific region** continued to recover strongly during the closing months of 2009, with China in particular reporting significant increases in factory output, trade and retail sales, and indicating thereby that recovery was broadening out from government-led infrastructure building to other sectors. In China, however, monetary policy was loose as, despite the money supply growing at more than 25% per annum, consumer prices were reported to be rising only modestly.

Asian central banks intervened heavily in currency markets early in the fourth quarter to try to stem the appreciation of their currencies against the U.S. dollar, the weakness of which, ironically, may have been attributable in part to the decisions of some authorities in Asia to switch reserves of dollars into gold. Such moves to suppress currency strength came less than a week after the world's leading finance ministers and central bankers had concluded their meeting in Istanbul with a commitment to foster the sort of balance in economic growth that less encumbered exchange-rate movements might be expected to help deliver.

In **Latin America**, similarly, authorities have acted to contain the appreciation of their currencies, being concerned apparently about the impact of strong currencies on their export competitiveness, but sanguine meanwhile about the risk of inflation to which manipulated exchange rates can give rise. In Brazil, the central bank intervened consistently during the quarter to stem the rise of the real, motivated as much presumably by the desire to cool speculation in Brazilian capital markets as by the imperative to protect the country's trading interests (which account for less than 15% of overall output).

Brazil remains a particular area of economic optimism in the region, with the decision to host both the 2014 (soccer) world cup and the 2016 Olympics there being symbolic of the progress the country has made on many fronts in recent years. In contrast with many of its 'developed-world' counterparts, Brazil should benefit in the period ahead from the frugality of its government and its households to date.

Investment implications

Government bond markets lost ground during the final quarter of 2009, with rising yields (and falling prices) reflecting perhaps investors' concerns that several developed-world governments are on 'borrowed time' in relation to their fiscal responsibilities. Large-scale bond issuance by those governments has been generally permissible in a broadly deflationary environment, and particularly in the context of the quantitative-easing programmes of central banks (which serve to contain the 'open-market' supply of bonds). However, governments, particularly those in the U.S. and the UK, which are heavily reliant on overseas investors to finance their debts, will have to formulate credible deficit-reduction plans if they wish to avoid the imposition of higher yields upon them by bond-market 'vigilantes'.

Sound fiscal policies and low official interest rates may provide a positive backdrop to (selective) sovereign-bond investing in the period ahead, but investors may have to be mindful of the

ramifications of ‘overcrowding’ in bond markets more widely. At present, fiscal policy in many countries resembles a game of ‘jenga’, in which governments continue to place further blocks of borrowing and spending on top of already precarious commitments, all the time hoping that their towers of debt do not topple upon them. The rising sovereign risk associated with this practice necessitates a judicious, country-specific approach to government bond investment.

In the absence of support from quantitative-easing programmes, a broad array of governments will have to compete for finance from the same sources simultaneously. Should economic recovery spawn keener borrowing on the part of the private sector, those sources may prove less forthcoming and yields on government debt may well rise, as they did dramatically in 1994 amid large-scale issuance by the Clinton administration, to the obvious detriment of investors.

In **corporate bond markets**, there has been evidence of a striking shift in patterns of corporate financing. Investment-grade (higher-quality) companies have replaced much of their bank funding with long-term bond issuance; in 2009, for the first time, the amount of money raised by such companies in both European and U.S. bond markets exceeded their bank borrowing.

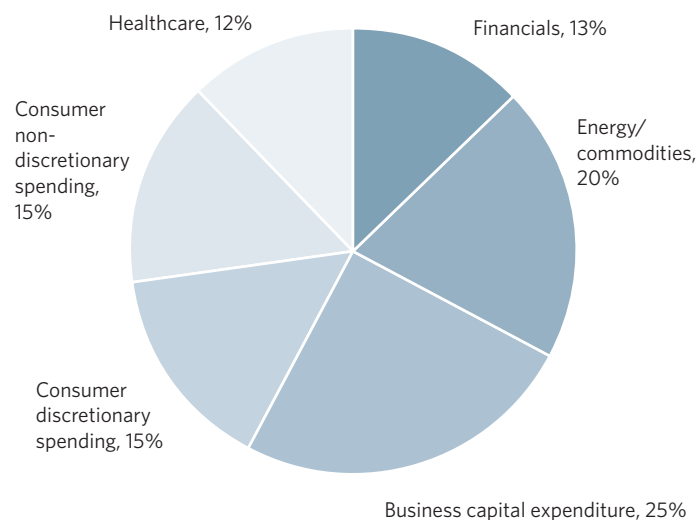
Amid renewed investor demand for corporate debt, investment-grade bonds performed well in 2009, but they may struggle to do so during 2010 following the falls that have already occurred in their yields. Issuance of dollar high-yield (‘junk’) debt has never been higher than in 2009 and high-yield bonds returned more than 50% over the year as default rates stayed below the levels forecast by the bond rating agencies. Those default rates are expected to fall sharply in 2010 and high-yield debt may continue to perform well, but investors’ fortunes might be endangered by any worsening of the economic outlook.

The **U.S. equity market** achieved a stronger final-quarter return than its major-market counterparts, propelled by unexpectedly strong corporate earnings results. With the profits of companies in the S&P 500 Index forecast at the beginning of the quarter to fall in aggregate by 50% on a peak-to-trough basis in the current downturn, against the previous worst decline of 24% (in 1992), there was plenty of scope in hindsight for a less savage outcome. U.S. companies were reported to have achieved remarkably strong productivity gains during the third quarter which, while hostile to household incomes (and perhaps also therefore to hopes for a durable economic recovery), were highly favourable to corporate profitability.

With the Federal Reserve apparently committed to maintaining highly accommodative monetary policy, share prices may continue to rise, but investors should be cautious about seeking to prosper from

U.S. CORPORATE EARNINGS

SHARE OF S&P 500 EARNINGS BY SECTOR



Source: UBS, July 2009.

that policy alone. Until employment conditions improve, it is improbable that central-bank policy will be tightened speedily or significantly, but rising bond yields or a sustained reversal of the dollar’s weakness hitherto could occur swiftly and with significant damage to investments predicated on ‘easy’ monetary conditions.

The uncertain outlook for U.S. households continues to be a concern in an economy in which consumer spending comprises two-thirds of GDP. However, such spending accounts for a much less significant proportion of corporate earnings, with ‘consumer discretionary’ spending generating directly only 15% of the profits of the S&P 500 companies. Subject to the effects that a withdrawal of the liquidity that slaked stock markets in 2009 would have, there should continue to be attractive opportunities for investment among the diverse constituents of the U.S. equity market.

In the ten years to the end of December, investors in **UK equities** suffered their weakest decade since the Great Depression, although the exclusion of income (the bedrock of most stock-market returns) by some commentators in their analysis of UK equity market returns is disingenuous; the MSCI UK All-Share Index returned (in dollar terms) -18.4% over the decade in price-index terms, but including income its total return was a less dispiriting +14.7%.

There are notable challenges to the welfare of UK companies, not least from the indebted nature of large swathes of the economy, from the implications of gargantuan public-sector borrowing to date, from

growing pension-fund ‘deficits’, and from increasingly active trade unions and uncertainty surrounding the outcome of a general election that must be called by June. Investors in UK equities will have to beware the threats associated with such challenges (muted revenue growth, higher taxes, selective dividend cuts and, in the extreme, capital flight from the country). However, given the increasingly global orientation of UK stock-market constituents, domestic difficulties should guide rather than obscure the significant opportunities for investment in some of those companies.

In **Europe**, the region’s globally diversified ‘blue-chip’ companies should be well-placed to benefit from improving demand elsewhere in the world, particularly in the emerging markets in which European exporters are increasingly active. With interest rates low, and bond yields generally lower than the yields available from equities, there is scope for stock markets to continue to appreciate in 2010. However, a country-specific (as well as stock-discriminating) approach is likely to be critical in the period ahead as public-sector debt tackling, a strong euro and uneven economic recovery give rise to a more discordant setting than that which investors enjoyed previously. In particular, investment in the ‘core’ of Europe, where those challenges are likely to take a lesser toll than in the ‘periphery’ of the region, is likely to be preferable.

Japanese equities marked the twentieth anniversary of the peak in the headline Nikkei 225 Index in 1989 with underwhelming returns in the final quarter of 2009 (up only marginally in local-currency terms and down in sterling terms owing to the weakness of the yen)

JAPANESE EQUITIES

NIKKEI 225 INDEX (‘000)



Source: Thomson Reuters Datastream, January 2010.

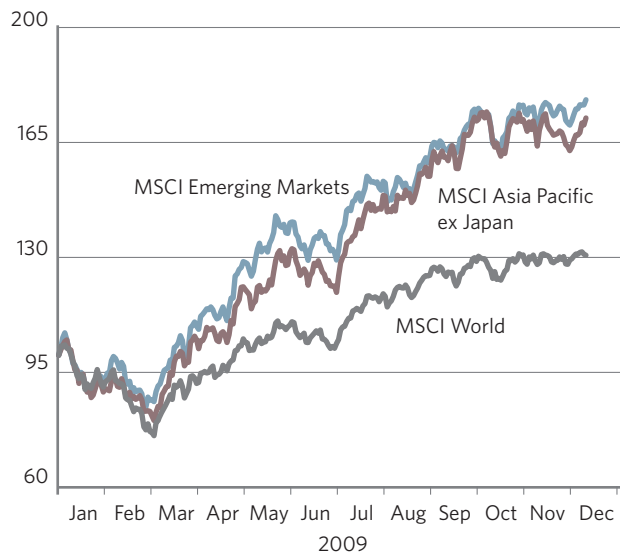
despite better than expected earnings reports from companies. The Nikkei 225 now stands almost three-quarters below its all-time high but, remarkably, Japan’s remains the second-largest stock market in the world in U.S.-dollar terms.

Japan’s challenges have been documented interminably. Domestic economic activity remains sluggish, the threat of deflation has not been vanquished, the population is ageing markedly and the public-sector debt burden is enormous. There is considerable uncertainty about how the new Democratic Party of Japan government will reconcile the tackling of those various challenges (for example in balancing the necessity of reducing the fiscal deficit with the requirement to maintain economic stimulus). In the meantime, investors are likely to have to maintain a discriminating approach to identify opportunities among Japan’s listed companies, many of whom are globally competitive and have improved their financial discipline and increased their dividend payments over recent years.

Equity markets in the **Asia-Pacific region** and **emerging markets** maintained their strength during the final quarter of 2009 to confirm impressive gains for the year as a whole. In places, the rapid ascent of share prices spawned further concerns about speculative ‘bubbles’. In China, for example, the country’s foreign-exchange reserves were reported to have swelled during the previous quarter by significantly more than the amount by which the trade surplus and foreign direct investment increased (suggesting the existence of large inflows of capital to the country’s asset markets). Elsewhere, in Brazil and Taiwan for example, authorities took steps to try to stem capital

ASIA-PACIFIC AND EMERGING-MARKET EQUITIES

TOTAL RETURNS, REBASED TO 100 AT 31.12.08 (\$)



Source: Thomson Reuters Datastream, January 2010.

flows into their markets in fear of the currency-boosting effects that such flows may have.

Asset markets in Asia and emerging economies have been clear beneficiaries of 'easy' monetary policy around the world in the wake of the global credit crisis, including the effect of a 'carry trade' abetted by the weakness of the U.S. dollar. Less accommodative central-bank activity and/or a resurgent dollar would be adverse developments for investors in those regions, but that observation should not eclipse more fundamental attractions. In both areas, there is significant scope for sustained growth in domestic spending and for supportive monetary and fiscal stimulus given the relatively ascetic behavior of local households and governments in recent years. There should continue to be abundant opportunities for well-chosen investment in both Asia and emerging markets elsewhere in the years ahead.

Conclusion

During the course of 2009, the healing actions of the world's leading central banks and governments restored confidence in financial markets. This year, those actions may continue to foster higher asset prices, particularly if they are not threatened by the sort of improvement in economic and financial conditions that would call for the implementation of less obliging measures. However, governments are reaching the limits of their fiscal ambitions, and a tightening of monetary policy (whether by central bankers or via the effects of 'vigilantism' in the bond markets) may occur in areas where economic improvement is more marked or discipline in the tackling of public-sector deficits is less visible.

Global economic activity has recovered over the last year and may continue to do so, but some of the world's major economies have a distinctly unbalanced look about them. Having been force-fed by monetary and fiscal policymakers, those economies have been

fattened sufficiently to be insulated from the cold winds blowing in the aftermath of the financial crisis. However, self-supporting demand in the developed world remains weak, particularly where it is encumbered by over-indebted households and still-fragile banking systems, and it remains dubious that it will improve sustainably in the near future.

Events such as those in Dubai and Greece during the final quarter of 2009 provided reminders that the world is not yet 'out of the woods' in relation to its post-credit-crisis challenges. Those challenges are widespread in nature, but the extent of the regional variations to which they give rise appears to be growing, for example in the scale of public-sector debt and the associated means by which it will be tackled, in costs of capital, in exchange rates, and in rates of inflation and economic growth. 'Sovereign risk' is increasing and sound investment strategies will need therefore to take heed of the growing potential for localized troubles, as well as of the implications of broader macroeconomic and financial factors.

Returns from developed-world equity markets were generally disappointing in a decade branded, rather unfortunately in hindsight, the 'noughties', and investors might hope that early suggestions that the new decade be called the 'teenies' are spurned if they are not to tempt another period of inadequate returns. As they grapple with the uncertainties inherent in financial markets, investors should benefit from an approach which seeks to harness opportunities associated with preferred themes and via investment in specific stocks rather than from markets as a whole. In particular, a focus upon the securities of companies that achieve steady growth in their earnings and have robust cash flows, and that reward shareholders with attractive and growing dividends, remains appropriate.

"Force, unaided by judgement, collapses through its own weight."
Horace, 'Odes', Book 3

All data is sourced from Thomson Reuters Datastream unless otherwise stated.

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