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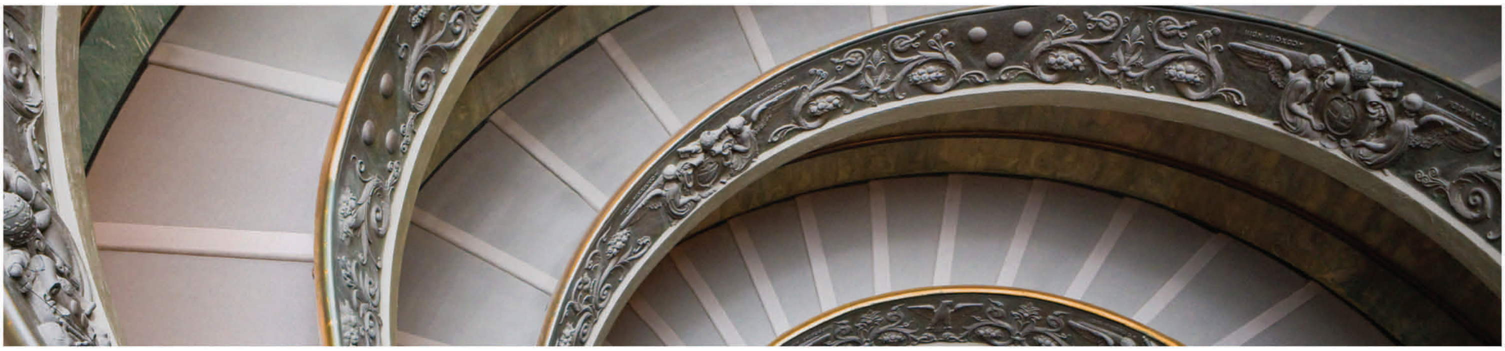

Making sense of the world

Newton's Themes: an update

Newton's investment philosophy is based on the firm conviction that no company, market, or economy can be considered in isolation and that each must be understood in a global context. Newton's investment specialists believe that in an increasingly integrated world, the prospects for equities and bonds can be evaluated properly only by understanding events, trends and competitive pressures and other major factors affecting the global economy.

These factors, or 'themes' as they call them, include changing demographics, the effects of globalisation, the developments in global credit markets and the impact of new technologies. The investment themes provide a basis for the investment debate within the team at Newton and highlight opportunities in the market to pursue in depth. These themes also provide an additional focus when assessing the merits of the stocks in their sectors.

This framework allows Newton's specialists to step back from the day-to-day market 'noise' and focus instead on building a long-term view of global trends and how they might be helping or hindering certain investments. Investment insights and views can then be used in constructing portfolios through an unconstrained, bottom-up stockpicking approach. In the current market environment, the team at Newton seeks robust, well-financed businesses with stable revenues which are more likely to outperform in all markets.

NEWTON
The Power of Ideas

Using themes to maintain perspective

It has been unusually difficult for investors to maintain perspective over the last few years, given the multitude of challenges during the global financial crisis and ever since. Not least among these have been double-dip recessions, persistent sovereign debt woes in the Eurozone and the US, unrest in the Middle East and rising energy prices.

Meanwhile, the investment team at Newton believes that the policies enacted by authorities around the world have served to distort economies and financial markets. The liquidity from highly accommodative monetary policies appear to have had a broad range of effects, seeping into asset and commodity markets, spawning higher prices (for example in energy and food), and leaving economies in much of the western world still beholden to overly stimulated and concentrated financial systems.

In the period ahead, several of these challenges seem set to persist, not least as the world adjusts to deleveraging (debt reduction) in many of the leading economies. Historically, recessions grounded in excessive credit growth and subsequent banking crises are invariably followed, at best, by periods of sluggish economic growth (Source: This Time Is Different, Eight Centuries of Financial Folly, Carmen M. Reinhart and Kenneth S. Rogoff, 2009, Princeton University Press)

The team believes that maintaining perspective in such an environment is crucial to longer-term investment success but, paradoxically, it may be harder to achieve. When near-term events are highly uncertain, asset prices volatile and investors' moods changeable, there tends to be plenty of 'noise' in financial markets. Newton's themes help their specialists to focus on what is important and screen out that noise; they may each be considered on their own merits, but they are also interconnected in nature.

At present, the world is undergoing a number of significant changes, and Newton's themes have evolved to reflect these. As well as less debt, the team believes we are moving towards a world characterized by a more balanced global economy, a higher cost of energy, an older population and a greater degree of connectivity. Each of these transitions is considered in more detail below.

Investment specialists at Newton believe that themes help them to gain perspective on the important risks and opportunities in investment markets. The themes, which represent their convictions about the likely forces of change in the world, are based upon observable and structural trends, rather than speculative or short-lived ideas.

Newton's thematic framework develops over time, reflecting the emergence of new ideas and the culmination of old ones, as well as the evolution of existing themes.

A world with less debt

DELEVERAGE

Three years ago, Newton introduced a theme called 'all change', which described the likely implications of the global financial crisis (and of the accumulation of debt in many developed economies which had preceded it). The team observed in relation to the theme that the bursting of the credit 'bubble' in 2007 had important consequences in a wide range of areas.

Much of what they anticipated in 'all change' has transpired, albeit that the extent of asset-price inflation during 2009 and 2010, much of it driven by ultra-loose policy settings, was remarkable. In addressing the further implications of developed world indebtedness and the imperative to reduce it, 'all change' was replaced with a new theme, 'deleverage', which they believe is more appropriate in capturing these further implications.

'Deleverage' asserts that excessive debt is weighing on economic activity, and that the way in which deleveraging occurs is critical to the outlook for economies and financial markets. The team at Newton anticipates a prolonged period of relatively low (and more volatile) growth in many economies as debt is reduced to more manageable levels. They believe that scale of the accumulated public and private debt means that how deleveraging occurs (whether in disorderly fashion or not), as well as the effect of offsetting actions by authorities, will be critical for all aspects of the investment outlook.

Associated with 'all change' was a theme called 'more government', which underscores the heightened role of states across the world in the life of economies and financial markets. State intervention and forms of managed capitalism hold sway

over an increasing proportion of global output. This is a function, they believe, both of superior growth in the developing and resource-rich parts of the world, in which ‘command’ economies are more prevalent, and of governments in developed economies increasing their role in the wake of the financial crisis. They believe that the crisis has been billed wrongly as a market failure, and achieving sustainable growth is widely seen as requiring more economic intervention, market manipulation and regulation. According to Newton’s fund managers, the result is a potentially volatile and unpredictable mix of distorted price signals and financial asset prices, as well as the risk, of severe mispricing of risk and poor capital allocation.

Amid the sporadic mispricing of risk, however, they continue to identify attractive investment prospects, as depicted partly by our large cap laggards theme, which identifies opportunities among larger companies whose balance sheets are generally robust. With cyclical risk having risen significantly in the wake of the financial crisis, and secular changes having occurred in access to and attitudes towards credit, the team believes the deleverage environment should, over the medium to longer term, generally benefit larger cash-generative corporations with strong balance sheets and relatively stable end demand.

The ideas inherent in Newton’s ‘deleverage’ theme are reflected also in a number of their other themes. Among these is ‘financial concentration’, which evaluates the implications of the post-crisis banking sector. The radical restructuring of the financial system mooted in the immediate aftermath of the financial crisis lost significant momentum once the early ‘v’-shaped recovery took hold, and the structure of global banking remains much as it was in the years before the crisis. The regulatory ‘heat’ on the banking sector has been turned up, but the lack of global coordination and widely divergent vested interests have, the team believes, precluded the sort of radical restructuring that was widely expected in the midst of the crisis. In their view, banking appears still to be dominated by opaque institutions which have questionable balance sheets, but are deemed ‘too big to fail’. The team believes that this represents a substantial risk for both the global economy and investors.

A further point, explored in Newton’s ‘fire risks’ theme, is the risk that the actions of authorities give rise to inflation. Monetary policy settings deemed appropriate for the emergency of the global financial crisis and its aftermath have continued well into the recovery, giving rise to monetary inflation. Although unemployment remains stubbornly high in much of the mature western world, unprecedented peacetime debt levels, almost universal deficit spending and palpable inflationary pressures in the developing world provide the backdrop, in their view, for inflation expectations to become entrenched.

A more balanced global economy

A second area of transition is the movement towards a more balanced global economy. This trend is not just about greater balance between economies, but also about balance within them. According to the team, this will involve shifts in economic influence and difficult decisions being taken by authorities (with scope for vested interests to dictate some areas of policy).

Many of the characteristics of this transition are captured by both Newton’s ‘global realignment’ and ‘Chinese influence’ themes. While industrialised nations still dominate the world’s economic output, wealth, consumption and market capitalisation, and consume the lion’s share of natural resources, the team believes the stronger growth potential and increasing economic influence of the developing world are progressively challenging this position.

According to fund managers at Newton, realignment is likely to be volatile and increasingly prone to cyclical divergence. Maintenance of loose policy in the developed world is likely, they believe, to lead to greater variations in approach elsewhere as faster-growing developing-world and resource-rich economies are forced to tighten policy and/or allow their currencies to appreciate in order to avoid inflation.

In a post-crisis world of lower aggregate economic activity, in which almost all authorities must produce growth (to service debts and/or appease their populations), maintaining market share, and therefore relative competitiveness, seems of prime importance. This is the kind of environment in which the team believes few administrations will choose to have a strong currency. As a consequence, trade tensions could easily grow, and governments might become increasingly tempted by capital controls, according to the team. The transition to a more balanced global economy is likely also, they believe, to have inflation-related consequences, explored in the 'fire risks' theme, particularly as developing economies choose to maintain currency pegs to the US dollar and thereby import inappropriately loose (and inflation-promoting) monetary policy.

A more highly connected world

The final area of transition which the team at Newton regards as significant is the move to a more highly connected world. As their long-standing 'networked world' theme observes, networks are now ubiquitous, allowing information to flow between entities that may previously have been unconnected. The technologies being built into these networks are still developing at a rapid pace, but, according the team, the ecosystem of the web is unstable, presenting unprecedented opportunities and risks for both web-based and traditional business models.

Newton's new 'smart' theme builds on the ideas inherent in their 'networked world' theme. It recognizes that a range of technologies are making networks, systems, processes and products of all kinds increasingly responsive and intelligent. In turn, these 'smart' entities have the potential, they believe, to enhance efficiency and productivity radically, as well as enable more targeted and tailored products.

A world with a higher cost of energy

The team at Newton examines the risks and opportunities associated with the transition to higher energy costs in their 'energy economy' theme. The end of the era of cheap, easily extractable oil reserves is likely, they believe, to give way to a potentially volatile transition towards more energy-efficient models of economic activity. Higher energy costs and environmental concerns are stimulating investment in alternative (though much less concentrated) forms of energy. Modern consumer-oriented economies are highly energy-intensive; substantial improvements in productivity, infrastructure, efficiency and conservation will be necessary, in their view, if this trend is not to act as a drag on economic growth and investment returns.

Newton covers this transition in a number of other themes, including 'state intervention', 'smart' (see above), 'fire risks', 'construction and reconstruction', and 'Earth matters'. The last of these notes that environmental issues have become prominent in the minds of both the public and policymakers. A political consensus is emerging around investment in 'green' technology, but current growth trends in the developing world suggest significant additional stress on resources and the environment.

An older population

Newton's 'population dynamics' theme is concerned with demographic and related trends. The distribution of age, income and wealth creates dynamics, both at national and global levels. Although demographic profiles currently differ markedly between different regions and countries, the team observes that populations are broadly ageing, with developing world demographics changing more rapidly as incomes in local economies grow.

The ageing of the world's population has important implications, according to the team, in a number of areas, including the nature of economic recovery, patterns of spending and saving, costs (not least among already fiscally challenged economies) and taxes.

In several areas, demographic changes appear to us to be creating opportunities. Newton's 'healthy demand' theme explores the ramifications of ageing populations for the health care sector. The team observes that expanding incomes and changes in lifestyles in the developing world, combined with ageing populations and severe budgetary constraints in the mature economies, are fuelling strong demand for affordable healthcare solutions.

Conclusion

Looking at the areas of transition and change set out above, heightened volatility in financial markets is likely to be accompanied by considerable market 'noise', according to specialists at Newton, and investors may face significant risks in seeking to meet their investment objectives. However, change often leads to opportunity.

Newton's themes have evolved over time and become active in our clients' portfolios before being formalised and publicised. As such, changes and developments highlighted by Newton's themes are not a 'watershed' in portfolio construction. Amid pronounced economic and financial market challenges, maintaining perspective appears crucial to fund managers at Newton in seeking both to manage risk (which they believe is the corollary of all investment activity) and harness opportunities. They believe that their thematic framework provides that perspective and allows them to make sense of risks and opportunities in a volatile and complex world.

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