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## Using themes to manage risk

At Newton, we employ a global, thematic approach that allows us to gain perspective on financial markets. That perspective directs our analysts and portfolio managers towards profitable investment opportunities around the world, but it serves also to identify areas of risk. In this article, we look at how our themes are enabling us to manage risk in our clients' portfolios, with particular emphasis upon our *more government* and *fire risks* themes.



*More  
Government*

### **More government**

Our *more government* theme explores the ways in which governments are becoming more influential in all aspects of economies and society. The increasing role of governments can be seen most obviously in the heightened regulation of the financial sector, but also in a number of other areas, such as the healthcare sector and the environment. Other clear features of *more government* are heightened public spending and associated changes in taxation.

In the pharmaceutical sector, regulation is vital to ensure the safety of new drugs. In the last 15 years, there has been a significant increase in this regulation, which has led to a doubling in the number of patients required to be involved in clinical trials and a quadrupling in the costs of running such trials. For pharmaceutical companies, such an escalation of costs is highly significant and explains partly 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, and the lower rate of overall drug approvals focuses our attention on identifying companies that can be innovative despite more onerous regulation.

The *more government* theme is also evident in the increasing scope of climate-change-related legislation and regulation. Amid a growing conviction that global warming is linked to increased levels of carbon dioxide in the atmosphere, governments around the world have moved to reduce greenhouse gas emissions, for example via free-market measures such as carbon trading. Government legislation on carbon allowances is likely to have a significant impact on the carbon price in the future and is likely to drive changes in corporate behaviour as companies attempt to reduce additional costs. In short, we think that the trend towards more complex regulation is likely to continue in relation to a number of different industries.

Increasing government 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 towards nationalised equivalents.

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 and it is noteworthy, given that the US was felt to be at the epicentre of difficulties in financial markets, that the UK's commitment to the banking sector is actually twice that made in the US. The UK economy is, compared with the US economy, relatively small but has a very large banking sector and we believe that will curb UK economic activity in the years ahead.

Government spending has risen fast, not simply in the aftermath 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, and higher taxes are being implemented across the world.



### *Fire risks*

Our *fire risks* theme looks at the potential for inflation to rise in the future. Historically, there have been a number of times when the printing of money by authorities 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 in the wake of central banks' and governments' stimulus measures.

In the US, for example, the Federal Reserve pumped \$1.1tn into the financial system in response to the global credit crisis, an amount equivalent to 20 times the scale of its monetary expansion at the turn of the Millennium and in the period following the September 11, 2001 terrorist attacks. 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. In the oil industry, for example, the volume of 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. Discoveries are likely to remain modest in the years ahead and oil production costs are likely to rise as it is becoming more and more challenging to extract oil from the ground. Simultaneously, oil demand will continue to rise.

In relation to another commodity, food, rising populations, increased urbanisation and climate change have put greater pressure on arable land; the amount of land available for agriculture has fallen markedly over the last 60 years and 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. 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.

### Applying themes to portfolio construction

Our *fire risks* and *more government* themes, like many of our other themes, are proving to be highly useful in identifying risks. With government ownership being highly relevant in the oil sector, for example, we want to invest in companies with strong reserves and to avoid investing in those that lack reserves (or control of their reserves). We want also to avoid companies that may become involved in conflicts with governments because 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'.

Instead, we favour exposure to oil 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.

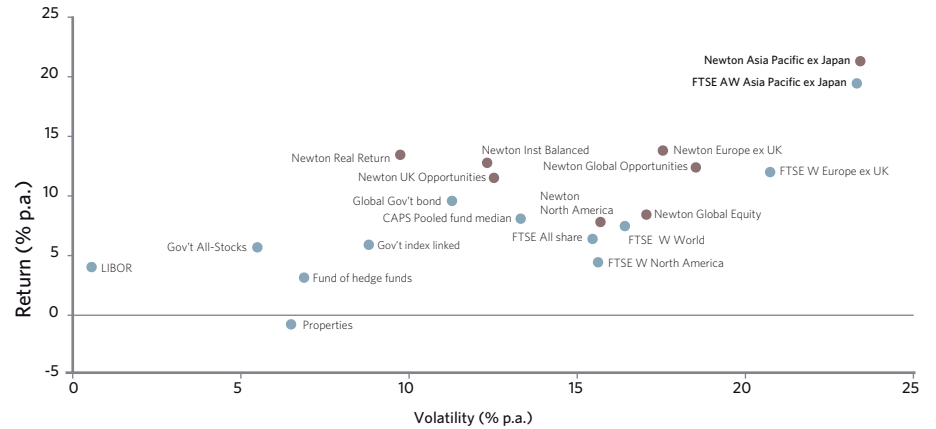
We are also mindful of *fire risks* (the risk of inflation) in relation to the oil sector, and particularly in terms of the cost of extracting oil from the ground. In seeking to manage that risk, we are looking at companies that we believe are going to benefit from rising costs. Among the likely beneficiaries of rising costs are the oil service companies, the companies that help producers extract oil.

Our *fire risks* theme also entails our preference, where mandates allow, 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), through gold ETFs and in 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, and we show below the risk and return characteristics of a number of our strategies.

## RISK VS RETURN - 5 YEARS ENDED 30/09/09

Source: Newton as at 30/09/09



We discussed this topic at our investment briefing in November, a full review of which is available from Johanna Thomas (020 7163 2751 or [johanna\\_thomas@newton.co.uk](mailto:johanna_thomas@newton.co.uk))

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