

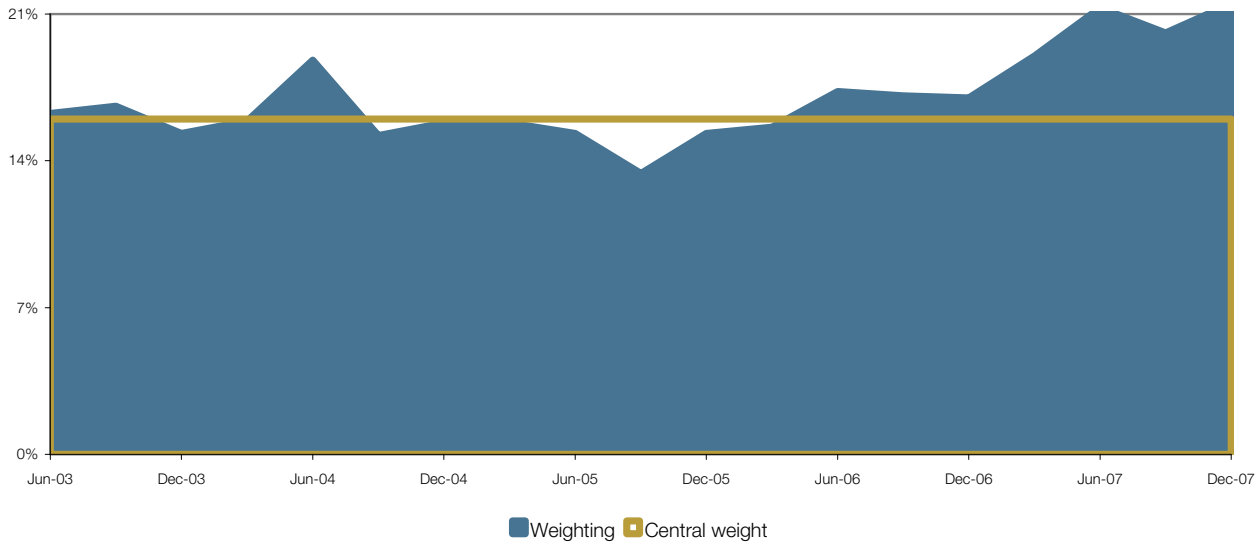
Hedge fund exposure in the Newton Phoenix Fund

We increased the Phoenix Fund's allocation to hedge funds last year. This note explains our rationale.

The fund's exposure over time

Chart 1 shows the fund's exposure to hedge funds since launch. Until the spring of 2007, the allocation to hedge funds is close to 16% - the weighting suggested by the expected long term return and volatility of hedge funds (the brown line). The allocation then moves sharply up to its maximum of 21% - its current level.

Chart 1

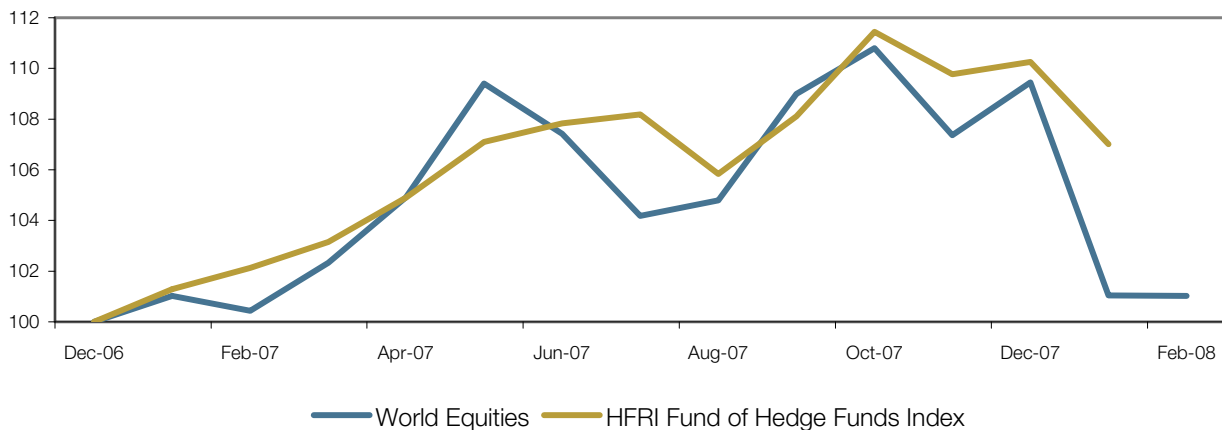


Source: Newton

From 2003 to early 2007, we were attracted by the lower volatility of hedge funds but expected better performance from other assets such as equities and property. This was indeed the case through to mid 2007. However, the onset of the credit crisis in the summer of 2007 marked a reappraisal of risk – equities, credit and property entered a period of higher volatility.

Initially, hedge funds did little to enhance their reputation as diversifiers – falling 2.2% in August (HFRI Fund of Hedge Funds Composite). Since then, hedge funds have continued to show some correlation to equities, but chart 2 shows the improved performance recently. In 2007, hedge funds were one of only three assets in the fund that rose more than 10%.

Chart 2



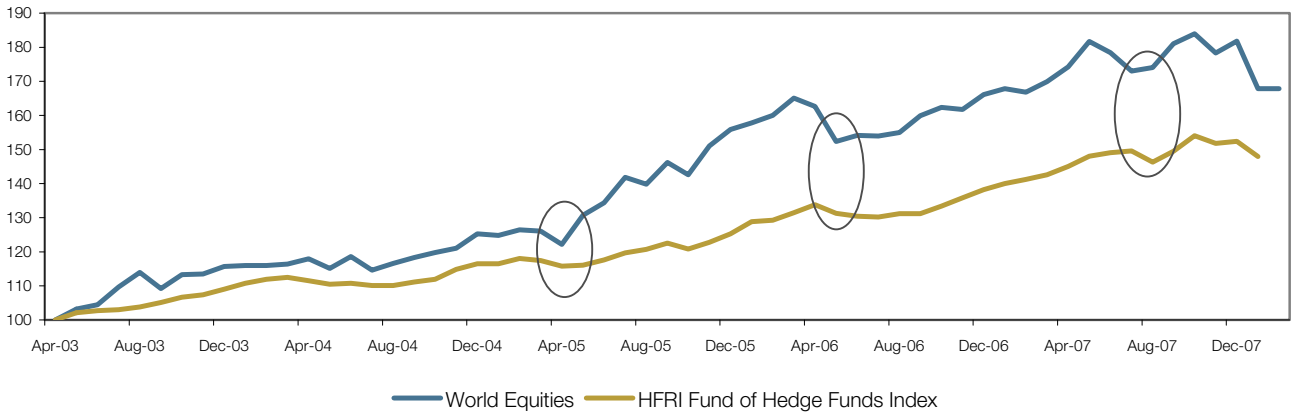
Source: Thomson Datastream

Many investors (including us) were concerned in early 2007 that lower grade bonds were overpriced and that the newly invented CDOs, ABSs and other acronyms might prove very dangerous to hedge funds. In the event, the severe movements in credit markets damaged investment banks far more than hedge funds.

The bad news

The closure of a Peloton hedge fund in February has drawn further negative publicity to hedge funds. Peloton’s ABS fund rose 87% last year, but tighter credit terms forced a sale of assets at deeply unattractive prices causing clients to lose all their money. There are likely to be more examples of a combination of debt and investment in illiquid assets causing the demise of a hedge fund. In the light of capital losses suffered by a number of investment banks, they are likely to reassess their appetite for providing credit to hedge funds. Our preferred method of investment is therefore by funds of hedge funds, despite the extra layer of (high) fees, on top of the (high) fees charged by individual hedge funds. Finally, chart 3 shows that equity market falls have too often been reflected in falls in hedge funds.

Chart 3



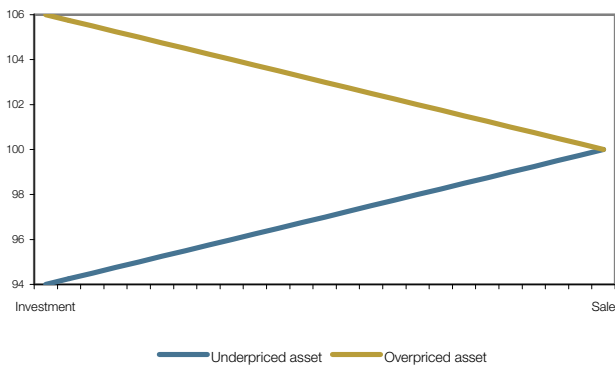
Source: Thomson Datastream

Reasons for increased allocation

As multi asset investors we view the attractions and risks of one asset relative to the attractions and risks of the others. With increased volatility of riskier assets, the attractions of lower volatility hedge fund returns increase.

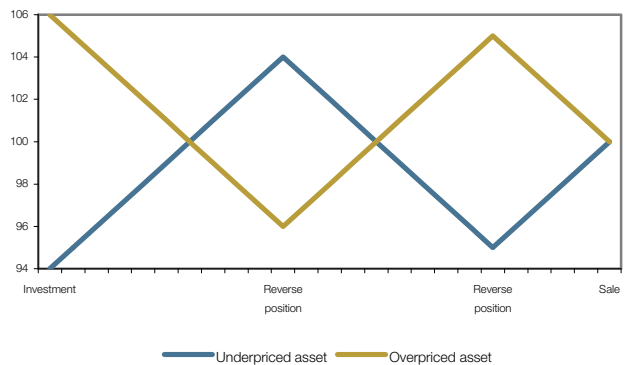
Heightened volatility brings opportunities that hedge funds are able to exploit. An example of this is arbitrage strategies, which exploit pricing inefficiencies between related assets. Chart 4 shows two related assets with low volatility – one overpriced by 6%, one underpriced by the same amount. An arbitrageur will buy the underpriced asset and sell the overpriced and realise one profit on the final sale. Chart 5 shows two related assets with higher volatility. An arbitrageur is able to sell the overpriced and buy the underpriced not once but three times, realising a profit on each occasion.

Chart 4



Source: Thomson Datastream

Chart 5

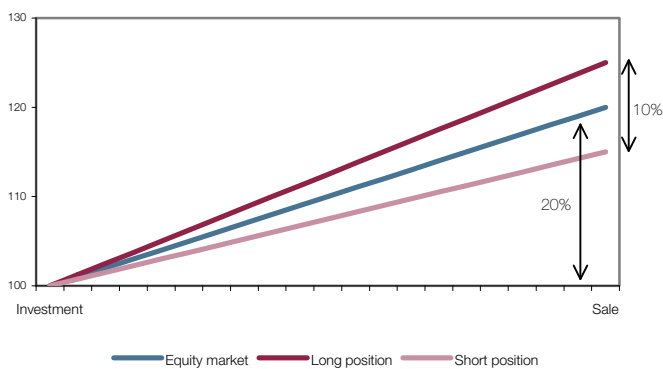


Source: Thomson Datastream

Additionally, there has been an increase in dispersion of returns recently. The best performing assets have outperformed the worst performing assets by a wider margin. While equity markets rose, the returns from equities were very attractive to investors. Hedging this market return and replacing it with a return generated by buying the best performing shares and selling short the worst performing shares reduced profits. This was compounded by the lower margin between the best and worst performing shares. The increased dispersion and lower equity returns have made long/short equity more attractive.

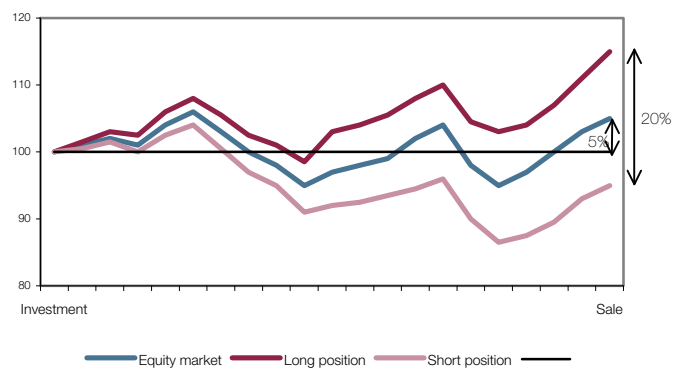
Chart 6 shows the performance of an investor in a steadily rising equity market (blue solid line) and that of a long/short investor who buys a share that outperforms by just 5% (dark purple line) and sells short a share that underperforms by 5% (light purple line). Chart 7 shows a weaker bull market in equities and long and short positions that out and under perform by 10%. The scenario in chart 6 is better for long only equity investors; the scenario in chart 7 is better for long/short investors **if** they are good stock selectors. We would argue that chart 7 better represents the current situation.

Chart 6



Source: Thomson Datastream

Chart 7



Source: Thomson Datastream

These market conditions give hedge funds opportunities to make bad as well as good decisions. We expect there to be plenty of hedge fund collapses in 2008, but we also expect the returns from hedge funds as a whole to be attractive.

The returns from our hedge funds suggest this allocation has been beneficial to date. We will be watching events closely to see whether this continues or a change is warranted.

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For the latest performance of the Newton Phoenix Fund, please ask for the latest factsheet.

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