

# Performance of the Newton Phoenix Fund

17 October 2008



Since the launch of the Phoenix Fund in 2003, we have seen four distinct phases in equity markets – a rally from the trough in the spring of 2003, a retreat in the spring of 2006, followed by a further move upward in late 2006 and during 2007, then falls over the last year. This note focuses on the latest bear market up to the end of September and on the month of September in particular, which was the worst month for the Phoenix Fund since inception.

We show below the performance of the various assets in which the Fund invests and of the Phoenix Fund in each of the market phases (and in September alone). All figures are total return, and the Phoenix Fund return is after management fees.

	11 April 2003 to 6 April 2006	6 April 2006 to 13 June 2006	13 June 2006 to 12 October 2007	12 October 2007 to 29 September 2008	September 2008
<b>Newton Phoenix Fund (B)</b>	<b>+56.6%</b>	<b>-5.6%</b>	<b>+13.5%</b>	<b>-10.8%</b>	<b>-8.3%</b>
<b>Equities</b>					
FTSE All Share	+86.2%	-8.7%	+28.5%	-26.6%	-13.2%
FTSE World (£)	+72.8%	-12.3%	+27.6%	-19.9%	-9.9%
<b>Bonds</b>					
UK gilt index	+16.1%	+0.2%	+2.0%	+7.4%	+0.1%
UK non gilt index	+21.0%	+0.1%	+1.0%	-2.7%	-4.6%
Sub investment grade bonds (£)	+46.4%	+0.6%	+7.2%	-15.2%	-9.5%
UK index linked gilt index	+22.2%	+0.5%	+5.8%	+11.4%	-4.0%
<b>Property</b>					
FTSE All Share Real Estate	+204.7%	-10.4%	+3.9%	-31.5%	-5.2%
Property investment trusts	+140.4%	-6.3%	-2.2%	-34.8%	-7.4%
<b>Hedge funds</b>					
Hedge fund investment trusts	+31.7%	-2.3%	+12.0%	-13.5%	-10.7%
<b>Private equity</b>					
Private equity investment trusts	+110.7%	-12.1%	+30.7%	-25.1%	-12.8%
<b>Commodities</b>					
GSCI Commodity index (USD)	+78.0%	-1.0%	+1.8%	+9.3%	-12.4%
Dow Jones AIG Commodity index (USD)	+77.4%	+2.5%	+29.8%	+3.1%	-11.2%
<b>Sector average funds</b>					
IMA Cautious Managed	+41.9%	-4.2%	+10.2%	-12.1%	-6.5%

**Fund data:** Source: Lipper, as at 30 September 2008. **Calculation basis:** Sterling, total return, bid to bid, without initial charges, net income reinvested, net of management fees.

**Index data:** Source: Datastream and Bloomberg, as at 30 September 2008. **Calculation basis:** Sterling unless otherwise indicated, total return, bid to bid, without initial charges, net income reinvested.

Returns during the latest phase (12 October last year to 29 September this year) show the extent to which the prices of many different assets fell; the exceptions were government bonds and commodities. Clearly, with markets falling so broadly, it was virtually impossible to achieve the Fund's target return of 2% more than cash. Below, however, we review the investment decisions we took to see which worked well and which worked poorly.

### Equities

By the end of June 2008, the equities within the Phoenix Fund had performed approximately 40% better than the FTSE World Index and 24% better than the FTSE All Share since inception (Phoenix Fund equities +109.4%, FTSE World Index +69.3%, FTSE All Share +85.6%). This can be attributed to our global thematic investment process which, for example, led to our aversion to Western banks. However, from mid July banks were stronger than the broader market and other sectors such as oils and mining declined sharply, reducing our outperformance over the market indices to just over 20%. The equity allocation accounted for more than half of the decline in value in September. The worst performing equities in September were Anglo American, Harbin Power, K&S, Subsea 7, Thyssenkrupp and Xstrata, each of which fell more than 30%, but all of them are favoured by our research team for the longer term. Due to our diversification policy of investing no more than 1% in any one share, the effect on the Fund of each of these was less than 0.15%, with the exception of K&S, whose share price fall cost the Fund 0.22%.

In terms of asset allocation, the move to reduce our equity weighting from approximately 34% to 28% in February and April 2008, when equity market indices were 20% to 25% higher than end September levels, was very helpful.

### Bonds

We divide our allocation to bonds between higher quality investment grade bonds and a much smaller weighting to lower quality sub investment grade bonds. Credit rating agencies rate bond issuers according to their view of the safety of those issuers. While the shortcomings of those ratings have been exposed recently, such ratings remain the standard measure of a bond's safety. The rating 'AAA' is awarded to the safest bonds, followed by 'AA', 'A', 'BBB' and so on. Reviewing the investment grade bonds first, we had increased our exposure to the very highest quality corporate bonds significantly from late 2005, well ahead of the credit-related troubles that began last summer. In 2005, one third of the Fund's bonds were rated 'AA' or above. In 2007, this proportion had been increased to three quarters, which together with our avoidance of mortgage-backed bonds was very beneficial.

However, earlier this year, we sold most of our safest investment grade bonds in the belief that we were being adequately compensated for the extra risk of lower quality (but still investment grade) bonds by a higher yield. In fact, the extra yield of such bonds has increased as panicky investors have sought the safe haven of 'AAA' rated bonds. In addition, we held too many bonds issued by banks. While these were issued primarily by UK high street banks, rather than any of the building societies or US investment banks that have got into serious trouble, these bonds also fell. It remains highly likely that each of these bonds will be repaid, but the market's flight from bonds issued by banks in general has driven down prices in the shorter term. The Fund's investment grade bond allocation cost the fund 1% in September, with the largest fallers being bank bonds issued by Barclays and HBOS.

Sub investment grade bonds are rated lowly by the agencies; they offer a higher yield but with higher risk. We reduced exposure to such bonds from 7% in 2005 to below 3% in 2007 and we have remained averse to these bonds since then. For this reason, the performance impact in September of this allocation was less than 0.5%.

We had switched a number of our sub investment grade bonds into autocallable structured products some years ago. In the first few months of 2008, we had switched all those structured products that relied on the market rising in order to pay a healthy return into products that would pay a good return if the market fell. None of the structured products we own have defaulted, although some of them have faced liquidity problems owing to illiquidity in the underlying credit markets.

### Property

We had reduced our UK property exposure from 14% in 2006 to 8% in June of last year, but the falls in our property investments were precipitous in the second half of last year and in the first half of 2008. The price of the Fund's property investments outside the UK (principally Europe and the Far East) also fell substantially. Our property exposure has been at its low point of 7-8% for almost a year now and consequently this area played little part in the falls of September (less than 0.7%).

### Hedge funds

In 2007, we had overcome our dislike of the fees, gearing and opacity of hedge funds sufficiently to increase our weighting to 20%, believing that increased volatility and performance dispersion offered significant opportunities. However, we decided to trim exposure by 3% in the third quarter of this year given our increased concerns about the safety of counterparties. Our favoured method of reducing hedge fund exposure has been to sell those funds of hedge funds that trade above underlying values. To recap, the Phoenix Fund owns quoted investment trusts that invest in hedge funds. The prices of those investment trusts are determined by supply and demand in the market – popular trusts tend to be priced above the value of the underlying hedge funds and less popular trusts tend to be priced below underlying value.

At the end of September, the market uncertainty caused many share prices to fall far below the underlying hedge fund values at the same time as many of the underlying hedge funds were reporting poor results. These factors account for the sector's fall of 10.7% in September, part of which is due to poor underlying hedge fund performance and part due to share prices falling much further. The hedge funds within the Phoenix Fund fell rather less (-7.5%), with the two largest fallers being F&C Event Driven and Marshall Wace TOPS. Since September, these funds have decided to sell investments and return capital to shareholders - this capital is likely to be well in excess of end September share prices. Nonetheless, hedge fund weakness cost the Fund 1.4% in September.

### Private equity

We have bought very little private equity since 2005 and the weighting has been below 2% of the Fund for almost three years. The performance cost in September was 0.1%.

### Commodities

Our focus within this asset class has been on agricultural commodities for some time now, but all commodities except gold have been falling recently. Although the recent falls have been severe, our weighting is quite low (less than 4%). Given the strength of the Fund's gold exposure, the performance cost to the Fund in September was only 0.1%.

### Summary

The Phoenix Fund has avoided the very worst of the recent market falls owing to our avoidance of Western bank shares, mortgage-related securities and similar instruments. We can also point to a number of decisions to reduce assets that have subsequently performed poorly. However, we failed to adjust our equity exposure away from commodity-related areas and our allocation to bank bonds also hurt performance.

It is worth reiterating the objectives of the Phoenix Fund – the Fund invests in a diversified manner to produce returns above cash with lower volatility than equities. Since launch, the Fund has consistently achieved its objectives of diversification and lower volatility than equities. Over the five and a half years since launch it has also achieved its return objective. However, this will be of little consequence to more recent investors who have seen significant losses over the past year.

We will continue with our policy of investing widely in order to reduce volatility, but this will only yield positive returns if the prices of some of the assets in which we invest rise. There is much work to do to return the Fund to a positive trend; almost certainly the Fund will deliver a loss this year and we will not increase our risks in order to try to avoid this. While the Newton Phoenix Fund remains well ahead of other funds in the Cautious Managed sector, we will not focus on this as a comparator. We believe that the relative outperformance has been driven by our independently minded approach.

I hope that this note has provided you with more information about the recent performance of the Fund. Your fund manager keeps closely in touch with, and is often part of, the decisions being made in relation to the Phoenix Fund and is happy to answer any of your questions.

**Philip Collins**  
Investment Director  
Newton Investment Management Limited

#### Discrete past performance - percentage change

From	30/09/03	30/09/04	30/09/05	30/09/06	30/09/07
To	30/09/04	30/09/05	30/09/06	30/09/07	30/09/08
Newton Phoenix Fund	11.0%	16.5%	7.0%	8.5%	-11.0%

**Source:** Lipper, as at 30 September 2008. **Calculation basis:** Sterling, total return, bid to bid, without initial charges, net income reinvested, net of management fees.

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

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**Sources:** Index data throughout is from Datastream and Bloomberg, unless otherwise indicated. As at 30 September 2008. **Calculation basis:** Sterling unless otherwise indicated, total return, bid to bid, without initial charges, net income reinvested.

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