



Newton Fixed Income March 2010

Newton's approach to global bond investing

Our approach to global bond investing is based upon the following principles:

We are active managers of global sovereign bonds and currencies and have a long track record in this asset class

We believe that a passive, index-based approach to sovereign bond investing could have negative implications for investment returns. The composition of bond indices is determined by the market 'capitalisation' of sovereign issuers, with a greater debt burden increasing the weighting of an issuing government in an index. However, if increased issuance is attributable to a higher level of government borrowing (as a % of GDP), it is likely to be associated with that government's declining credit quality and the underperformance of its bonds, making the greater holding of such bonds by the passive investor counterproductive. A good example of this has been Japan, whose weighting in bond indices has risen over the last 15 years, but whose bond market has been one of the worst performing in the sovereign universe. By taking active country, duration and currency decisions, in the context of a global thematic approach, investors can avoid this phenomenon.

Our global thematic approach is ideally suited to fixed-income investing and has led to outperformance over time

Our global themes are long-term in nature and the forces they identify tend to have a significant effect on interest rates and currencies. Using themes gives us an advantage over other managers, who may be caught up in the short-term 'noise' of markets. Recent examples include our *global realignment* and *all change* themes, which have led us to favour currencies other than the euro, the yen and the US dollar. We prefer currencies such as the Australian dollar, the Swedish kroner and some Asian currencies that are not held back by over-indebtedness and that have good support from economic growth.

We are benchmark-aware, but we are not slaves to benchmarks

In addition to the credit-quality rationale highlighted above, there are periods when duration flexibility can be extremely important. Sticking close to the duration of an index during times of rapidly

rising or falling interest rates can lead to capital losses or missed opportunities. Instead, we strive to achieve our clients' objectives by managing a number of factors actively, including duration, credit-quality exposure, stock selection and currency exposure. In short, we use indices to identify the universe of investment candidates, but it is the ability to deviate thoughtfully from the composition of those indices (within acceptable levels of risk) that creates significant investment opportunities.

Our duration range is adjusted according to the interest-rate cycle. Over the last few years, it has been as low as less than three years and as high as ten years (against index duration of about six years). This has protected portfolios from significant capital loss during periods of rising bond yields and it has led to good returns during periods in which growth has been weak and markets have witnessed 'flights to quality'. Our country allocation can also be described as 'active', being independent of index weights. We do not own securities in a bond market that we expect to weaken (even if that market has a large weighting in the index).

We manage bond and currency risk separately, but each draws upon the same process

The economic circumstances that support a bond market may undermine its related currency. Weak economic growth and declining interest rates are generally good for domestic bond markets but bad for currencies. Investing in a bond market, but hedging related currency exposure (into another currency that has better support), is a strategy that we use extensively in our global bond portfolios. Our global themes are vital in guiding our respective decisions about bond and currency exposure.

Our flagship global bond portfolios do not hold corporate bonds; they hold only sovereign bonds and the issues of sovereign-supported entities

Our global bond strategy is focused upon sovereign bonds. We may hold quasi-government bonds, such as supra-nationals and agency debt, but we do not have any material exposure to corporate bonds. Duration, country and currency allocations provide sufficient opportunities for portfolios to achieve good investment returns.

All data is sourced from Bloomberg unless otherwise stated.

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