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Newton's approach to absolute-return bond investing

Why take an absolute-return approach to bond investing?

Bond markets are driven by investors' expectations about interest rates and inflation. As these expectations change, so do bond yields. For many years, low inflation and steady economic growth have allowed bond markets to be relatively stable. However, the credit crisis has changed the background for fixed-income investors, with short-term interest rates having had to be cut to unprecedented lows and government debt levels having risen to historic highs. In the aftermath of the credit and economic crisis, interest rates will, at some point, rise once more and this may create a 'bear' market in bonds. As most investors hold bonds for their scope to protect capital and income, bear markets in bonds can be especially painful (and usually unexpected). There are two ways in which bond investors may lose capital: through default and via rising interest rates. During the credit crisis, investors have experienced some of the former; as the crisis abates, they may be vulnerable to more of the latter.

No need for complicated derivative transactions

There are several ways in which investors may limit capital losses in an environment of rising interest rates. For example, if interest-rate expectations are mounting, using derivatives to offset the risk of higher rates should be beneficial. Such derivative use need not be complicated and need not cover an entire investment portfolio; buying put options on government bonds, for instance, can be an effective way of generating positive returns from falling bond prices. Alternatively, adding holdings of high-yield corporate bonds may allow investors to benefit from an asset class that tends to do well during times of strong economic growth. Whichever approach investors take in seeking to limit capital losses, their priority should be to keep their strategy simple and liquid; history is littered with strategies that were over-complicated and which, in the case of LTCM for example, proved inadequate in protecting capital when markets became unstable.

Our global thematic approach is ideally suited to absolute-return investing and has led to good returns during the recent volatile past

Our global investment themes are long-term in nature and the forces to which they refer tend to have a significant effect on interest rates and currencies. Using themes to identify areas of opportunity and risk gives Newton an advantage over other investment managers, who may be caught up in the short-term 'noise' that affects markets. Current themes include *global realignment* and *all change*, both of which have encouraged our bias to currencies other than the euro, the yen and the US dollar. We favour, for example, the Australian dollar, the Swedish kroner and some Asian currencies, which are not tarnished by excessive debt and which enjoy strong economic support.

Summary

An absolute-return approach which uses (over-) complicated derivative structures to achieve its objectives can create an illusion of stable returns which is eventually shattered. An absolute approach that relies upon investment manager skill and which harnesses a broad range of opportunities is easier to understand and can be more profitable over time. A dynamic, absolute-return strategy may invest opportunistically in government bonds, emerging-market sovereign debt, and investment-grade and high-yield corporate instruments. It may also hold currencies and derivatives to generate additional returns and control risk. Given the prevailing (ultra-low) interest-rate backdrop, there is a threat that central banks are too slow in removing their stimulus and that inflation expectations start to rise. Traditional bond funds would be vulnerable to higher rates and to expectations of higher inflation, but a diversified fixed-income portfolio, with some downside protection, should still be able to make a positive return, even in a rising interest-rate environment.

All data is sourced from Bloomberg unless otherwise stated.

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