

The use of structured products within the Phoenix Fund

Any investment which has limited downside and significant upside is an obvious choice for the Phoenix Fund. All the more compelling given the decline in the pricing of structured products due to cheaper option prices (owing to lower volatility) and a reduction in fees.

We have purchased a number of these investments in Phoenix, such as the Japan Capital Protected Fund. This is a relatively simple structure, repaying 100p six years from launch in 2005. If the Japanese Topix Index rises over this period however, it will pay 165% of this rise. Thus, if the stockmarket rises 30% over that period, the Phoenix Fund will receive 149.5p for every 100p invested. An investor in an index tracking fund would only receive 130p, assuming no change in the Yen/Sterling exchange rate.

A slightly different structured product, which behaves more like a bond, is an auto call, where the upside is limited. The best return an investor could hope for from a corporate bond at maturity would be all of its income and the original sum invested. The worst return would be zero if the company went bust. The latter scenario should be unlikely for a prudent investor.

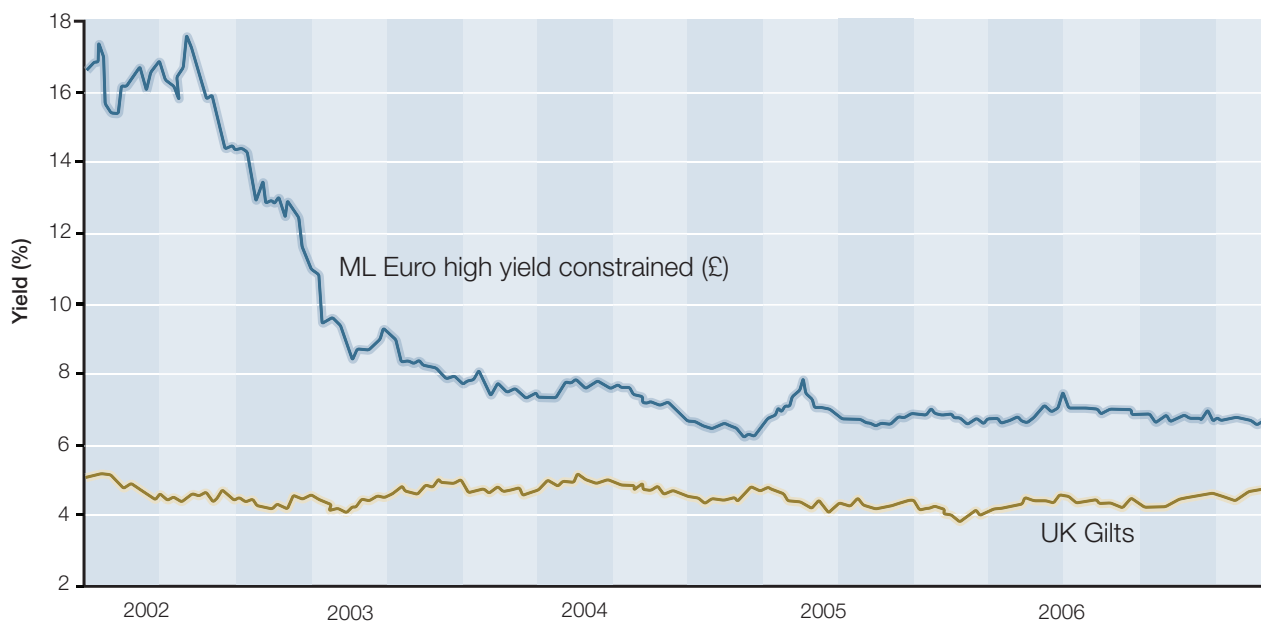
The Phoenix Fund has invested in the Barclays FTSE Auto Call, which will pay the original 100p plus 11p if the FTSE 100 increases by 2.5% or more over one year. If the FTSE 100 does not manage this return, the structure continues until the end of year two when the investor would receive 100p plus 22p, as long as the index has risen 5% or more. This process carries on until the end of year six when the investor receives 166p or just 100p (if the FTSE 100 has not risen sufficiently). The final

proviso is that if the UK stockmarket falls by more than 50%, the 100p is under threat and the fund will suffer a loss in line with the UK stockmarket. Therefore, if the UK stockmarket falls 70%, the fund will receive just 30p for the original 100p invested. All of these promises are based on the assumption that Barclays (who make the promise) does not default. There is, therefore, an additional small risk that all of these promises become worthless due to some significant financial catastrophe.

The chart below compares European sub investment grade bond yields as measured by Merrill Lynch with the more conservative UK gilts yield. This demonstrates the collapse in yields over the past five years in the high yield arena, as investors have gained confidence in companies' abilities to repay debt. Arguably, this has gone too far and any economic slowdown would force corporate bond yields to rise where companies were under threat.

Whilst we are unclear as to the timing and extent of any yield rises, it seems that the risk for sub investment grade prices is primarily on the down side. We have, therefore, reduced our exposure to these bonds to around 2% and reinvested the proceeds into structured products such as the Barclays FTSE Auto Call.

In summary, the Phoenix Fund has a range of sub investment grade bonds with yields ranging from 6% to 9% that mature between 7 and 10 years. It now also has a range of structured products with annual returns of 9% to 14.25% if certain stockmarkets rise.



Risk factors

Past performance is not a guide to future returns. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested. The value of overseas securities will be influenced by fluctuations in exchange rates. Part of the Fund may be invested in sub-investment grade bonds that typically have a low credit rating and carry a high degree of default risk, which can affect the capital value of your investment. As the Fund has exposure to hedge funds, gold, private equity and property via publicly quoted transferable securities, there are additional risks associated with these sectors.

Issued by Newton Investment Management Limited. Newton Phoenix Fund is an authorised unit trust operated by Mellon Fund Managers Limited. Newton Investment Management Limited and Mellon Fund Managers Limited are authorised and regulated by the Financial Services Authority and are members of the IMA.

Newton Investment Management Limited (NIM)
Mellon Financial Centre
160 Queen Victoria Street
London EC4V 4LA

Mellon Fund Managers Limited (MFM)
Mellon Financial Centre
160 Queen Victoria Street
London EC4V 4LA

Telephone: 020 7163 9000
Fax: 020 7163 5063
www.newton.co.uk

Registered office for NIM and MFM: Mellon Financial Centre
160 Queen Victoria Street, London EC4V 4LA
Registered in England No.1371973 (NIM) and No.1998251 (MFM).

Both Newton Investment Management Limited and Mellon Fund Managers are authorised and regulated by the Financial Services Authority.

A Mellon Financial CompanySM

Also at

NIM Edinburgh
2 Festival Square
Edinburgh EH3 9SU

NIM Leeds
No.1 Whitehall Riverside
Leeds LS1 4BN

NEWTON
The Power of Ideas