

Hedge fund exposure in the Newton Phoenix Fund (2)

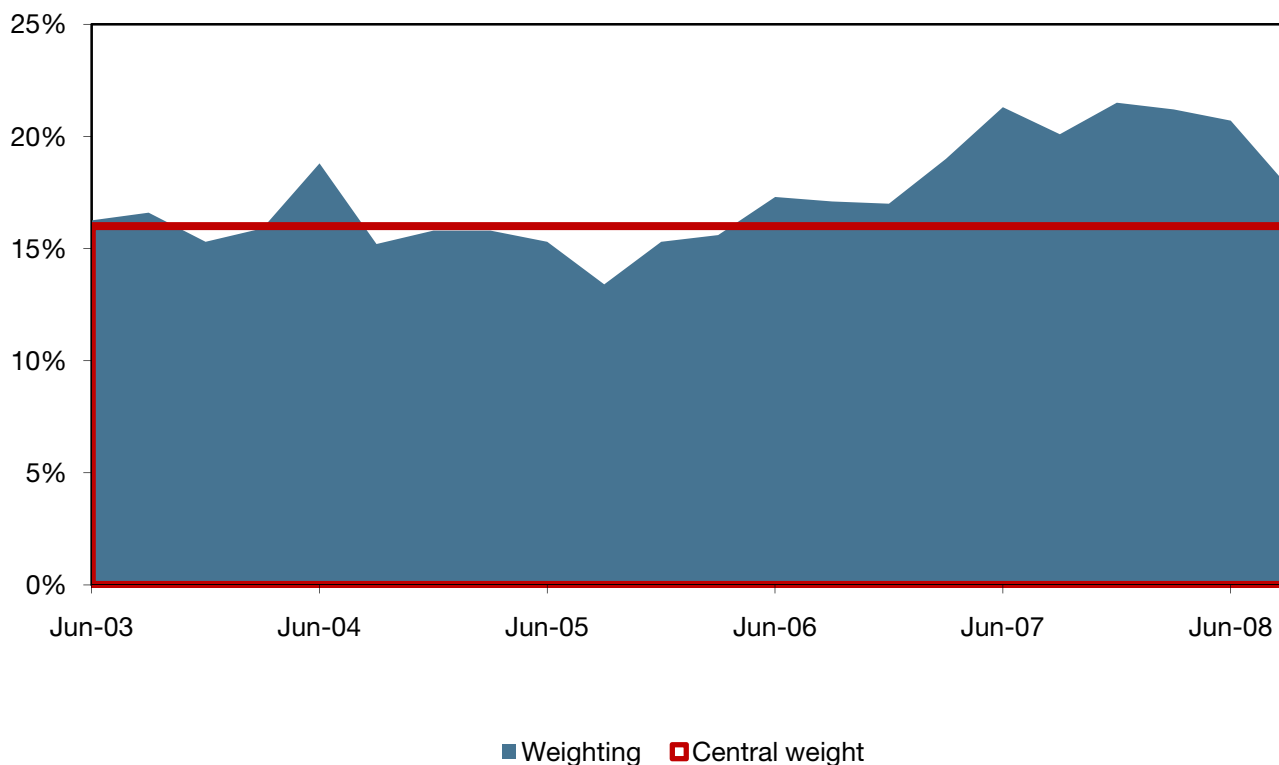
29 December 2008



The recent Madoff scandal has prompted us to update our note of March (copies available) which detailed our thoughts on hedge funds. The first point to note is that the Phoenix Fund's exposure to Madoff was through one fund of hedge funds (not affiliated with Newton or any other entity of The Bank of New York Mellon), which itself amounted to less than 1% of the Fund's total value. That fund of hedge funds had 1.6% of its value invested with Madoff, **meaning that the effective exposure of the Phoenix Fund was just 0.02%**. The remainder of the note discusses our approach to hedge fund investments more widely.

The first chart is an update of the previous chart showing the Phoenix Fund's exposure to hedge funds since launch. For much of the life of the Fund, we felt that better returns could be achieved from equities and so we kept our exposure to hedge funds close to 16% - the weighting suggested by the expected long term return and volatility of hedge funds. However, in early 2007, we increased our weighting markedly before reducing significantly in the third quarter of 2008.

Chart 1 – Newton Phoenix Fund hedge fund exposure over time



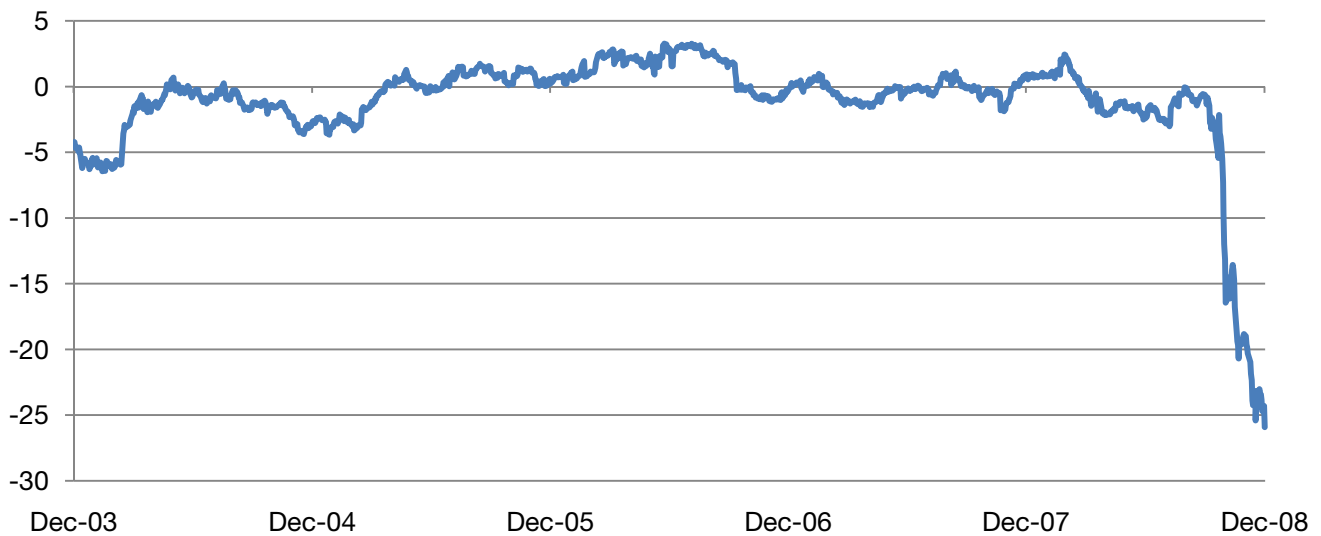
Source: Newton, as at 30 September 2008.

We detailed the reasons for the increase in hedge fund exposure in the March note; heightened volatility offered more opportunities for arbitrageurs and wider dispersion of returns in a falling market offered better opportunities for long/short hedge funds than traditional long-only investors.

However, these positive factors have been offset by the imperative of hedge funds to sell assets in order to reduce their debt levels and to meet the redemption requests of selling investors. Many retail investors now have turned their backs on hedge funds; the lack of transparency of hedge funds, their holdings of illiquid investments and their use of debt have offered little of interest to investors with sharply declining risk appetites. In the last two weeks of September and throughout October, the share prices of the listed

funds of hedge funds have slipped markedly from the value of the underlying hedge fund investments (known as Net Asset Value or NAV) as shown in the next chart.

Chart 2 – Discount or premium of share price to NAV (%) – listed hedge funds



Source: RBS, as at 9 December 2008.

The funds of hedge funds generally have plans to limit the extent to which the share price will fall below the NAV. Often, this takes the form of a continuation vote if the share price trades consistently at a discount of more than 5% to the NAV. Many of these votes will be triggered early in 2009 and if the votes fail, the NAV less (small) costs will be returned to shareholders. We have been very active in the last two months in writing in excess of thirty letters to more than ten boards of closed-end hedge fund companies as well as having many telephone conversations and meetings. Boards vary in their willingness to return capital to shareholders and thus to shrink the size of their company. Of the 18% of the Phoenix Fund invested in hedge funds, funds representing 3.6% have announced that all capital can be returned to shareholders (starting in 2008 with the majority of proceeds received in February 2009). Funds representing a further 4.8% of the Phoenix Fund have announced plans to return capital to shareholders. This will leave the Newton Phoenix Fund with a reasonably low weighting in hedge funds.

A number of commentators have written off hedge funds and certainly the hedge fund industry is shrinking enormously. Losses suffered by hedge funds this year combined with likely further sales by hedge fund investors make it likely that the hedge fund industry will have shrunk by up to 50% in 2008. However, this is only part of the story; most funds have a lower gearing than at the start of 2008, so the assets managed by hedge funds will shrink by more than this. Finally, proprietary trading desks of investment banks have reduced their investments (assuming they still have a job). All told, money invested in a hedge fund like manner may have reduced by up to 90%. It is no surprise therefore that the pain in the industry is so acute and unlikely to be over yet. Against this background, should the Phoenix Fund simply sell its remaining holdings?

A 90% reduction in capital allocated to hedge fund strategies throws up an awful lot of opportunities for those funds that are left. The funds remaining will be very well-run and face a lot of pressure to increase transparency, reduce fees and to be subject to more regulation. They are likely to need lower debt levels to generate attractive returns. Until the period of deleveraging is complete, hedge funds are likely to remain unloved and we will continue to work to extract value by persuading boards to return capital to shareholders and shrink the value of their funds. At the end of this process, we can revisit the attractions of the sector and consider using the cash raised to reinvest if we choose to do so.

Our largest hedge fund holdings and their performance to the end of November are shown below.

	Net asset value	Share price
Marshall Wace TOPS	-15.8%	-21.5%
Bluecrest Allblue	+10.8%	+3.8%
FRM Credit Alpha	-10.7%	-22.9%
Tapestry	-22.1%	-36.7%
BH Global*	+2.3%	-10.0%

Source: Datastream. * Since launch in May 2008.

Although the performance of Tapestry has been very disappointing, other funds such as Bluecrest and BH Global have been rather more encouraging.

The funds of hedge funds will return capital to the Phoenix Fund, reducing our exposure. Such exposure is likely to remain low as we enter 2009.

Philip Collins

Investment Director

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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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