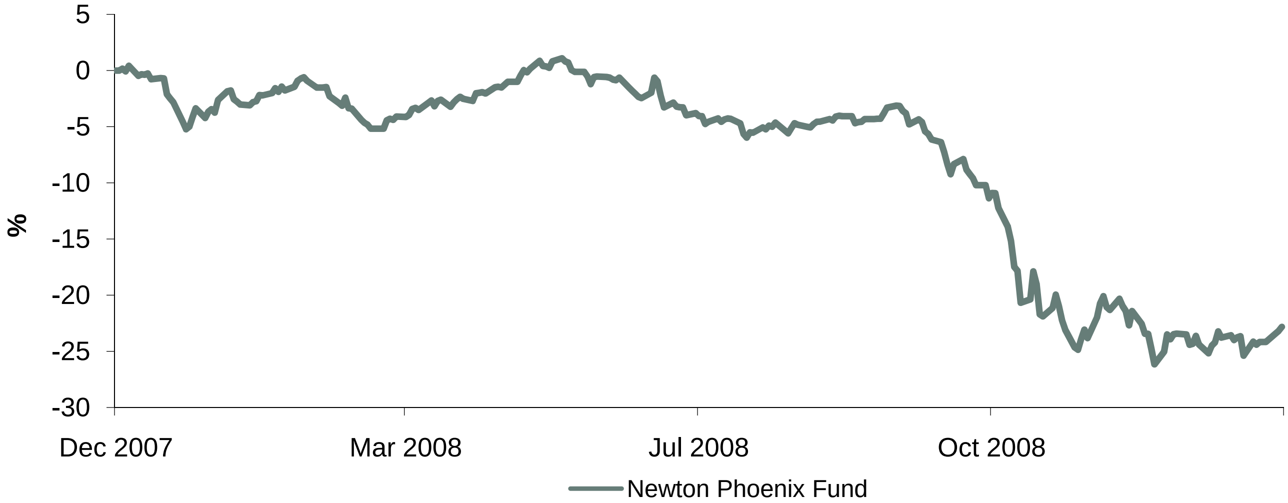
Newton Phoenix Fund performance in 2008

21 January 2009

The Newton Phoenix Fund delivered a negative return of -22.8% in 2008, all but 1.6% of this occurring in September and October. The drivers of this negative return have been the subject of two notes following these very poor months (copies available). This note reviews the Fund throughout 2008 in the context of market movements. It focuses on three key areas – performance, volatility and correlation. It also considers whether the methodology of the Fund should change.

Equities

Chart 1: Performance of the Newton Phoenix Fund in 2008



Source: Thomson Datastream, as at 31 December 2008. Calculation basis: Total return.

The performance of the fund in 2008 was self evidently below the target of cash +2%. The performance of each underlying asset is reviewed in the table below. The ideal picture would be positive signs in the relative return and asset allocation columns and negative signs in the relative volatility columns.

Table 1: Performance of the assets within the Newton Phoenix Fund

	Since launch		2008		
	Return relative to indices	Volatility relative to indices	Return relative to indices	Volatility relative to indices	Asset allocation
Investment grade bonds	-	+	-	+	- -
Sub investment grade bonds	+ +	+	+	+	+ +
Index-linked bonds	-	+	-	+	+
Equities	+ +	+	+	+	+
Hedge funds	+ +	- -	+ +	- -	-
Commodities	+ +	- -	+ +	- -	+
Private equity	+ +	- -	+ +	- -	+ +
Property	- -	-	-	-	+ +

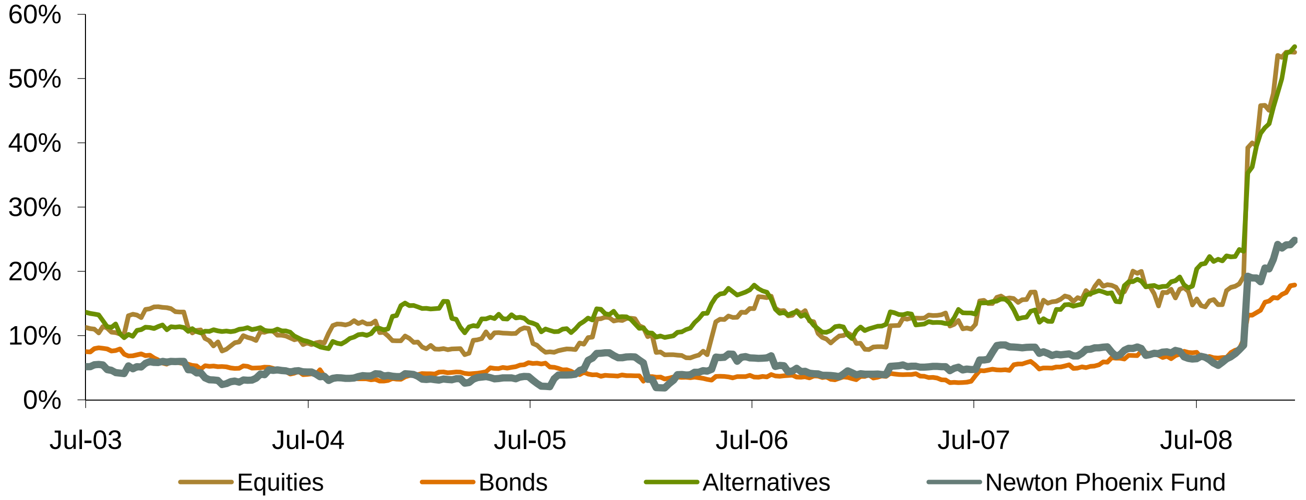
Source: Newton.

Property selection has been the main disappointment, but our decision to reduce property exposure from mid 2006 to its current (very low) levels protected the Fund from greater losses. In contrast, while our selection of hedge funds was very positive, our decision to reduce exposure by only 5% since the end of 2007 was damaging. The Fund's selection of investment-grade bonds was above the average performance of corporate bonds but well below that of gilts. Our preference for corporate bonds over gilts was arguably the biggest factor affecting performance in 2008.

Volatility

The volatility of the Fund is shown in the chart below together with the volatility of equities, bonds and alternatives. Volatility is measured over rolling three-month periods for the Phoenix Fund and for a broad sample of key asset indices.

Chart 2: Volatility of the Newton Phoenix Fund and key indices

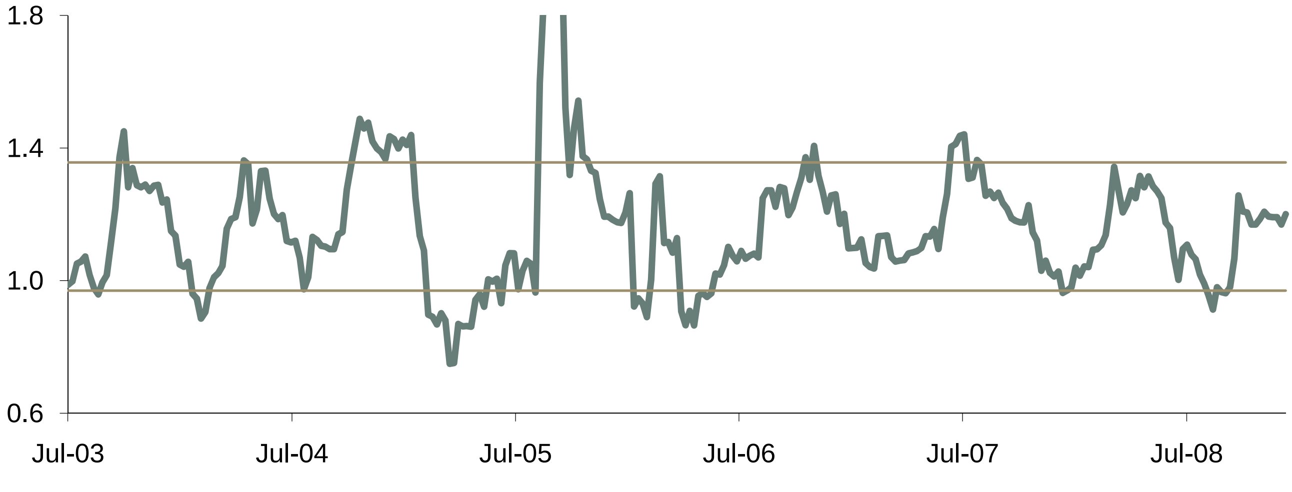


Source: Thomson Datastream, as at 26 December 2008. Calculation basis: Total return.

As you would expect, bonds (in orange) have shown consistently low volatility until recently, with the volatility of all bonds (including UK gilts) more than doubling from 2007 levels. Led by property and commodities, the volatility of alternative assets had been rising for a while, but by the end of November the volatility of hedge funds and private equity had also risen substantially. Equities have been broadly as volatile as alternative assets and this volatility has risen dramatically recently. The teal line represents the volatility of the Phoenix Fund, which is just above bonds for much of the time.

We have carried out further analysis to see if the Fund's volatility is different from that of other similar funds. The next chart shows the volatility of the Phoenix Fund relative to the average cautious managed fund.

Chart 3: Volatility of the Phoenix Fund relative to the average cautious managed fund



Source: Thomson Datastream, as at 26 December 2008. Calculation basis: Total return.

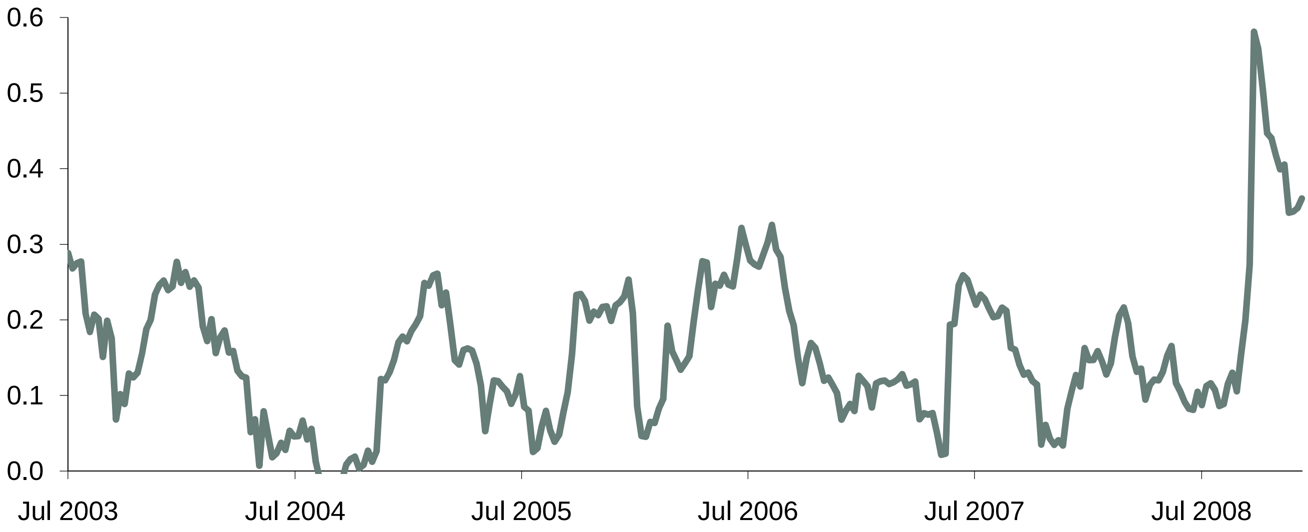
The Newton Phoenix Fund has spent the vast majority of its life with volatility within one standard deviation of the average relative volatility of 116%. The most recent period is no exception.

These charts suggest that the increased volatility of the Phoenix Fund is broadly as one would expect given increased market volatility. However, we also need to examine correlation. After all, it is only when assets move independently of each other that the benefits of a diversified fund are enjoyed.

Correlation

The next chart shows the average correlation over three months of all the different asset indices we follow when monitoring the performance of the different parts of the Phoenix Fund.

Chart 4 – Average correlation of assets held within the Newton Phoenix Fund



Source: Thomson Datastream, as at 26 December 2008. Calculation basis: Total return.

At the same time as volatility has spiked, correlation has also risen dramatically. As a reminder, a correlation of 1 means that each asset moves exactly in line with all other assets, while a correlation of 0 means an asset moves entirely independently of others. Correlation reduces the benefits of diversification.

In 2008, almost all assets fell, the volatility of all assets rose and the correlation between the performances of different assets rose. In such circumstances, a diversified approach produced very poor returns.

Should the Fund's methodology change?

It is tempting after a period of poor performance either to 1) ignore it (suggesting that this was an extraordinary period that is most unlikely to recur) or 2) at the other extreme, make sweeping changes that prepare the Fund for market conditions that no longer apply. We have reviewed the structure of the Fund in light of the past year and considered what changes would be advantageous in the future. Certainly, we wish the Phoenix Fund to be evolutionary to reflect market changes. During the fourth quarter of the year, we made two changes.

First, we gave ourselves the ability to adjust our exposure to each asset by 10% above or below the central level (an increase from 5%); this gives us greater flexibility to be able to protect the Fund in the event of an anticipated downturn. Second, we have split our allocation to investment-grade bonds between government bonds and corporate bonds. The markedly different performance in 2008 suggests that these two types of bonds should be considered as separate asset classes.

Are further changes helpful? The confluence of falling markets, rising volatility and increasing correlation between asset classes challenged a number of the assumptions behind our central allocation to each asset. We believe that volatility and correlation in financial markets will remain higher than in the first half of this decade. As we passed our five year anniversary, we placed considerably less emphasis in client meetings on our central asset allocations, preferring to show how our asset allocation has changed over those five years. We will continue to do so with the undertaking that the Fund will remain diversified by asset as well as within each asset, but without reference to central weightings. We will invest no more than half of the Fund in equities, bonds or alternatives and we are able to invest considerably less than half of the Fund's value in each of these areas if we wish.

We do not plan to make any major alterations to the asset allocation at present, but we have given ourselves greater flexibility in our asset allocation to achieve our aim of a return superior to cash but with considerably less volatility than equities.

Philip Collins
Fund Manager
Newton Investment Management Limited

Discrete past performance - percentage change

From	30/12/03	30/12/04	30/12/05	30/12/06	30/12/07
To	30/12/04	30/12/05	30/12/06	30/12/07	30/12/08
Newton Phoenix Fund	10.5%	15.0%	7.2%	5.2%	-22.8%

Source: Lipper, as at 31 December 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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