

THE BIG INTERVIEW

NEWTON FIXED INCOME

Paul Brain, the head of fixed income at Newton Investment Management, explains how his team has negotiated market turbulence, with three out of its six themes playing out over a rough period for fixed income managers

By David Walker

To keep your head while the markets about you are losing theirs, it helps to have a reliable map to guide you.

Paul Brain, Newton Investment Management's head of fixed income, says his team has been aided in navigating this year's turbulence by the macro themes at Newton that guide its understanding of the world.

As at least three of its six themes have played out – the ride has been as rough as it gets for fixed income managers.

Since February, Spanish and Greek debt has been dubbed 'junk', blue-chip UK credit became safer than gilts and the IMF helped provide a €750bn (£623bn) rescue package for beleaguered EU nations. Germany banned naked short-selling of sovereign debt, and many practitioners expect Greece will default.

Corporate and sovereign spreads throughout Europe have widened and narrowed, sometimes on rumour alone.

The big picture

The themes underlying all this form a sort of compass Newton managers can refer to through thick and thin. As Brain explains: "They provide a long-term orientation – a big picture that avoids a short-term focus."

This stands Newton in contrast to many bottom-up managers, where the big picture is overshadowed, if not forgone totally in favour of pure security selection.

Brain says: "We do not pretend to cover everything, and we do not suggest we can analyse everything, but using the themes we can start at a very early stage in the process to see where we expect opportunities."

Under its 'Becalmed' theme, Newton foresaw investors would hunt for yield, but their search would be "a house of cards".

As complex debt instruments began to fail, this house of cards collapsed in 2008 and 2009. Muted rates and inflation have been the painful hangover of the pre-crisis debt binge – what Newton calls its 'All Change' theme.

The unwinding was sharper and more extensive than Newton had expected. Brain says his team "instantly bought treasuries and bonds and sold credit wherever possible" on seeing it unfold.

The equity teams also offloaded banks while taking a defensive stance.



L-R: Jonathan Day, Parmeshwar Chadha, Carl Shepherd, Scott Freedman, Howard Cunningham, Paul Brain

PAUL BRAIN CV

Newton's self-explanatory topic of 'More Government' ties into Western politicians taking over banks, organising bailouts and generally becoming more involved in their citizens' financial affairs.

Population dynamics

A further theme of 'Population Dynamics' is widely expected to make its effects felt in Japan, where an ageing

some point this year, supply will overcome demand and Japanese bond yields will rise," Brain says.

It is not the first time he and his long-standing team members, have seen such themes evolve.

All but one of the seven in Brain's unit has been investing generally for seven or more years, and for at least three years at Newton.

Brain has 25 years of investing experience,

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population will turn the savings rate negative.

"This faces Japanese government bonds with a potentially severe gap. At

experience, followed closely by Howard Cunningham with 21 years.

Together, the unit runs £1.5bn in seven retail funds and £1.6bn more in

- 2004 to present: Newton Investment Management.
- 2001 – 2004: MSG & Partners, chief investment officer, fixed income.
- 1995 – 2001: Investec Asset Management, formerly Guinness Flight.
- 1991 – 1995: Credit Suisse Asset Management – head of currency overlay and European fixed income.
- Has 24 years' experience in managing fixed income portfolios. His early career was spent investing in high grade bonds with Credit Suisse and Baring Asset Management. He sits on various committees at Newton and is leader of the fixed income team.

offshore and segregated mandates for larger clients. They also provide fixed income input to Newton's multi-asset funds.

Brain emphasises the collegiate climate his employer fosters – one he clearly enjoys, sharing ideas within and between disciplines.

"In 2007 and 2008, our fixed income credit analysts, Howard Cunningham

and Parmeshwar Chadha, talked extensively with the bank analysts about the credit crisis, for example," he says.

"There is no need to defend your position or job – no-one will stick the knife in because of a wrong call, which means you can discuss an example and thrash out ideas.

"I have worked in other organisations where you dare not question a decision because of house policy or people feeling personally threatened."

But he quickly adds, when it comes to actual investing, the buck stops with the fund managers.

"There is a danger of becoming a talk shop, but we ensure you have a manager for the team, and for each fund," he says.

"We do not have a committee-based approach to actual decision making. We believe if you have experienced fund managers, you give them every resource to come up with the right decisions.

"A committee takes a lot of time coming to decisions, which tend to get watered down and be delayed."

When questioned on how they viewed the fixed income line-up at Newton, multi-managers say they appreciate its experience and disciplined process. But some expressed initial concern after the departure in December 2008 of Stewart Cowley, Brain's predecessor.

Brain joined Newton in 2004 to work with Cowley on global bond funds and to launch the flagship Global Dynamic product.

Cowley's departure for Old Mutual Asset Managers was a blow for Newton, and a few fund of funds managers said initially it was unclear who would do the various tasks on the team. But no team members have left since, and Newton's funds have retained profile.

Most rank more highly among their peers over one year than they do over three or five years.

A composite index of all Newton's fixed income products has beaten the unhedged J.P. Morgan Global Government Bond dollar index in 12 of the past 14 years, and also this year to 31 March. Only 1999 and 2008 were losing years against this benchmark.*

Professional scope

While heading the team, Brain has also pushed his colleagues to extend their professional scope.

"When I took over, I thought there were really good skills in the team, and it was ready to move onwards," he says.

Cunningham, manager of the £69.5m Corporate Bond and the £160m Long Corporate Bond strategies and the driver of the team's credit process, has

also been able to do more work on gilt and government bond mandates, and move away from credit, Brain says.

Manager Jonathan Day's duties have expanded from concentrating on credit to encompass global fixed income, and forecasting and modelling how much has already been priced into securities.

Parmeshwar Chadha runs Newton's £50.4m Global High Yield Bond strategy, and analyses high yield issues for the team.

Carl Shepherd specialises in emerging market debt and cash funds, while Scott Freedman joined Newton this year as an investment grade analyst, and Trevor Holder writes reports and communicates with clients.

Brain runs the £741m International Bond, £298m Global Dynamic and £7.3m BNY Mellon Sterling Bond strategies, and is hunting for an additional investment grade financial analyst.

The team shuns the 'alphabet soup' of acronyms such as CDOs, CLOs, and RMBSs that wreaked havoc as they imploded during the crunch.

"I will not fund them, nor use complex derivatives. When we invest in government bonds, for example, we will just buy them, or vanilla exchange-traded derivatives to track the risk," Brain says.



The team is, however, considering buying insurance

against securities defaulting, known as credit default swaps (CDSs).

"This market continues to evolve and may now be more useful as a tool in hedging credit risk" says Brain.

Keeping it simple

Overall, the trading within the unit is kept simple.

"That is important because there are lots of opportunities, and we want to be

NEWTON

INVESTMENT MANAGEMENT

Paul Brain has 24 years' experience managing fixed income portfolios. His early career was spent investing in high grade bonds with Credit Suisse and Baring Asset Management. He sits on various committees at Newton and is leader of the fixed income team.

Manager biography

2004 to present: Newton Investment Management
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 1995 – 2001: Investec Asset Management, formerly Guinness Flight
 1991 – 1995: Credit Suisse Asset Management – head of currency overlay and European fixed income
 Responsibilities at Newton: Investment leader, fixed income; chairman of bond / FX strategy group; member of macro strategy group; member of asset class strategy group; member of global investment meeting; member of investment committee
 Qualifications: Stage II Candidate – Chartered Institute of Bankers.

able to apply the themes quickly where possible," Brain explains.

"We still lean towards strategic investing rather than trading, and I would rather be in the markets for strategic reasons rather than to trade. I would rather concentrate my interest-rate risk in something that is more liquid, and we have been shifting back into more liquid markets.

"The next phase that could alter things is a rising interest-rate phase like early in 1994. Less liquid investments will suffer, but I think that is next year's problem rather than this year's."

Brain expects a bear market for fixed income in 2011.

The process

Newton's long-term themes form an overarching framework for the fixed income team's thinking.

Brain says: "The top-down part of our process is more important than the bottom-up part, so if for example there are 150 banking names, we will only try to cover 25."

After calculating a fund's proportionate allocation within asset types, countries, along the yield curve and among sectors, the team conducts detailed analysis on individual companies, and whether they trade cheaply or not compared to the market.

"In 2008, you saw just buying a bank's bond was not the end of the story. You have to know the capital structure, the call dates, and whether the loan is variable. You really must know about the bond issue as well as the company."

Brain has been increasing the exposure of his Global Dynamic Bond strategy to developed market sovereign debt recently, trimming its overweight position in credit to do so.

However, Global Dynamic and International Bond have dipped toes in Greek government debt periodically as yields spiked this year, as well as in Irish and Italian sovereigns. The Greek bond position was sold following the announcement of the ECB buy-ins.

His global bond funds now have 7% exposure to the Piigs, but have the bulk of their European sovereign exposure to Northern Europe.

* Source: Newton

For example, Newton's global government funds split their allocation simply, about 85% to advanced countries' sovereigns, and up to 15% in developing nations' government debt.

"These are transparent, pure investments, which we have not tainted with credit investments," Brain says.

"We do not want to have 50 different high yield holdings and CDS holdings. We want to be able to get into markets, but also to get out. We do not want to have to spend two or three weeks unravelling the strategy."

Not surprisingly, market liquidity is also at the forefront of Brain's mind.

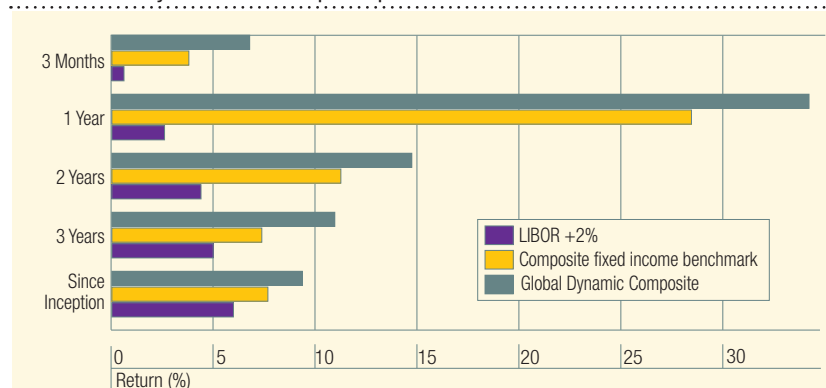
Many of his peers have bemoaned its near evaporation in primary and secondary credit markets recently, leading to higher trading costs and a lack of opportunities generally.

"We are very conscious of liquidity, and most of our investments in high yield are in frequently traded names. We can get a price on everything we own, but the real worry is how liquidity could change."

Strategy

Brain says some traders have re-entered markets with dealing teams since the beginning of 2009. "However, I would not suggest we are back to normal, even if we are slowly getting there.

Newton Global Dynamic Bond Composite/performance vs benchmark



As at 31 March 2010 Source: Newton. Performance is stated gross of fees. The impact of management fees can be material.