

THE FLEXIBILITY TO NAVIGATE UNPREDICTABLE MARKETS

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October 2020

Newton Real Return team

With the shape of any post-coronavirus recovery still highly uncertain, investors are facing a polarised backdrop with little certainty as to how equity or bond markets will react over the coming months. In this context, our Real Return team explain why they believe a flexible approach to asset allocation, with the ability to respond swiftly to challenges along the way, will be critical in generating credible long-term absolute returns.

Key points

- While reflationary forces currently appear to have the upper hand as economies attempt to emerge from the coronavirus crisis, material risks to the economic backdrop remain, and investors will require the flexibility to respond to a wide range of potential outcomes.
- Specifically, should inflation return with any vigour as a result of the unification of monetary and fiscal policy, well-judged timing to reduce a strategic allocation to fixed income will be important.
- In this uncertain environment, we believe there is a strong case for investment strategies which focus on active security selection and diversification by asset type, with the flexibility to adjust positioning both strategically and tactically to reflect the changing economic circumstances.
- The Newton Real Return strategy has been making full use of its flexible approach to seek to take advantage of the changing and volatile backdrop.

As the Covid-19 crisis has unfolded, one of the key themes emerging is the 'tug of war' that has developed between inflationary and deflationary forces. On the deflationary side, the massive collapse in private sector-generated cash flow and incomes since the introduction of lockdowns will lead to significant deleveraging as debt burdens become too large for many businesses to manage. Conversely, the unprecedented policy response, with public-sector balance sheets expanding to new levels, represents an inflationary influence which seeks to limit the fallout from the crisis.

Based on financial-market price action since late March, it is tempting to conclude that the reflationary forces are winning. However, it is premature to declare the battle has been won, as several material risks to the economic outlook remain. More fragile businesses are failing, and there will be job losses as a result. Recessions have also traditionally provided a good excuse for companies to 'trim the fat', and government furlough schemes are likely to have only deferred the timing of some redundancies, while many businesses may look to cut capital expenditure. Furthermore, until a vaccine is found for the virus, there will be restrictions and costs of doing business that did not exist before.

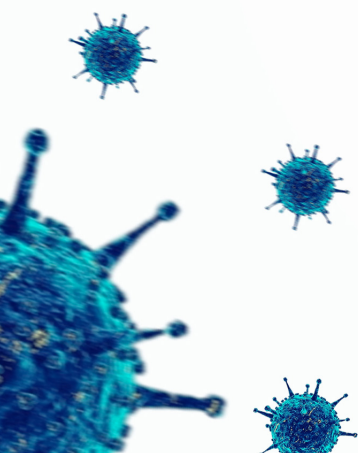
The very nature of the current recession, which was initiated by a state-imposed collapse in activity, makes the outlook that much more uncertain. One scenario is that, as restrictions on economic and social activity are lifted, economies will bounce back quickly. However, there are clear signs that damage has already

been done to economies. In addition, further damage is possible as renewed restrictions will affect certain sectors more than others.

Moreover, as we have learnt over the post-financial crisis period, monetary easing has a much greater impact on financial-market prices than it does on the non-financial economy. While fiscal policy is playing a much greater part in the policy response to the Covid-19 crisis than it did during the 2007-8 global financial crisis, monetary easing has continued to dominate, with risk assets sustaining a broadly upward trajectory. Should the recovery in the non-financial economy be slow, or undercut by a resurgence of the virus, nominal cash flows and earnings will not recover, which could leave valuations for risk assets elevated and exposed. Against this background, investors will require the flexibility to respond to a wide range of potential outcomes.

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Your capital may be at risk. 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.



Structural shift in the inflationary environment?

For over a decade our thematic framework – and specifically our *state intervention* theme – has highlighted how authorities have engaged in ever-greater policy intervention and regulation to shore up economic growth. We have long held the view that monetary policy would be unsuccessful in returning nominal growth rates to the levels they were at prior to the 2007-8 financial crisis, owing to structural and cyclical factors, and had anticipated that the perceived solution to low nominal growth would be the unification of monetary and fiscal policy. We also expected that it would take a crisis in order to catalyse this transition, since fiscal policy, which necessitates an increased role for governments, marks a break from the policy orthodoxy of ‘free markets’. The Covid-19 pandemic now looks to be that crisis.

Government fiscal deficits have trended steadily larger since the end of the Bretton Woods system of monetary management in 1971, when the US announced that it would no longer exchange gold for dollars. While fiscal policy has mainly been counter-cyclical during this period, in recent years larger government deficits have not been restricted to economic downturns. Now, in the wake of Covid-19, the remnants of any pretence of a link between government revenues and spending has been abandoned. ‘Modern Monetary Theory’ (MMT) has been put forward as the intellectual justification for the monetary financing of fiscal deficits. Should such policies be widely implemented by governments around the world, we could be in the foothills of a new inflationary era, which would lead to major changes in many financial-market trends.

To be specific, if inflation returns with any vigour it could materially undermine returns from a wide variety of fixed-income strategies given the low yields available. Well-judged timing to reduce a strategic allocation to fixed income will be important to preserve capital.

The benefits of a flexible, diversified approach

In this uncertain environment, we believe there is a strong case for investment strategies which focus on the diversification of asset types and uncorrelated return streams, and which have the flexibility to adjust positioning both strategically and tactically (even overnight) to reflect the

changing economic circumstances. Our Real Return strategy aims to create an asymmetric return profile and deliver strong risk-adjusted returns by using a globally diversified portfolio to balance growth with capital protection. While our investment approach is derived from our longer-term views of the world, as articulated by our investment themes, the strategy's objective necessitates flexibility: we do not run a policy portfolio and can adapt the strategy to suit the environment while still having a longer-term roadmap in mind.

A rich source of ideas provides the Real Return strategy with exposure to diversified asset types with favoured characteristics that support its objectives. These currently include equities, credit, high yield, contingent-convertible bonds, royalty streams, emerging-market debt, infrastructure, renewables and precious metals, as well as both inflation-protected and conventional government bonds. However, diversification is not about having an allocation to every asset class, and the Real Return strategy has no obligation to invest in all asset classes at all times. This flexibility is not just apparent at the asset distribution level; because we largely invest in underlying securities, we can alter the ‘style’ or characteristics of positions the strategy owns in an asset class as the backdrop changes, rather than just the weights.

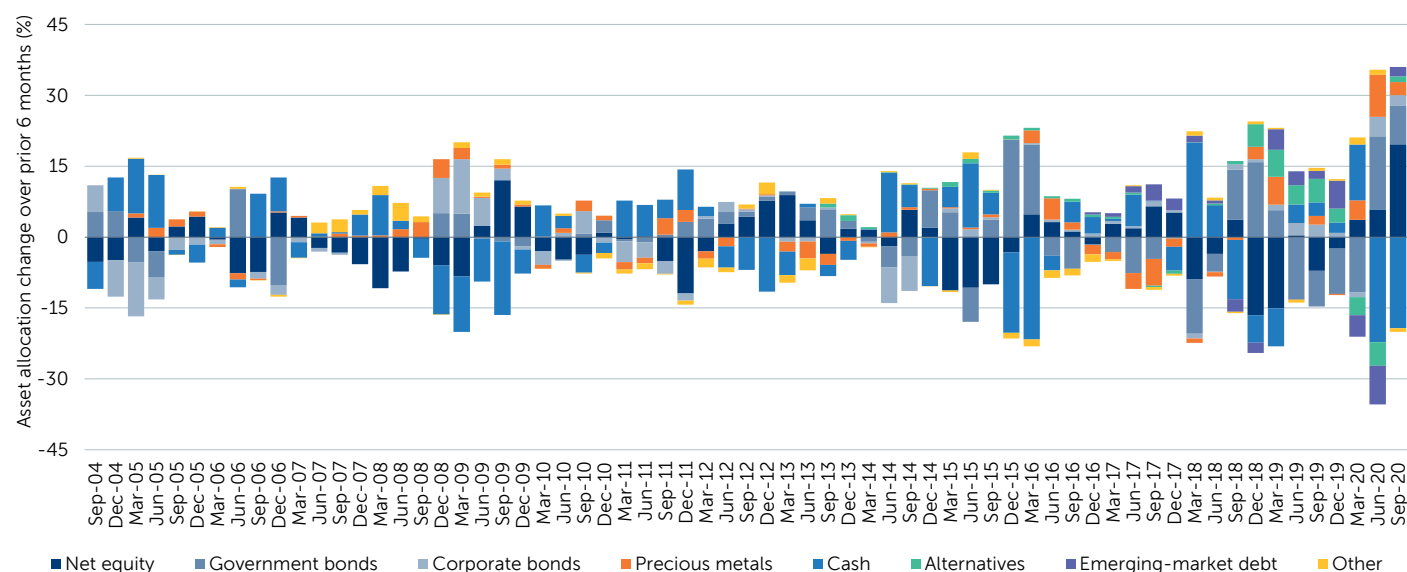
The strategy's dynamic and flexible approach is demonstrated by the below chart which illustrates how asset allocation has moved over time.



If inflation returns with any vigour it could materially undermine returns from a wide variety of fixed-income strategies given the low yields available.



Newton Real Return: Changes in asset allocation over six-month periods



Source: Newton, October 2020. For illustrative purposes only. Information shown above is for the BNY Mellon Real Return Fund which is a representative portfolio and adheres to the same investment approach as the Newton Real Return strategy.

Recent changes illustrating our flexible approach

The Real Return strategy has been making full use of its flexible approach to seek to take advantage of the changing and volatile backdrop.

Fixed income

We tactically increased the portfolio's investment-grade bond exposure in the second quarter of 2020, as a better substitute for cash, and to take advantage of the value that had appeared during the market disruption, which had been underpinned by central-bank demand. Subsequently, investment-grade spreads (the yield premium over US Treasuries) rallied significantly, driven by optimism on the pace of reopening after lockdown and the news of the US Federal Reserve's introduction of primary and secondary market corporate credit facilities. This illustrated that the potential for any additional return in allocating to corporate bonds to take advantage of the coronavirus market disruption had mostly passed. We therefore then began to reduce corporate-bond exposure and invest the proceeds in what we viewed as more attractive opportunities, such as undervalued equities and high-yield debt, the latter benefiting from the tailwind of a US dollar in structural decline versus other major global currencies.

The recovery in investment-grade credit has been much faster than in 2009 as central banks have this time been more coordinated and faster to act. However, at the same time, the fundamentals are mixed and the full effect of the crisis on issuers is still to be revealed. We expect to see a continued increase in the number of 'fallen angels' (investment-grade issuers downgraded to high yield) throughout this year, as well as general downward rating migration for the more challenged business models. Nevertheless, with dispersion between industry sectors remaining high, there is still an opportunity to add value through active credit selection.

We increased government-bond duration¹ from low levels during the first quarter of 2020, which initially provided some cushion during market turbulence, although government bonds were ultimately used by investors as a source of liquidity in what rapidly became a liquidity squeeze. We increased the portfolio's return-seeking core after the March sell-off, at the same time tactically increasing exposure to duration as an offset by using 10-year US Treasury futures² to provide optimal liquidity should we quickly want to sell. We do still see government bonds as a useful 'hedge' should the global economy suffer a worse-than-expected recession and corporate profit margins be eroded.

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Gold

We have held gold in the strategy for more than a decade, recognising its appeal as a real asset that cannot be manipulated or debased. Gold forms a substantial part of the strategy's stabilising layer, and has been a proven hedge during inflationary periods. Our gold position has not been immune to this year's market volatility and, as one of the

most liquid assets, initially suffered from the need for mass liquidations. It has, however, begun to work as an indirect hedge in the portfolio and we have been adding to the position. Given the huge level of fiscal stimulus we have seen from governments, in addition to unprecedented monetary stimulus, we continue to favour it as a hedge against the likely resurgence of inflation expectations.

Equities

Since Real Return is unconstrained in terms of its asset allocation, we can, to a significant degree, step away from equities if we see poor near-term prospects. However, we also have considerable potential to harness stock selection in seeking to deliver a superior outcome. It is important to note that global equities are not a homogenous asset class, and one of the consequences of the pandemic has been to catalyse a significant bifurcation between the 'winners' and 'losers'.

During the current crisis, more economically sensitive companies (many of which had already been under pressure for much of 2019), as well as those dependent upon 'normal' patterns of human activity, have lagged. Undoubtedly many of these companies are beset with structural and balance-sheet issues that are likely to render them poor long-term investments. Nevertheless, it feels as though a few babies have been thrown out with the bathwater. In all but the most negative public health and economic scenarios, such situations appear to us to represent the best hunting ground for opportunities at the present time, although clearly it is vital to be highly selective. In this vein, since the market trough we have been adding to companies in areas such as mining, industrials and insurance, to achieve a balance alongside strategic positions in sectors favoured by our longer-term thematic work, including health care, technology and branded consumer exposures.

Building a return profile

A multi-asset strategy can build its return profile by drawing on the different return characteristics of the securities that it invests in. In today's low-yield world, we believe that, with careful security selection, an income of about 2.4% per annum could be a realistic target for investors, while aiming for a capital return of at least 4% per annum from return-seeking assets. Through a business cycle, stabilising or hedging assets can offer the prospect of a lower but still positive annual return, while tactical asset-allocation flexibility can also have the potential to contribute positively. In aggregate, these elements seek to provide a respectable return profile in a very low-yield world.

Conclusion

While policymakers' unparalleled attempts to stimulate economies via both monetary and fiscal means appear likely to keep the party going for now, the many unknowns that exist around the shape of any recovery from the pandemic and associated economic disruption mean that markets are likely to remain highly volatile. Drawing on our long-term investment themes, which help to provide perspective against a distorted backdrop, our Real Return strategy's unconstrained nature enables it to offer a flexible approach to asset allocation, with the ability to be nimble and respond to surprises along the way. Such a focus could be valuable for portfolios as both a stabilising element and a diversifier, without forgoing the possibility of participating in capital growth.

1. Duration is a measure of how quickly a bond will repay its true cost – the longer it takes, the greater exposure it has to changes in the interest-rate environment.

2. A future is a financial contract obligating the buyer to purchase an asset at a predetermined future date and price.

Want to find out more?

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E: institutional@newtonim.com

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E: uk.lgps@newtonim.com

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BNY Mellon Real Return Fund key investment risks

- **Performance Aim Risk:** The performance aim is not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for returns to vary significantly.
- **Currency Risk:** This Fund invests in international markets which means it is exposed to changes in currency rates which could affect the value of the Fund.
- **Derivatives Risk:** Derivatives are highly sensitive to changes in the value of the asset from which their value is derived. A small movement in the value of the underlying asset can cause a large movement in the value of the derivative. This can increase the sizes of losses and gains, causing the value of your investment to fluctuate. When using derivatives, the Fund can lose significantly more than the amount it has invested in derivatives.
- **Changes in Interest Rates & Inflation Risk:** Investments in bonds/money market securities are affected by interest rates and inflation trends which may negatively affect the value of the Fund.
- **Credit Ratings and Unrated Securities Risk:** Bonds with a low credit rating or unrated bonds have a greater risk of default. These investments may negatively affect the value of the Fund.
- **Credit Risk:** The issuer of a security held by the Fund may not pay income or repay capital to the Fund when due.
- **Emerging Markets Risk:** Emerging Markets have additional risks due to less-developed market practices.
- **Liquidity Risk:** The Fund may not always find another party willing to purchase an asset that the Fund wants to sell which could impact the Fund's ability to sell the asset or to sell the asset at its current value.
- **Charges to Capital:** The Fund takes its charges from the capital of the Fund. Investors should be aware that this has the effect of lowering the capital value of your investment and limiting the potential for future capital growth. On redemption, you may not receive back the full amount you initially invested.
- **Shanghai-Hong Kong Stock Connect and/or the Shenzhen-Hong Kong Stock Connect ('Stock Connect') risk:** The Fund may invest in China A shares through Stock Connect programmes. These may be subject to regulatory changes and quota limitations. An operational constraint such as a suspension in trading could negatively affect the Fund's ability to achieve its investment objective.
- **CoCos Risk:** Contingent Convertible Securities (CoCos) convert from debt to equity when the issuer's capital drops below a pre-defined level. This may result in the security converting into equities at a discounted share price, the value of the security being written down, temporarily or permanently, and/or coupon payments ceasing or being deferred.
- **Counterparty Risk:** The insolvency of any institutions providing services such as custody of assets or acting as a counterparty to derivatives or other contractual arrangements, may expose the Fund to financial loss.
- **Investment in Infrastructure Companies Risk:** The value of investments in Infrastructure Companies may be negatively impacted by changes in the regulatory, economic or political environment in which they operate.

Investment performance – 12-month returns (%)

	Sep 19 – Sep 20	Sep 18 – Sep 19	Sep 17 – Sep 18	Sep 16 – Sep 17	Sep 15 – Sep 16
BNY Mellon Real Return Fund	3.26	8.61	1.72	-2.82	10.69
Performance benchmark	4.43	4.74	4.53	4.31	4.52

Source: Newton, as at 30 September 2020, Newton Institutional Shares 1 (Accumulation) share class (ISIN: GB00B01XJC27). Fund performance calculated as total return including reinvested income net of UK tax and charges, based on net asset value. All figures are in GBP terms. The impact of an initial charge (currently not applied) can be material on the performance of your investment. Further information is available upon request.

The objective of the Fund is to achieve a rate of return in sterling terms that is equal to or above a minimum return from cash (1-month GBP LIBOR) + 4% per annum over five years before fees. In doing so, it aims to achieve a positive return on a rolling three-year basis (meaning a period of three years, no matter which day you start on). However, capital is in fact at risk and there is no guarantee that this will be achieved over that, or any, time period. The Fund will measure its performance before fees against 1-month GBP LIBOR + 4% per annum over five years as a target benchmark (the 'benchmark'). LIBOR is the average inter-bank interest rate at which a large number of banks on the London money market are prepared to lend one another unsecured funds denominated in British pounds sterling. The Fund will use the benchmark as a target for the Fund's performance to match or exceed because, in typical market conditions, it represents a target that will be equal to or greater than UK inflation rates over the same period and is commensurate with the investment manager's approach. The Fund is actively managed, which means the investment manager has discretion over the selection of investments, subject to the investment objective and policies as disclosed in the Prospectus.



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