Newton Real Return team

REAL RETURN: NAVIGATING 20 YEARS OF EVOLVING MARKETS

April 2024

After reaching the milestone of the Real Return strategy's 20-year anniversary, the Real Return team reflect on the highly varied and unpredictable backdrop that they have navigated since the strategy's inception. While many competitors in the diversified growth space have fallen by the wayside, the strategy has stayed true to its original philosophy while evolving its approach to address a changing landscape.

The genesis of the Real Return strategy, when it was first set up in 2004 under the leadership of former Newton veteran Iain Stewart, centred on the concept of a long-term savings vehicle that should be highly flexible and exhibit asymmetry of return by balancing participation in risk-asset markets with a strong emphasis on capital preservation. Rather than relying on models to forecast market returns, insight and perspective were gained through long-term thematic research, allowing the team to make sense of a complex, interconnected world and provide ideas for security selection. Risk was defined as a permanent loss of capital rather than volatility which, although commonly used as a risk proxy, may in fact represent an opportunity.

The global financial crisis and its aftermath

Much of the first ten years of the strategy's existence was dominated by the fallout from the 2007-8 global financial crisis, an extended cycle prolonged by repeated waves of monetary largesse and supressed volatility, and characterised by historically low interest rates.

During the run-up to the crisis, the team foresaw challenges within many major economies, namely the build-up of debt and excess leverage in the financial system, and indeed this development was encapsulated in the Newton 'debt and credit' theme.

The acid test for the strategy occurred in 2008 when the financial crisis unfolded in full force. The strategy was able to benefit from a combination of its direct equity protection, significant cash exposure diversified out of sterling into safe-haven currencies, and indirect hedges in the form of call options on government bonds and gold. It was during this period that the appeal of having a fully flexible strategy was appreciated by clients, while the shortcomings of pursuing an equity index-tracking strategy were keenly felt. The strategy ended 2008 in positive territory, amid carnage in equity markets.

The team quickly capitalised on attractively valued securities during the indiscriminate sell-off that ensued, and the period served as something of a blueprint for how to make full use of the wide range of tools available. Indeed, the success of the strategy gave rise to US-dollar and euro versions, launched in 2009 and 2010 respectively, in response to demand from international investors.

The strategy further evolved in 2018 with the creation of a separate sustainable version, in recognition of the priorities of a subset of clients. This version of the strategy focuses not only on seeking to deliver a long-term performance objective, but also on investing in issuers that positively manage the material impacts of their operations and products on the environment and society.

Lessons learned from unpredictable markets

The Real Return strategy has experienced a range of difficult periods through its long history, many of which were navigated successfully, while others served as a 'lesson learned'.

For example, 2017 was a challenging year during which the team underestimated the impact on markets of quantitative easing (the process by which central banks purchase government bonds or other financial assets to stimulate economic activity) and portfolios suffered the cost from the strategy's derivative protection. Indeed, one of the takeaways from this period was that we were navigating a market backdrop that was being manipulated by policymakers to an extent never seen before.

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In contrast, 2019 was an example of when the strategy's rich blend of asset classes pulled their weight. Both the strategy's core of return-seeking assets and its insulating layer of 'stabilising' assets (which aims to hedge perceived risks and dampen volatility) generated positive returns, illustrating the benefit of diversification across asset classes and harnessing different sources of returns. While the team had increased exposure to core return-seeking assets, reflecting a pickup in global growth, this was matched with substantial offsetting positions and therefore did not result in a significant increase in the strategy's overall risk.

Perhaps one of the most seismic periods for the strategy was the outbreak of the coronavirus pandemic in Q1 2020. The team was fairly constructive going into 2020, owing to a combination of improving economic data, less macro uncertainty, and continued intervention by central banks to support markets. However, it was concerned about investors' seeming nonchalance about the impact of the virus and took some risk off the table while simultaneously increasing cash as the ultimate safe-haven asset. This underestimated the extraordinary monetary and fiscal stimulus that ensued, which greatly improved the outlook for risk assets. Once this was identified, the team quickly assessed the implications and increased the portfolio's return-seeking core, focusing it on high-quality businesses that were well placed to survive the economic uncertainty. These moves enabled the strategy to claw back initial losses and end the calendar year 2020 in positive territory.

2022 is also worthy of mention, given that it was the only calendar year in which the strategy posted a negative return. A backdrop of stressed market conditions caused by the rapid, steep rise in interest rates affected a swathe of asset classes. While the team actively shifted the asset allocation to navigate this difficult period, with the benefit of hindsight it should have taken advantage of oversold conditions in October to close out the strategy's short positions on equity-market indices.

Thematic research focus

These contrasting periods illustrate the need to be flexible and nimble, as well as quickly assessing scenarios, particularly where there is no 'playbook' to follow. While a sound investment process represents the backbone of any strategy, we believe a key determinant of the strategy's outcomes has been the experience of navigating challenging market conditions using thematic research as a compass. Dominant macro themes, both monetary and geopolitical in nature, such as an increasingly complex and financialised backdrop, governments intervening in economies more actively, and competition between great powers, help identify evolving opportunities and risks.

For example, at the time of the strategy's launch, China was viewed by investors as an exciting new frontier, offering unprecedented opportunities. Today the baton has been passed to India, with China now viewed with more caution owing to the government's 'common prosperity' wealth redistribution agenda, and as geopolitical tensions between China and the West have risen.

Enriching the asset-class mix

The other area of development within the portfolio has been the asset-class mix which has been progressively enriched, in part to reflect the evolution of markets. When the strategy was first launched, it could broadly be described as a modern balanced portfolio with a focus on traditional asset classes: equities, bonds and cash. Derivatives on major market indices were also used for protective purposes very early on in the strategy's history. The team added gold in 2005 as an indirect hedge, and the fourth quarter of 2018 saw alternative assets take on a larger role in the toolkit. Their appeal was their less-than-perfect correlation to traditional assets and, in areas such as renewables and infrastructure, they have offered an explicit inflation linkage which has proved particularly helpful more recently as inflation has surged. This diversification of the sources of return has provided a buffer against more challenging market conditions, although we recognise that such assets are not immune to volatility when market conditions worsen.

The use of derivatives has enabled us to calibrate the size of the return-seeking core and stabilising layer, benefiting from the liquid nature of these instruments while still enabling our long-term views to prevail in respect of physical positions in securities.

Keeping the client objective in focus

As a team, we have matured together over the years (and many of us are still here, which is unusual in an industry with notoriously high turnover). We have taken stock of previous experiences and have weathered some difficult times, notably the sudden death of the strategy's investment leader, Suzanne Hutchins, in late 2022. The shocking news tested our resilience and cohesion. However, as we had been working together for many years, we already understood and appreciated each other's strengths, and that enabled us to support each other strongly in taking the strategy forward. It was a tough period for the team, but we never lost our focus on seeking to fulfil the strategy's original client goal.

Where are we now against a backdrop of significant global uncertainty and opportunity? This is arguably a sweet spot for the strategy: volatile markets with shorter cycles of greater amplitude are conditions in which the strategy should thrive. The need to shift asset allocation to reflect market vicissitudes is more relevant than ever, as is the need to design portfolios to be future-proof and robust. We thank our client base for their loyalty over the years and believe that the next decade should favour the strategy's process, incorporating a judgement-based assessment of fundamentals, backed by a sound risk-management process and quantitative measures.

Key lessons we have learned over the years are to expect the unexpected, and that having confidence and a deep understanding of what we own and why we own it should pay off in challenging conditions. Moreover, the ability to embed some downside protection and make a careful, measured assessment of the most effective tools to implement is invaluable and aligns us with our clients' objectives.

Performance and risks

TEN-YEAR PERFORMANCE RECORD TO 31 MARCH 2024

	March 2023-March 2024	March 2022-March 2023	March 2021-March 2022	March 2020-March 2021	March 2019-March 2020	March 2018-March 2019	March 2017-March 2018	March 2016-March 2017	March 2015-March 2016	March 2014-March 2015
Newton Real Return strategy (net of fees) %	7.72	-4.34	1.23	19.19	-2.30	6.90	-2.24	2.09	0.80	6.30
Newton Real Return strategy (gross of fees) %	8.61	-3.58	2.03	20.14	-1.52	7.76	-1.46	2.89	1.60	7.14
SONIA 1 Month Compounded (performance benchmark) %*	5.05	2.09	0.11	0.07	0.68	0.66	0.36	0.35	0.51	0.50
SONIA 1 Month Compounded + 4% (performance benchmark) %*	9.07	6.12	4.14	4.07	4.68	4.66	4.36	4.34	4.51	4.50

Source: Newton, close of business prices, total return, income reinvested, in GBP, 31 March 2024.
Performance is stated gross and net of management fees. The net-of-fee returns are calculated by deducting an annual management charge of 0.75% from the strategy's gross-of-fee returns. The impact of management fees can be material. A fee schedule providing further detail is available on request.
Performance benchmark: The strategy seeks to deliver a total return of SONIA (30-day compounded) +4%* per annum over rolling 5-year periods, from a globally diversified portfolio. In doing so, the strategy aims to achieve a positive return on a rolling 3-year basis. However, a positive return is not guaranteed and a capital loss may occur.
*Effective 31st October 2021, The benchmark changed from the London Interbank Offerred Rate (LIBOR) to the Sterling Overnight Index Average (SONIA).
All benchmark perfromance prior to this date was calculated against LIBOR.

Past performance is not a guide to future performance.

The value of investments can fall. Investors may not get back the amount invested.

Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA), BNY Mellon Fund Management (Luxembourg) S.A. (BNY MFML) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA, BNY MFML or the BNY Mellon funds.

Newton Real Return strategy - key investment risks

- **Performance aim risk**: The performance aim is not a guarantee, may not be achieved and a capital loss may occur. Strategies 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 strategy invests in international markets which means it is exposed to changes in currency rates which could affect the value of the strategy.
- **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 strategy 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 strategy.
- **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 strategy.
- **Credit risk**: The issuer of a security held by the strategy may not pay income or repay capital to the strategy when due.
- **Emerging markets risk**: Emerging markets have additional risks due to less-developed market practices.
- **Liquidity risk**: The strategy may not always find another party willing to purchase an asset that the strategy wants to sell which could impact the strategy's ability to sell the asset or to sell the asset at its current value.