BNY Mellon Global Real Return Fund (EUR)

BNY MELLON

Prepared for professional clients only
As at 31 December 2012

Investment manager

Newton Investment Management: Newton pursues a distinctive global thematic investment approach and provides added value from extensive proprietary research.

General information

Total net assets (million)	€ 1,140.13
Fund type	ICVC
Fund domicile	Dublin
Base currency	EUR
Currencies available	EUR
Fund launch	08 Mar 2010

EUR C share class details

Inception date	08 Mar 2010
Min. investment	€ 5,000,000
Annual mgmt charge	1.00%
Max. initial charge	5.00%
ISIN	IE00B4Z6MP99
Bloomberg	BNGRRCE ID
Sedol	B4Z6MP9
Valoren	10742535
WKN	A0RP2E

Registered for sale in: AT, FR, DE, GIB, GUE, IRL, IT, JER, LU, NL, NO, PT, ES, SE, CH, UK

Fund Ratings

S&P CAPITAL IQ | Platinum FUND GRADING

INVESTMENT OBJECTIVE

A total return comprised of long-term capital growth and income by investing in a broad multi-asset portfolio.

PERFORMANCE AIM

The fund has a performance aim of cash (1 month EURIBOR) + 4% p.a. over 5 years before fees. This 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 the returns to be significantly different than expected.

PERFORMANCE NOTE

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. For a full list of risks applicable to this fund please refer to the Prospectus or the Key Investor Information Document (KIID).

PERFORMANCE RETURNS(%)

					Annualised		
	1M	3M	YTD	1YR	2YR	3YR	5YR
EUR C	-1.27	-3.06	3.98	3.98	2.62	-	-

Source: Lipper as at 31 December 2012. Performance is shown for EUR C unless otherwise stated. Total Return, including annual management charge, but excluding initial charge, net of performance fees income reinvested gross of tax, expressed in share class currency. The impact of the initial charge which may be up to 5% can be material on the performance of your investment. Performance figures including the initial charge are available upon request.

PERFORMANCE SUMMARY

The Fund generated a negative return in absolute terms.

Positive
- Holdings in European high yield bonds

Negative
- Exposure to telecommunications, utilities, pharmaceuticals, tobacco and oil & gas producers
- Exposure to gold and gold mining equities
- Holdings in Koninklijke KPN and Telekomunikacja Polska

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Market background

- The final quarter of 2012 saw a continuation of government policy intervention driving global financial markets upwards.
- Investors maintained their appetite for risk, heartened by the US Federal Reserve's announcement that it would continue with its policy of monetary easing until unemployment improves. This combined with the continued risk rally in Europe started when European Central Bank president Mario Draghi promised 'to do whatever it takes' to save the euro.
- Investor sentiment was helped by the Spanish government's successful refinancing of some of its debt and by Greece receiving the conditional assistance promised.
- Concerns about whether US politicians would be able to resolve their differences in time to avert the so-called 'fiscal cliff' of huge tax rises and spending cuts weighed on investor sentiment, however. (A deal was reached before financial markets opened on 2 January 2013.)
- With the once-in-a-decade leadership transition complete in China (Xi Jinping emerged as the new Communist Party chief), signs of improving industrial output in China helped Asian financial markets make a strong finish to the year.
- Given the sustained appetite for 'risk', higher quality government bond markets lost their allure. Returns from corporate bond markets reflected the strength of equities.

Performance review

The Fund's defensive strategic positioning meant that it was not favourably placed to deliver returns against the very strong financial markets of the final quarter. The Fund delivered a negative return, primarily on account of sector selection and stock-specific events within equity holdings.

Sectors of the market that produced negative returns over the quarter included telecommunications, utilities, pharmaceuticals, tobacco and oil & gas producers, some of the Fund's most significant exposures, and this was against a rising market driven by financials, real estate and construction. We maintain our conviction that gold has and will prove to be a natural beneficiary of the current policy environment; however, the price of gold has proved to be volatile, and its mid-single-digit decline over the quarter had a significant impact on the Fund's gold-related holdings. Newcrest Mining and Barrick Gold were particularly hard hit. Stock-specific concerns had an impact on Koninklijke KPN and Telekomunikacja Polska.

On a more positive note, the Fund's holdings in European high-yield bonds continued to produce strong returns, including those of Italian telecommunications operator Wind Acquisition Finance and Croatian food distributor Agrokor. In this market segment, we have access to higher risk businesses further up the capital structure.

Activity review

The US Federal Reserve has made a subtle but significant shift in rhetoric towards emphasising unemployment rather than inflation for the setting of monetary policy. In light of this, we believed that there was an increased probability of the current policy-driven cycle being sustained for long enough to warrant a tactical reduction in cash and an associated increase in equities.

During the quarter, we established a new position in US payroll outsourcing provider Paychex, where we feel that the slowdown in its business is cyclical rather than structural, and the company provides a buying opportunity in a high quality durable franchise at an attractive valuation. We also opened new positions in United Utilities Group and Eldorado Gold, as well as adding significantly to some existing holdings that had been weak, such as GlaxoSmithKline and Reynolds American. Following a meaningful deterioration in the competitive environment within the Polish telecommunications market, we chose to exit the position in Telekomunikacja Polska.

We started to reduce the holding of US Treasury Inflation-Protected Securities (TIPS), given the significant returns they have delivered, and invested the proceeds in lower duration Australian state index-linked issues. In addition we reduced the Fund's floating US dollar exposure following the Fed's actions; however, the US dollar negative correlation remains intact, and continues to act as an indirect risk asset hedge.

TOTAL PORTFOLIO BREAKDOWN (%)

Equities		57.3
	Europe ex UK	19.9
	North America	17.8
	UK	13.5
	Pacific Ex Japan	3.0
	Japan	2.6
	Others	0.6
Risk offsetting positions - equities (Delta netted exposure)		3.3
	Index option S&P 500	3.3
Bonds		25.5
	Corp Bonds	11.1
	Govt Bonds	10.6
	Index Linked Govt	3.8
Convertibles		2.3
Cash and Cash Equivalents		10.9
Others		4.1
	Commodities	3.7
	Derivatives	0.4

Risk offsetting positions:

Equity index options - *Providing downside protection if equity markets sell-off.* **Currency positioning-** *Long USD (We expect the USD to remain negatively correlated with risk assets).*

Corporate Bond portfolio breakdowns

RATING BREAKDOWN (%)

A	8.5
BBB	3.4
BB	34.5
B	45.2
CCC & Below	8.4

AVERAGE DURATION (IN YEARS)

Average Duration	
Inv Grade	9.0
High Yield	2.3

SECTOR ALLOCATION (%)

Industrial	71.2
Telecoms / Utilities	25.8
Financial	3.0

SECTOR BREAKDOWN (%)

	Fund
Pharmaceuticals & Biotechnology	11.9
Mobile Telecommunications	6.9
Mining	6.4
Gas, Water & Multiutilities	5.3
Tobacco	4.9
Chemicals	4.0
Oil & Gas Producers	3.9
Fixed Line Telecommunications	3.1
Food & Drug Retailers	2.9
Support Services	2.0
Electricity	1.5
Media	1.0
Aerospace & Defense	0.9
Real Estate Investment Trusts	0.9
Beverages	0.8
Health Care Equipment & Services	0.8

TOP 10 HOLDINGS (%)

	Fund
ETFS Physical Gold 0% Secured Note (USD)	3.7
Glaxosmithkline Plc	3.2
Bayer AG	2.8
Australia (Commonwealth) 5.5% Bds 21/04/2023	2.7
USA Treasury Bonds 2.5% Tii 15/01/2029	2.5
Reynolds American Inc Com Stk	2.5
Total SA	2.3
Norway (Kingdom Of) 4.5% Bds 22/05/2019	2.3
Roche Hldgs Ag	2.0
Australia (Commonwealth) 4.75% Bds 21/04/2027	2.0

Investment strategy

Overall, we continue to emphasise sustainable cashflows and yields, and to find such attractive characteristics in stable growth areas, such as food, beverage and tobacco companies. Elsewhere, we are identifying areas of structural growth that are consistent with those identified by our themes. Among these are areas of innovation, including the healthcare and information technology sectors.

We continue to favour investments that we expect to perform well in the event of higher inflation, such as real assets. With the Japanese becoming just the latest nation to start explicitly targeting a weaker currency, and the Federal Reserve just beginning its current round of balance-sheet expansion, gold is likely to remain an attractive alternative to fiat currencies being a real asset, not an obligation. This attraction is likely, we believe, to become more valued as the world comes to understand how much of the current stock of debt is unsustainable.

Clearly, some hedges against the risk of recession/deflation also remain appropriate, in case we really are following the Japanese experience of two 'lost' decades, given the wide range of possible outcomes. These may be a drag on shorter term portfolio performance at times when markets adopt a reflationary/inflationary mindset but should continue to provide a cushion against the inevitable challenges that lie ahead.

Economic outlook

Capital market performance during 2012 was dominated by the rhetoric and actions of governments and central banks. 'State intervention', a key idea within the Newton thematic framework, has taken centre stage, its main aim being to influence asset-price movements, chiefly by preventing or reducing the tail risks of extreme outcomes.

There have been pockets of improvement in recent months, including positive data on the US housing market, a Greek debt deal which eases some near-term concerns about the eurozone debt crisis, resilient Chinese economic activity, progress on the US Fiscal Cliff and the cleansing effect of US banking sector fines. However, despite these, we remain concerned about the intractable nature of the structural problems in the global economy.

Too much debt, weak competitiveness and challenging demographics are (in the absence of some kind of radical policy action) likely to lead to sluggish economic growth in the foreseeable future. Addressing these factors head-on is the key to providing a long-term solution, but doing so is unlikely to 'win friends and influence people'. The result is that the authorities have so far preferred to provide immediate respite care rather than radical surgery and that has rubbed off on financial markets and the population at large. Structural issues aside, with monetary policy so extreme and focused on short-term outcomes and fiscal policy highly polarised and politicised, it is not surprising that markets have become more volatile, and that corporations and households have been reluctant to invest and spend.

Significant adjustments and powerful vested interests

The classic post-war recipe for highly indebted economies is much like that being imposed on Greece now: use austerity to balance the budget (before financing costs) and then radically restructure the legacy debt. By not confronting the fact that the bulk of the Western world has similar problems, authorities are implicitly choosing to take the slow road towards resolving the problem.

The reason why this kind of resolution is not being universally applied is, paradoxically, the widespread nature of today's giant debt load. The truly global scale and interconnectedness of the issue is important; had the legacy of the credit super-cycle been owed to Martians, we would already have defaulted and moved on!

To misquote Winston Churchill, never in the field of human finance have so many owed so much to each other. Moreover, these obligations, as we are acutely aware, are important assets for many. The official line is that allowing market forces to make the necessary budget and balance-sheet adjustments would be just too painful, and result in an asset deflation and depression. Of course, there is a relatively good example of what has happened in the West being played out in Japan before our eyes and in real time. In relation to Japan, it is interesting that a key consensus among observers is that not recognising and tackling the extent of the bad debts in the banking system has been a major contributor to why the problems in that country have been so prolonged.

By slashing interest rates and keeping them at close to zero, to quote John Plender in the *Financial Times* '[prolonged] monetary ease tends to freeze the existing industrial structure'. [1] It risks maintaining the structures, behaviours and vested interests (such as 'too big to fail banks'!) of the boom phase, which acts against the periodic 'creative destruction' that is central to how capitalism works.

All this sounds eerily familiar, and indeed the Bank of England has warned in a recent paper of the development of 'zombie' companies that are being kept alive with their main purpose being to continue to service their debt obligations but with no real growth prospects. We believe this is important, because some of the zombies, nurtured by unnaturally low rates and excess liquidity, may have grown such that they represent a not insignificant part of equity and debt markets. A normalisation of interest rate conditions could lead to their demise.

Not tackling structural issues has costs

It is heartening that the Bank of England has considered such unintended consequences of ultra-loose policy, albeit that it thinks that, to date, its use of more unorthodox policy such as quantitative easing (QE), has been appropriate. Bank governor Mervyn King has also used a recent speech to indicate that QE-type policies may have limits, stressing that they work by bringing forward demand from tomorrow to today. [2]

Of course, QE 'front-loads' both demand and asset-price appreciation; borrowing demand from the future implies lower trend economic growth, and higher valuations now (which support asset prices today) imply lower returns tomorrow. If we all need to save significantly more today in order to have a decent standard of living in the future, doesn't this make us less likely to go out and stimulate the economy through consumption?

Sustainable growth, in our mind, is a function of savings, investment, productivity and innovation. QE encourages us to continue to pursue credit-driven growth. Although it is clearly very effective at pushing up asset prices in the short term, it is a dangerous cocktail in an environment where profits are at peak levels and demographics are deteriorating.

Central banks moving away from price stability?

Meanwhile, the Bank of England announced that the current head of the Bank of Canada, Mark Carney, will replace Sir Mervyn as Bank of England Governor in July 2013. Mr Carney's reference to an increasingly fashionable "nominal GDP-level target" as a replacement for the inflation-targeting approach that has been championed by his predecessor suggests his approach will be more 'dovish' (accommodative).

Further change in central bank policy was also evident in the recent quarter with the announcement that that US Federal Reserve will make additional 'unsterilised' US Treasury purchases (not matched by corresponding sales) to their existing purchases of mortgage bonds. As such, it will be expanding its balance sheet (printing money) at an annual rate of around US$1 trillion. This compares to previous purchases under QE2 of US$600bn. However, the most significant difference is that, unlike the earlier fixed-dollar amounts of asset purchases, the scale and end-date of these new monthly purchases will remain open-ended, continuing until conditions in the labour market improve.

This change at the Federal Reserve was mirrored by the newly elected Liberal Democratic Party (LDP), which had made a more aggressive pursuit of inflation by the Bank of Japan (BoJ) a key pre-election policy initiative. With the LDP successfully regaining power after three years in opposition, the choice of the replacement for BoJ governor Shirakawa in April 2013 – and the mandate that the new governor is given – may well bring about a further shift in central-bank policy.

These approaches are likely to distort financial markets further and take more risks with inflation….

We have previously talked about the potential for unintended consequences of the above policy measures, such as the risk of inflating serial asset-price bubbles, of distortions (e.g. in government bond prices, in order to make manageable the existing stock of debt and fund deficits), and in market dysfunction. We have highlighted, too, the risk that more widespread inflation takes hold.

How inflation manifests itself is crucial; the intention of the authorities is to see inflation coming through in the form of rising asset prices, in the hope of creating a virtuous cycle of improving wealth, which generates greater confidence and economic activity. However, more consumer-price inflation (CPI) would be a tax on households at a time when real incomes are already flat. There appears to be considerable scope for these policies to increase inequalities. Higher CPI would probably result in a significant rise in bond yields, if not a change in policy on short interest rates.

Japan is not the only country responding to the latest unconventional policies in the US with further monetary stimulus intended to weaken its currency. After a period of slower growth, this may not be an immediate problem but, for many economies in the developing world, operating at high rates of capacity utilisation creates further inflationary pressure.

Bottom line: longer-term rebalancing and global realignment are likely to lead to slower trend economic growth in *both* developed markets *and* emerging markets.

In the short term, the transition to more radical models for resolving the challenges inherent in overly indebted economies would be painful, so has been heavily resisted by vested interests. However, ultimately legacy debt needs to be dealt with and balance sheets written down accordingly. This is clearly true at present in the developed world, as the previous boost to activity from falling interest rates and credit expansion (evident during the 'Great Moderation'), and the growth in the 'Baby Boomer' population, have passed. However, the process is equally likely to occur in developing economies, with cost bases increasing as incomes advance and with authorities seeking to manage the transition from export-driven growth to domestically driven expansion.

In both developed and developing economies, political developments are likely to remain challenging as growth in tax revenues slows, forcing greater compromise between opposing views. Although the political and financial event risks in the final quarter of 2012 have passed with relative market calm – despite the media excitement about the US Fiscal Cliff – the likelihood remains that uncertainty caused by political divisions will add to economic and financial volatility.

[1] Japan counts 'zombie' cost of easy money, John Plender, Financial Times, 7 November 2012 [http://www.ft.com/cms/s/0/012b2f68-282b-11e2-a335-00144feabdc0.html#axzz2GpC2ZYR5]

[2] Mervyn King to the South Wales Chamber of Commerce, Cardiff, 23 October 2012 [http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech613.pdf]

Source: BNY Mellon Asset Management
Portfolio holdings are subject to change at any time without notice, are for information purposes only and should not be construed as investment recommendations.

Important information