

NEWTON

Investment
Management

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DYNAMIC EQUITY: DIFFERENT APPROACH, DIFFERENT OUTCOME

Multi-asset solutions team

March 2023

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EXECUTIVE SUMMARY

- Equities tend to be at the core of investors' risk budgets but active returns have not reliably met expectations.
- To generate more consistent excess returns in core equities, we take a different approach.
- Dynamic Equity targets excess returns versus broad equity benchmarks through more risk-efficient portfolio construction and dynamic allocations.
- Over its 33-year live history, the US version of Dynamic Equity has generated excess returns above the S&P 500®, with annualised net-of-fee outperformance of 2.5% (as shown in the graph on page 4).

NEWTON'S MULTI-ASSET TEAM

Dimitri Curtil - Global head of multi-asset solutions

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The challenge for equity investors

It is no secret that many active equity managers struggle to generate alpha against core benchmarks. There is a basic mathematical reality underlying the empirical data: the pursuit of alpha through stock picking is a zero-sum game. William F. Sharpe eloquently proved that point in *The Arithmetic of Active Management* more than 30 years ago. When the investment universe becomes highly competitive—owing to comprehensive research coverage by both buy and sell-side analysts as well as growth in assets under management—the challenge in consistently extracting alpha increases.

Investors have responded by shifting to indexing strategies. However, indexing introduces other challenges: there is no potential for excess returns, no risk management or oversight, and in some cases, benchmarks are less than optimal.

How can investors bridge the gap between cost-efficient indexed implementation and the desire for excess returns? We advocate an approach that in our view tilts the odds of achieving performance targets more in favour of investors. Newton's Dynamic Equity strategy seeks to augment the return potential of investors' core equity allocation by seeking excess returns through a differentiated, cost-effective and highly liquid active approach.

More efficient return drivers for better outcomes

Dynamic Equity is an active strategy that employs a non-traditional approach when seeking to outperform equity benchmarks, thereby avoiding the zero-sum game of stock selection. The underlying philosophy is based on Modern Portfolio Theory (MPT) concepts. The strategy seeks to opportunistically combine equity exposure with two key diversifying assets—government bonds and cash—along with a modest amount of leverage. It aims to create a risk-efficient allocation, based on our current assessment of the risk and return relationship between stocks, bonds, and cash, to target more return per unit of risk than an equity-only portfolio.

By simply combining three assets and relaxing typical allocation constraints, we believe—and our track record shows—a larger and more consistent excess return can be achieved than is possible with traditional active equity strategies.

A dynamic approach

A dynamic allocation to stocks, bond and cash allows the strategy to respond to changing risk and return expectations. Dynamic Equity incrementally shifts the allocation toward equities when our assessment of the fundamental outlook for equities is positive, or away from equities if the outlook is more challenged. An opportunistic allocation to bonds can also help diversify the portfolio and add a source of excess return.

By implementing a modest amount of leverage, we can move up the capital market line to construct a portfolio that has a similar risk profile to equities but offers the opportunity for excess returns. The maximum combined gross exposure to stocks and bonds is 150%, although the amount of leverage varies depending on the attractiveness of equities, government bonds and cash, along with market conditions.

In our view, a diversified, flexible, dynamic approach can realise upside opportunities while also protecting capital when the outlook is less promising. In market environments when higher-risk assets such as stocks and bonds are expected to outperform cash, Dynamic Equity will tend to be overweight equities, apply prudent leverage, and hold government bonds. Conversely, when forward-looking risk premia are less attractive or the macro environment is not conducive to risk taking, the strategy will become more defensive by reducing equity exposure and leverage.

Proprietary forecasts drive dynamic allocations

Newton's multi-asset solutions team has a robust process for calculating proprietary expected returns and risk premia. The Dynamic Equity investment process relies on forward-looking asset premia, risk, and correlations to determine the optimal allocation. One critical driver of our dynamic allocations over time is our expected return for equities, which is based on a proprietary multi-stage discounted cash-flow framework. Company-level forecasted earnings and growth are aggregated to the index level and then adjusted based on our proprietary macroeconomic signals.

Our cross-asset expected returns are combined with expected risk and correlations in a mean-variance optimisation. The optimal portfolio is the blend of stocks/bonds/cash that offers the highest return per unit of risk.

Our fundamentally derived, systematically implemented approach has delivered consistent excess returns in the US version of the strategy (with outperformance in 25 out of 33 calendar years, net of fees, since inception), with a favourable upside/downside capture profile since the strategy was launched in 1989.

Dynamic Equity key attributes

- **Less constrained:** dynamically adjusts equity, bond, and cash exposure over time based on our current outlook.
- **Downside protection:** inclusion of diversifying non-equity assets alongside smart derivative usage enables impactful risk management.
- **Differentiated excess returns:** uncorrelated to traditional active managers and common risk factors.
- **Flexible access:** a suite of offerings across multiple benchmarks or as a portable-alpha overlay.

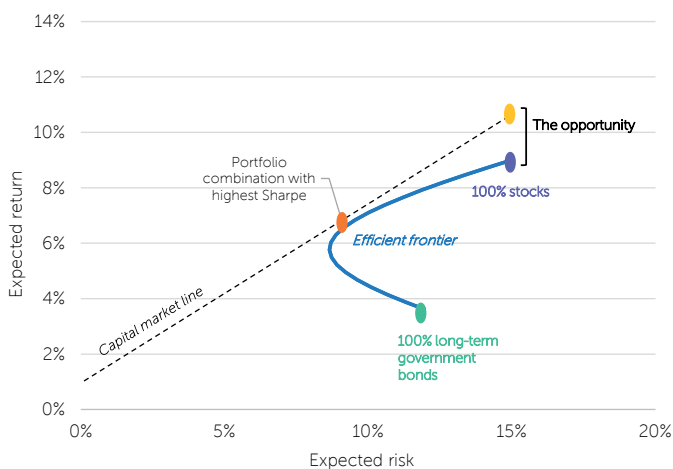
Proof statement

The live results achieved by the US version of our Dynamic Equity strategy over 33 years are a testament to the underlying philosophy, our process for determining forward-looking risk premia, and the multi-layer risk management. As anticipated, the combination of market structure, dynamic allocations to stocks, bonds and cash, and prudent leverage, has generated returns that have exceeded the S&P 500® Index at a similar risk level.

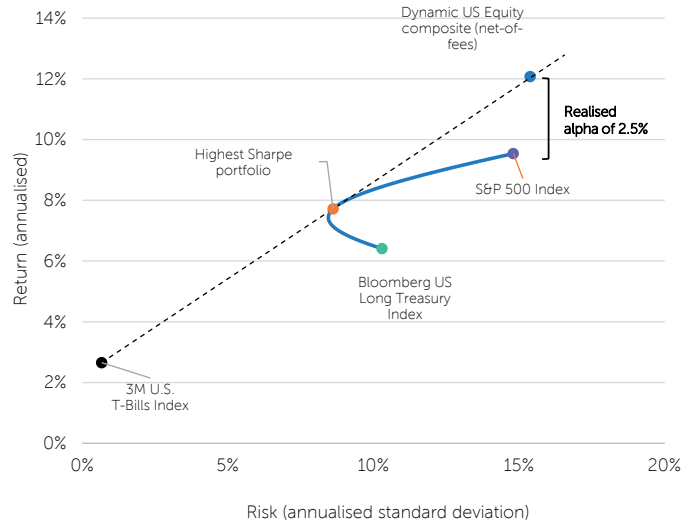
The chart on the left (below) shows the conceptual illustration of the opportunity we seek to exploit. The strategy design is anchored in the MPT concepts of the efficient frontier and capital market line. As noted above, it allocates to the most risk-efficient (highest Sharpe ratio) portfolio based on our proprietary risk and return forecasts.

The chart on the right (below) shows the realised results since the US strategy's inception in August 1989. The live track record demonstrates the durability of our approach and its fidelity to the underlying theory. We believe the premise of the strategy will persist. Dynamic Equity has navigated disparate market environments—which demanded a broad range of stock-bond-cash allocations—while maintaining an equity risk profile.

Theory: design anchored in Modern Portfolio Theory



Application: Dynamic Equity results risk/return profile (net of fees, August 1989-September 2022)



Comparisons are made to demonstrate volatility and correlation only and are for illustrative purposes only. Inception date: 31 August 1989. 1 On an annualised basis, net of fees since inception. The Bloomberg® US Long Treasury Index, FTSE 1-Month US Treasury Bill indexes are being shown for comparison purposes only and are not official benchmarks for this strategy. A definition of these indexes can be found at the end of this paper. The graph on the left-hand side is for illustrative purposes only and does not reflect actual returns. Source: Newton, S&P 500, Bloomberg®, 30 September 2022. Please refer to the composite information on page 5. This is supplemental information to the GIPS® compliant information. Performance is expressed in US dollars.

Why Dynamic Equity?

- Flexible, time-tested approach designed to outperform equity benchmarks in different market environments.
- Targets enhanced upside and seeks to protect capital in down markets.
- Low correlation to traditional active strategies and factors/styles.
- Seeks consistency of excess returns, with a higher hit rate than traditional active strategies.
- Valuation-driven, macro aware, and dynamic in nature.

Dynamic US Equity Composite

Year	Asset-weighted Gross	Asset-weighted Net	S&P 500®	Composite 3-Yr St Dev	Benchmark 3-Yr St Dev	Number of Portfolios	Composite Assets (\$mm)	Firm Assets (\$mm)	Composite Dispersion
2021	30.97	30.60	28.71	17.24	17.17	11	6,864	65,747	0.06
2020	19.63	19.22	18.40	19.30	18.79	11	5,794	601,427	0.12
2019	38.28	37.81	31.49	13.58	12.10	9	5,123	534,173	0.11
2018	-6.19	-6.52	-4.38	12.64	10.95	9	3,702	488,649	0.04
2017	28.50	28.05	21.83	11.40	10.07	≤ 5	1,967	376,540	N/M
2016	14.90	14.50	11.96	12.28	10.74	≤ 5	1,216	339,574	N/M
2015	0.42	0.07	1.38	12.55	10.62	≤ 5	1,042	349,089	N/M
2014	19.77	19.36	13.69	10.68	9.10	≤ 5	1,013	379,698	N/M
2013	39.08	38.61	32.39	13.44	12.11	≤ 5	628	348,634	N/M
2012	20.67	20.26	16.00	14.69	15.30	≤ 5	410	252,696	N/M

Performance disclosure

The Dynamic US Equity composite measures the total return of all fee-paying, discretionary, portfolios that actively allocates assets across the equity, fixed income and cash markets of the United States using a proprietary quantitative model. Typically, a combination of individual stocks, financial futures, and options are used to allocate to each of the asset classes. The composite may increase total notional asset class exposures up to 150% and may short bonds and cash up to 50%, with each asset class having its own allocation ranges. The use of derivatives is a characteristic of this investment strategy and may be used from time to time to obtain exposure, to provide liquidity for cash flows, to hedge accruals or for other purposes that facilitate meeting the composite's objective. The composite was created on August 31, 1995. The composite has an inception date of September 1, 1989. The performance of the composite is expressed in U.S. Dollars. A list of composite descriptions and a list of limited distribution pooled fund descriptions are available upon request. Policies for valuing investments, calculating performance, and preparing GIPS reports are available upon request.

Newton Investment Management North America, LLC ("NIMNA" or the "Firm") is a registered investment adviser and subsidiary of The Bank of New York Mellon Corporation ("BNY Mellon"). The Firm was established in 2021, comprised of equity and multi-asset teams from an affiliate, Mellon Investments Corporation. The Firm is part of the group of affiliated companies that individually or collectively provide investment advisory services under the brand "Newton" or "Newton Investment Management" ("Newton"). Newton currently includes NIMNA and Newton Investment Management Ltd. ("NIM"). Performance is presented to show the performance of all fee-paying portfolios with substantially similar investment objectives, policies and strategies, which were managed at a prior firm affiliated with NIMNA until September 1, 2021. Performance results from the prior affiliated firms were linked on September 1, 2021, to the results achieved at NIMNA in compliance with the GIPS Guidance Statement on Performance Record Portability. Firm assets presented through September 1, 2021, represent the Firm assets of NIMNA prior affiliated firms which managed this investment strategy prior to the formation of NIMNA.

The Composite's benchmark is the S&P 500® Index. The S&P 500® Index measures the performance of the large-cap segment of the U.S. equity market. The Bloomberg® US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The standard management fee for separately managed account in this strategy is 0.35% for first \$300M, 0.30% for the next \$200M, and 0.25% for the balance of assets under management. Net-of-fee returns are calculated using model fees which are equivalent to the standard fee schedule for each investment strategy. Composites containing broad distribution pooled funds apply a model fee equivalent to the investment management portion of the fund's total expense ratio. Fees are accrued monthly for each account according to their assets under management and the results are asset-weighted to arrive at the composite net-of-fee return. Additional information regarding historical net-of-fee returns calculation is available upon request.

Gross performance figures are time-weighted rates of return, which include the deduction of transaction costs. Performance results reflect the reinvestment of interest income and other earnings. Past performance is not an indication of future performance. Gross-of-fee performance figures for bank collective funds participating in the composite have been reduced by administrative fees in addition to trading expenses. Bank collective fund returns may exclude transaction costs associated with client-driven external contributions and withdrawals. The treatment of these trading expenses would have an impact on the fund return similar to as if a temporary new account was employed. Gross returns were used to calculate all risk measures presented in this GIPS Composite Report. Internal dispersion figures are an asset-weighted standard deviation of all portfolios that were included in the composite for the entire measurement period. Dispersion figures for years containing 5 or fewer Portfolios are considered Not Meaningful or "N/M".

Newton Investment Management North America, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Newton Investment Management North America, LLC has not been independently verified. Newton Investment Management North America, LLC's predecessor firms all have been independently verified for the periods January 1, 2007, through December 31, 2020.

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Investment performance

Performance is stated gross and net of management fees. The impact of management fees can be material. A fee schedule providing further detail is available on request. S&P500® Index performance benchmark is used as a comparator for this strategy. The strategy does not aim to replicate either the composition or the performance of the performance benchmark.

12-month returns, %	Sep-21 to Sep-22	Sep-20 to Sep-21	Sep-19 to Sep-20	Sep-18 to Sep-19	Sep-17 to Sep-18
Composite (gross)	-16.95	29.64	17.03	6.83	19.97
Composite (net)	-17.24	29.20	16.63	6.46	19.56
Benchmark	-15.47	30.01	15.15	4.25	17.91
Calendar year returns, %	2021	2020	2019	2018	2017
Composite (gross)	30.97	19.63	38.28	-6.19	28.50
Composite (net)	30.60	19.22	37.81	-6.52	28.06
Benchmark	28.71	18.40	31.49	-4.38	21.83

Source: Newton, close of business prices, total return, income reinvested, gross and net of fees, in USD, 30 September 2022. Net-of-fee returns are calculated using model fees of 0.35%, which are equivalent to the highest fee schedule for each investment strategy. Composites containing broad distribution pooled funds apply a model fee equivalent to the investment management portion of the fund's total expense ratio. Fees are accrued monthly for each account according to their assets under management and the results are asset-weighted to arrive at the composite net-of-fee return. Additional information regarding historical net-of-fee returns calculation is available upon request. Please refer to the composite information on page 5. This is supplemental information to the GIPS® compliant information.

Key investment risks

PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE. 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.

Objective/performance risk: There is no guarantee that the strategy will achieve its objectives.

Geographic concentration risk: Where the strategy invests significantly in a single market, this may have a material impact on 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 risk: The issuer of a security held by the strategy may not pay income or repay capital to the strategy when due.

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 strategy to financial loss.

Important information

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