

# Square Mile Fund Research Process



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 Square Mile Investment Consulting & Research Limited



## Square Mile Research Process

With one of the largest and most experienced investment research teams in the UK retail market, our award-winning analysts are committed to providing in-depth, high-quality research across a variety of asset classes and sectors to help you make the most informed investment decisions.



*At Square Mile, our research team meets with hundreds of fund managers a year to look at what is going on behind the data to understand how a fund behaves.*

## Six step research process

Through a combination of regular discussions with fund managers and qualitative and quantitative analysis, our research team's focus is to identify strategies, both funds and investment trusts, capable of meeting their investment objectives over the long term.



## 1. Universe Assessment

There are over 3,500 FCA registered funds and investment trusts available to UK investors. As performance screens in isolation have little use in differentiating between good and bad funds, uncovering good strategies involves much effort as a result. As part of our initial assessment, our ideas come from a range of sources, including:

- Our experience and market knowledge.
- Our extensive contacts in the industry including clients, fund managers and their peers.
- Our analysts who have in-depth knowledge of the sectors they cover.
- Attendance at conferences and industry functions.
- New strategy launches.

## 2. Initial Analyst Research

When beginning to research strategies, our analysts look for answers to the following high level questions:

### 1. What is the fund manager seeking to achieve?

From the start, we want to know what the strategy's objective is and whether it is assessable as this is how we shall be measuring the manager's success or otherwise.

In our experience, we suspect investors often underestimate the importance of a strategy's objective, so we start by assessing how well it aligns with their desired outcomes.

The objective needs to be realistic and suitable. The objective should describe the purpose of the strategy and be of help to investors to determine the suitability of the product. Investors have investment goals and we should consider what outcomes the strategy will meet.

### 2. How does the fund manager plan to achieve the objective and with what tools?

To answer this question, we investigate the strategy's philosophy, investment process and the resources at their disposal.

#### • Fund philosophy

We want to establish that an intellectually sound investment philosophy underpins the investment process. The manager needs to demonstrate where the inefficiencies in the market lie and how these opportunities can be exploited. Managers seeking to outperform the market consistently should be able to explain what their edge is and why this edge can be expected to persist.

#### • Investment process

To achieve its objective, we expect to see a clearly defined process, which encapsulates a manager's investment philosophy, with the appropriate supporting tools and systems in place. Critical elements of the process include idea generation, idea validation, portfolio construction, risk management and sell disciplines.

#### • Resources

We want to see that managers have the necessary resources, support and infrastructure to execute their strategy effectively. This enables them to focus fully on achieving the fund's objective. This can include assessing the effectiveness of a sizeable analyst team or screening tools that are used to reduce the potential investment universe.

### 3. Is it repeatable?

A coherent and repeatable process, compatible with the strategy's objective, is essential to long-term success. So, we evaluate whether the manager can ultimately deliver on their objective into the future.

We therefore expect to see a consistent application of the process and a radical departure from it would be a concern to us.

While we do not expect a slavish adherence to the process (a good investment process is a framework not a prison), a robust process is vital during difficult periods. Adherence to it ensures that the managers remain true to the principles backing their investment philosophy and do not stray into unfamiliar territory.

### 3. In-Depth Qualitative Research

As part of our in-depth qualitative research, our team of analysts regularly meet with fund managers to fully understand how a strategy behaves – and why. In doing so, we take a deep dive into a strategy's team, portfolio construction, risk management, cost, and where applicable, its approach to responsible investment.

#### People and their environment

Face-to-face meetings with fund managers to validate findings are crucial because:

- There are many components of a good strategy, the most important of which is the fund manager. The fund manager is the final arbiter on the strategy and ultimately responsible for the strategy's performance. We expect fund managers to display a clear understanding of their skill sets and how they intend to deliver the strategy's return aspirations. The term 'star fund manager' is an emotive one and it is not one that we feel comfortable using. There are many other factors, which are also critical to the success of the strategy.
- Fund managers rarely act in isolation. They require able support from their team and this can take many forms. In today's world, any informational edge is slight at best, but a team of analysts performing rigorous research can be helpful in identifying the critical elements that could drive the performance of an investment. A strong team will have complementary skills, provide sounding boards for ideas and have the ability to challenge investment theses. The cohesiveness of the team is therefore a vital component of a good strategy.
- We look to discover what motivates managers and their teams. We seek alignment of the managers' interests and those of their investors. We expect to see the structure of the managers' compensation package to be compatible with the strategy's objective and we prefer that the managers have a significant personal investment in the strategy.
- In addition to the immediate supporting team, we also consider the wider business environment that supports the manager. We expect the managers to have the resources that they require and that they are not overly distracted from their main function: managing client assets. Investment should be a simple process (though this is not to suggest that it is easy) and the organisation should be structured accordingly. We expect to find a culture where the interests of the investor come first.

#### Portfolio construction and risk management

We like to see, as part of a portfolio's construction, prominence of a manager's best ideas.

In terms of risk management:

- The strategy should be operating within a robust risk framework and be appropriately diversified. There is no perfect approach to risk management, but we expect managers to have an appreciation of the potential strengths and weaknesses in the approach that they take.
- We expect the risk controls to be compatible with the performance objectives of the strategy. Some strategies will be managed with risk as a primary objective with return being a secondary consideration. Such strategies may need to be considered in a different manner to return orientated strategies.
- Appreciating the liquidity characteristics of the portfolio is a vital component of understanding the risks. Liquidity has a nasty habit of evaporating at the moments when it is most needed. We expect the strategy's assets under management (AUM) to be compatible with the underlying liquidity in the market and the manager's investment style. We expect firms to assess what is a suitable capacity for the strategy and to take action as AUM approaches this level.
- We also consider the underlying investor base to ensure that it is well diversified and not dominated by a small number of investors.

#### Responsible investing

The inclusion of responsible investing (RI) factors in the investment process is of interest to a variety of investors. It is often used to great advantage both to enhance returns and perhaps, even more importantly, to understand and manage risk. With RI increasingly being integrated into a fund manager's investment approach, we consider this an important part of our analysis.

We consider RI at two levels:

- Individual fund level: for all funds, we assess how RI factors are considered by the underlying manager(s) of strategies. Where a Responsible Rating is being considered, it is imperative for the strategy to include a non-financial aspiration, which should be supported with the appropriate evidence.
- Company level: for funds that are being reviewed for a Responsible Rating, an assessment is also made at the fund management group level. This analysis appraises how a business integrates RI across all of its investment processes.

Additionally, we combine our in-depth quantitative and qualitative analysis with an evidence-based assessment using our proprietary 3D framework when evaluating responsible funds. We see RI as an umbrella term which is underpinned by the 3D pillars of “Do Good”, “Avoid Harm” and “Lead Change”.

### Value for money

In this increasingly price conscious world, cost is becoming an important consideration.

We believe that the value provided by the strategy is determined by both the access gained to the market and the value added by the fund managers.

The value of the former has been largely commoditised by the widespread introduction of passive strategies. Value added by fund managers is potentially very valuable to investors and it is not prevalent. While we believe it is fair and reasonable to reward managers who can reliably outperform, we need to ensure that fees are both appropriate and offer value for money for investors.

### Transparency and access

To undertake a thorough assessment of a strategy we must fully understand the strategy and the drivers of return. To do so, we need transparent access to the managers and we must have a continued dialogue with the manager to monitor and understand developments.

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In October 2023, we launched our Investment Trust research within the Academy of Funds. Given the nature of these strategies, our analysts also assess a number of additional factors:

### Board

We consider the existence of an independent board to be one of the greatest advantages of the investment trust structure. Whilst investment trust boards are not generally involved in the day to day management of the underlying portfolio, they are an additional and active layer of due diligence, have a fiduciary duty to ensure that all shareholders' interests are upheld and are front and centre of the decision making process across all elements of the trust's operations.

As such, the board's composition, including independence, relevant skill set, diversity, experience, alignment with shareholders and competence are a consideration of Square Mile's qualitative assessment.

### Discount control management

Investment trusts provide a regular net asset value (NAV), which incorporates the value of the assets held less any liabilities such as debt. As listed securities, investment trusts trade on an exchange, where the price is determined by market participants.

Consequently, the shares are likely to trade at a premium or discount to the latest stated NAV. In times of market stress, or hubris, there can be a substantial and sustained dislocation between the trust's share price and its NAV.

This may mean that share price (i.e., the investor's returns) do not reflect the performance of the underlying NAV.

It is one of the board's functions to consider the balance between supply and demand of the trust's shares, the level of the discount in absolute or relative terms or to put in place as appropriate, measures to limit or dampen the volatility of the discount. The efficacy of the implementation of such measures forms part of our qualitative assessment of the board's effectiveness.

### Gearing

The investment trust structure also allows for the potential deployment of gearing (via various debt instruments such as debentures, revolving credit facilities or Contracts for Differences), which can amplify both investment gains and losses and the income derived from the investments. More broadly, gearing is likely to increase the volatility of returns depending upon the magnitude of its use and the prevailing market conditions.

The use of gearing and its impact upon returns and the additional risk that investors are potentially exposed to is taken into account within the Square Mile expected outcome and our understanding for the trajectory of potential returns.

### Income

The investment trust structure requires that at least 85% of annually accrued income is to be distributed to investors. This flexibility allows the board the ability to transfer excess accrued income into a revenue account, which can then be used to augment future dividend payments.

Additionally, dividends can be further boosted from capital reserves where permitted. These additional facilities allow the board to potentially smooth dividend payments, to supplement distributions during times when dividends are constrained by economic conditions such as those caused by the Covid 19 pandemics impact upon the global economy.

In contrast, strategies within an OEIC or SICAV structure must distribute 100% of any income accrued annually. Therefore, we believe that the investment trust structure provides a notable advantage over open ended funds where distributions can be more volatile.

Throughout this part of the process, our analysts are also involved in the application of their initial research, so they know what is important to the client/user of the research, making it even more relevant. Our wider analyst team collaborates closely to discuss, challenge and inform decision making.

## 4. Rating Proposal

Once our initial due diligence has been completed, the covering analysts present the strategy to the Ratings Quorum with four possible outcomes:

- Rating proposal confirmed
- Go back with further questions
- Wait and monitor
- Rating declined

Only a small percentage of funds pass our comprehensive, independent research to be featured in the Academy of Funds.

## 5. Academy of Funds

On approval, the rated fund enters the Academy of Funds.

An Academy of Funds rating is only awarded to those funds that meet our rigorous standards and best-in-class rating criteria. Each rated fund undergoes Square Mile's thorough research process.

## The ratings and what they mean

Square Mile ratings reflect our confidence in a manager's ability to meet their objectives. Responsible ratings run along the same scale as standard ratings, the only difference is that responsibly rated strategies will have a responsible (which is typically non-financial) outcome or target incorporated into their objective or mandate, and our expression of confidence is in the manager's ability to meet both aspects of their objectives.



Assigned to strategies in which we have the greatest confidence will meet their stated objectives over an investment cycle.



Assigned to strategies in which we have a high confidence will meet their stated objectives over an investment cycle.



Assigned to strategies in which we have confidence will meet their stated objectives over an investment cycle.



Some strategies meet the highest standards in their fields, however, beyond this the strategies cannot be readily differentiated between each other. An example would be passive funds. Such products will be assigned a recommended rating.



Strategies which our analysts have identified as having the potential to be highly compelling propositions. However, there are some elements relating to the strategy where the analysts need more time to be satisfied that it merits a full rating. As a result, we award the strategy a qualified rating to highlight its appeal, but also to recognise Square Mile's reservations.



## 6. Monitoring & Re-assessment

Ongoing assessment of all rated funds is continuous to ensure performance is in line with expectations.

Monitoring includes regular meetings with the fund managers given that one of the primary reasons for selecting a strategy is the skills of the lead manager. Such skills are not widely available nor are they easily transferable. The departure of key individuals on the strategy would typically trigger a reappraisal of the fund's rating.

Additionally, we keep a close eye on corporate activity within the parent company as it can be a distraction for the investment team and it can have serious repercussions throughout the business. Such events can trigger 'turf wars' within the team, materially impact staff morale or be the catalyst for defections from the team. Corporate activity needs to be judged from the context of the company's structure, but often we consider it as a negative and, on occasion, a significant one.

We also strive to understand what is happening in the marketplace and what is happening within the strategy. At times, we struggle to reconcile between these two factors and it can become a concern. In addition, if a strategy is consistently falling short of its objectives or if the manager makes repeated errors of judgement, our conviction in the strategy will diminish.

We monitor performance and expect it to be consistent with the strategy's objectives, as both significant outperformance and underperformance need to be investigated.

We also recognise that the variance of returns in markets is wide and that unforeseeable events occur. Luck can have an outsized impact on short-term performance and both bad and good strategies are equally affected.

At times, we acknowledge that the market simply does not reward certain types of strategies. Our understanding of the strategy needs to be such that we can recognise this when it happens. Competitor analysis is helpful, though we recognise that the fund sectors are often too widely drawn to fully allow meaningful performance conclusions to be made.

Many managers are rewarded by the size of their book of business and not by their performance. Performance is likely to drive asset growth, but there comes a point when asset size conflicts with the performance generation. We are conscious of such conflicts and will reappraise the fund accordingly.

Fund and investment trust sectors are continually evolving and some strategies that were once novel can no longer be considered as differentiated products. Competition can mount and more efficient products may be introduced into the marketplace.

Due to their distinct characteristics, our re-assessment approach differs slightly for actively managed strategies compared to passive strategies:

### Actively managed strategies

We undertake to review the strategies within our universe of actively managed rated and recommended strategies on a regular basis. Reviews will typically be with the strategy's manager(s) and take place, at least, on a semi-annual basis. These reviews focus on exploring any changes to the supporting team, checking that the investment approach remains unchanged, assessing performance and determining the drivers of returns.

We also investigate how the strategy is positioned and discuss portfolio activity over the period. A summary of these reviews, including the confirmation of the strategy's rating, are provided by the covering analysts at the team's formal weekly meeting. In addition, we also formally appraise all rated and recommended strategies within their respective sectors on a quarterly basis as part of a sector and strategy review process led by our Quant team.

Both the weekly team and sector review meetings are minuted and an action log is kept in order to ensure actions are managed and completed appropriately.

### Passive strategies

We review rated passive strategies with their respective management teams on an annual basis. During these meetings discussions cover aspects such as changes to the team, evolution and enhancements to the process, including any developments to the systems used. It is vitally important that each strategy's costs remain competitive in light of any changes.

Outside of these annual reviews, we run various quantitative screens to ensure that the tracking error, cost and levels of assets under management remain within acceptable levels. These screens are run on a monthly basis.

Finally, our opinion could change due to fund manager or team changes, corporate activity, unexpected performance, liquidity concerns or new/better options presented.

## Important Information

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