Square Mile
Fund Research Process

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Square Mile Investment Consulting & Research Limited

SQUARE MILE
INVESTMENT CONSULTING & RESEARCH

Square Mile Research Process

Recognised as one of the strongest and most experienced investment research teams in the UK, the Square Mile team is committed to providing in-depth, high-quality research across 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 and whether it represents good value for investors.*

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. Idea Generation

Square Mile's research analysts make decisions in small groups to allow for better debate and decision making, coupled with in-depth knowledge and experience. Ideas are also generated by analysts who know their sectors, trends in the markets, and client needs.

2. Analyst Research

Research involves looking at the strategy's objective, the people and their environment, philosophy, process, portfolio construction, risk management, and value for money. Analysts are also involved in the application of this research, so they know what is important to the client/ user of the research, making it more relevant.

3. Qualitative Assessment

Investment trusts and fund research is a combination of art and science - humans and decisions are involved at all stages and therefore qualitative and quantitative assessments are necessary.

4. Analyst Meetings

Once our in-depth research has been completed, the covering analyst will present to the broader team with four possible outcomes:

i) Agree a rating
ii) Go back with further questions
iii) Wait
iv) Decline a rating

5. Monitoring

Ongoing monitoring including reviews with the fund managers and oversight from our quantitative team.

6. Reassessment Against Original Outcome

During the monitoring process some ratings need to be reassessed – this could be due to fund manager or team changes, corporate activity, persistent underperformance that we cannot explain or liquidity concerns.

1. Idea generation

There are over 3,500 FCA registered funds and investment trusts available to UK investors. Only a small proportion of these meet our qualitative ratings criteria. Regrettably, performance screens in isolation have little use in differentiating between good and bad funds. Uncovering good strategies involves much effort as a result. 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.

The quantitative assessment of a strategy is an important component of its appraisal. This becomes most pertinent once a full understanding of the approach has been determined and the appropriate metrics can be set.

2. Analyst research

Our team of analysts regularly meets with fund managers to fully understand how a strategy behaves. As part of this process, our team of analysts will look at:

People and their environment

- 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 fund's performance. We expect fund managers to display a clear understanding of their skill sets and how they intend to add value. Investment management skills are not easily transferable and take time to develop; we seek seasoned investors who have experience of different market conditions. 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 a vital component of a good strategy.
- We look to discover what motivates the 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 the managers are not overly distracted from their main function, which is to manage client assets. Investment should be a simple process (though this is not to suggest that it is easy) and the organisation should be structured so. We expect to find a culture where the interests of the investor come first.

Investment philosophy

- We seek 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

- We expect to see a clearly defined process, which encapsulates the managers' investment philosophy. The process should be designed to produce outcomes in a repeatable manner that are compatible with the strategy's objectives. Critical elements of the process include idea generation, idea validation, portfolio construction, implementation and sell disciplines.

- We do not expect a slavish adherence to the process; a good investment process is a framework not a prison. However, a coherent 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. We expect to see a consistent application of the process and a radical departure from it would be a concern to us.
- Understanding the strategy's objectives and how this could meet the expected outcome sought by Investors.
- We suspect that the importance of the strategy's objective to be generally underestimated by investors. The objective needs to be realistic and suitable for the strategy. 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.
- The objective should be assessable as this is how we shall be measuring the manager.
- We expect the manager's interests to be aligned with the objective.

Portfolio construction and risk management

The managers' best ideas should have prominence in the portfolio. 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 objective. Such strategies may need to be considered in a different manner to return focused 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.

ESG integration

- The growing use of Environmental, Social and Governance (ESG) factors in the investment process is of interest to a variety of investors and is often used to great advantage both to enhance returns and, perhaps even more importantly, to understand and manage risk. With ESG increasingly being integrated across business models, we have developed an approach to analysing and articulating the various approaches to ESG integration.
- We analyse ESG integration at two levels for each of the strategies which we rate:
  - Company level: assessing how a business integrates ESG across its investment processes.
  - Individual fund level: assessing how ESG is used by the individual manager(s) of strategies.

Cost/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 an assessment of a strategy we must fully understand the strategy and the drivers of return. We need to be able to gain access to the managers to determine this and we must have a continued dialogue with the manager to monitor and understand developments.

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 pandemic's 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.

3. Quantitative assessment

Manager fund research is a combination of art and science – humans and decisions are involved at all stages and therefore qualitative and quantitative assessments are necessary.

Performance assessment

- We monitor performance and expect it to be consistent with the strategy's objectives. Both significant outperformance and underperformance need to be investigated. We 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 performance conclusions to be made.

4. Analyst meeting

Once our initial due diligence has been completed, the covering analysts will present to the broader team with four possible outcomes:

- Agree a rating
- Go back with further questions
- Wait
- Decline a rating

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 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.

5. Monitoring

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-annul basis. These reviews focus on exploring any changes to the supporting team, checking that the investment approach remains unchanged, assessing performance and determing 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.

6. Downgrades/reassessments

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 trigger a reappraisal.

Corporate activity within the parent company 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 occasions, a significant one.

We strive to understand what is happening in the market place and what is happening within the strategy. At times we struggle to reconcile between these two factors and it becomes a concern for us. 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.

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 of interest and we 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 market place.

Important Information