For professional advisers only

Square Mile
Fund Research Process

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Square Mile Investment Consulting & Research Limited

SQUARE MILE
INVESTMENT CONSULTING & RESEARCH

Investment Process

I. Universe Screen

There are over 3,000 FCA registered funds domiciled in the UK. Only a small proportion of these funds meet our qualitative ratings criteria. Regrettably, performance screens in isolation have little use in differentiating between good and bad funds. Uncovering good funds involves much effort as a result.

Fund 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 that they cover
- Attendance at conferences and industry functions
- New fund launches

Quantitative assessment of funds is an important component of fund appraisal. This becomes most pertinent once a full understanding of a fund's approach has been determined and the appropriate metrics can be set.

> We expect fund managers to display a clear understanding of their skill sets and how they intend to add value.

II. Qualitative Fund Assessment

1. The People and their Environment

- There are many components of a good fund, the most important of which is the fund manager. The fund manager is the final arbiter on the fund 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 fund.

- 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 fundamental research can be helpful in identifying the critical elements that 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 fund.

- 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 fund's objective and we prefer that the managers have a significant personal investment in the fund.

- We consider the wider business environment that supports the managers. 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.

2. 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. All indices are market averages; for every pound out performing the market, a comparable amount must lag. 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.

3. Investment Process

- We expect to see a 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 fund'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.

4. Understanding the Fund's Objective and how this could meet Outcomes sought by Investors

- We suspect that the importance of the fund's objective to be generally underestimated by investors. The objective needs to be realistic and suitable for the fund's strategy. The objective should describe the purpose of the fund 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.

5. Portfolio Construction and Risk Management

- The managers' best ideas should have prominence in the portfolio. The fund 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 fund. Some funds will be managed with risk as a primary objective and the return is a secondary objective. Such funds may need to be considered in a different manner to return focused funds.

- 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 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 approach this level.

6. Performance Assessment

- We monitor performance and expect it to be consistent with the fund'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 funds are equally affected.

- At times, we acknowledge that the market simply does not reward certain types of strategies. Our understanding of the fund 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.

7. Cost

- In this increasingly price conscious world, cost is becoming an important consideration. We believe that the value provided by the fund 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 funds. 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.

8. Transparency and access

- To undertake an assessment of a fund 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.

Access to the managers and a continued dialogue allows us to monitor and understand developments.

III. Ratings Determination

Funds worthy of recommendation may be rated as AAA, AA or A. We expect any active fund to add value over a corresponding passive strategy where such an option exists and this should be reflected in the fund's objective. This added value is provided by the production of relatively high risk adjusted returns over a suitable time period. When rating funds we constantly ask ourselves whether we would be happy to invest our own money in the funds.

SQUARE MILE AAA

Assigned to funds in which we have the greatest confidence that the fund over an investment cycle will meet its stated objectives.

SQUARE MILE AA

Assigned to funds in which we have a high confidence that the fund over an investment cycle will meet its stated objectives.

SQUARE MILE A

Assigned to funds which we have confidence that the fund over an investment cycle will meet its stated objectives.

SQUARE MILE R RECOMMENDED

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

SQUARE MILE P+ POSITIVE PROSPECT

Funds which our researchers have identified as up and coming interesting propositions. However, the manager, their strategy or their process is new and has not been thoroughly tested in all market environments. As a result we are not in a position to provide a full fund rating. Instead we are producing a qualified rating to highlight the fund's potential but also recognise Square Mile's reservations.

IV. Monitoring

We undertake to review the funds within our rated and recommended universe quarterly. These reviews will focus on checking that the process remains unchanged, to assess performance and to determine the drivers of returns. We will also investigate how the funds are positioned. Reviews will typically be with the managers and at least two reviews each year will be with the manager.

V. Downgrades/reassessment

One of the primary reasons for selecting a fund 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 fund 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 on 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 fund. At times we struggle to reconcile between these two factors and it becomes a concern for us. In addition, if a fund is consistently falling short of its objectives or if the manager makes repeated errors of judgement, our conviction in the fund 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.

The fund sectors are continually evolving and some fund 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