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Square Mile's Approach to Researching Risk Targeted Funds

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Square Mile Investment Consulting & Research Limited

Investment Process

I. Universe Screen

We have, through our market knowledge and meeting investment businesses, identified over 150 or so funds that we believe fall in to our risk targeted universe. In order to be included within our risk targeted universe, funds generally fulfil a number of the following criteria:

- Their primary aim is to achieve returns within a clearly defined band of risk
- Risk modelling is generally used to define the risk bands
- Funds are part of a wider suite, where investors can choose from a selection of portfolios set along the efficient frontier
- The funds are not managed specifically with reference to a peer group or index
- The level of risk is regularly reviewed and rebalanced to maintain consistency with the stated objectives.

Funds that we believe may meet the above criteria are sent a questionnaire. This is followed up with a preliminary discussion with the asset manager before a decision on whether the range is to be included in the universe. This can be quite a subjective process and our decision will be based on our view of the information gathered. The universe will be continually assessed and refreshed as new funds are launched, remodelled or withdrawn from the market.

Determining whether a fund has maintained an appropriate level of risk in line with its stated objectives and whether it has added value relative to an appropriate benchmark or outcome can be screened quantitatively. However we look at more qualitative factors in order to build confidence that this is repeatable over the longer term. Assessing risk targeted funds can be a challenge as unlike traditional funds, which generally measure themselves against market indices and/or peer groups, their primary objective is risk. The level of return will be a function of the risk taken. We therefore assess each fund on its own merits and objective.

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 funds 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 a detailed understanding of where the portfolio risks lie and where they currently sit on the risk scale which they are targeting.
- 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. Performance which is significantly above or below expectations will be investigated, both within the range and in the context of the market. 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. However over the longer term we would expect to see funds within a range sitting at graduated intervals along the efficient frontier.
- 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.

III. Ratings Determination

Risk targeted funds which we believe meet the highest standards in their field are assigned a Recommended rating. It is difficult to differentiate between funds that tend to have different risk and return objectives, and over different time frames, and no easily accessible group of reference benchmarks exist.

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.

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