

For professional advisers only

# Square Mile's Approach to Researching Passive Funds

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 Square Mile Investment Consulting & Research Limited



# 1. Our Philosophy and Guiding Principles

## Square Mile's overriding approach is to focus on investor outcomes.

Our research is focused on investors seeking passive solutions that have a:

- Low cost approach that will approximate the average market return.
- Consistent approach that requires limited monitoring.
- Long term investment horizon.

We believe that:

- Investors value help in identifying a passive solution to meet the investment outcome that they are seeking i.e. to maximise the returns from their investments.
- The success of the strategy rests little on the precise composition of the index tracked.
- Passive strategies need to track diversified and liquid indices. Not all indices are suitable.

Therefore:

- We have little concern whether the fund performance matches every twist and turn of the market. Tracking error is not a major concern and it will be used only as a sanity check within the research process.
- Total return is the key rationale for investment. Return difference is the metric that we will consider and it is defined as the difference in performance of the fund and the index.
- Funds may employ different strategies to replicate the performance of the index. Our research considers the various approaches but our ratings will focus on the success of the outcome.
- We should help investors identify the appropriate index to track. For example, in practical terms investors should care little whether they invest in either the FTSE All Share or the MSCI UK index. We should consider funds following these indices together and identify the best ones. We can offer guidance as to the salient differences in index construction.

When looking at funds we need to consider:

- Most investors are investing with long term time horizons. Do the fund managers have a long term commitment to running passive strategies?
- Does the underlying index provide sufficient diversification and liquidity?

## 2. Our Process

### Our Aim

To identify passive open ended funds that are best in class and meet the needs of UK retail investors.

### Overcoming Some of the Technical Issues

There are a number of technical issues that we have had to overcome when assessing the funds. These include:

- Looking at performance data over a limited number of discrete periods can be misleading. A more rounded approach is to consider rolling periods of performance.
- There are often mismatches in the pricing time of the fund and underlying index. We therefore look at moving average trend lines that smooth out the impact of these pricing mismatches.
- In recent years there have been significant changes to fee schedules of many passive funds. Square Mile passive ratings are designed to be forward looking. Fees should be factored using current fee schedules not historic fee schedules.

### Qualities of Square Mile Rated Passive Funds

Passive funds rated by Square Mile will be:

- Run by investment firms that have a demonstrated a firm commitment to running passive strategies
- Tracking a sensible index suitable for retail investors. These consist of the main regional equity markets and UK bond markets
- Low cost products
- Managed in an efficient manner
- Of a sufficient size to allow an accurate implementation of the strategy (size allows efficiencies in passive funds)



Our research considers the various approaches but our ratings will focus on the success of the outcome.

### Meeting the Needs of the Investor

We believe that retail investors are focused on outcomes. In this instance it is to maximise returns from broad regional equity allocations or allocations to UK government or corporate bonds.

Retail investors are not particularly concerned with the precise index tracked. For example, for investors seeking North American exposure, they might be equally happy with a fund that follows the S&P 500, the Russell 1000 or the MSCI North America Index. However we will seek to provide a range of tracked benchmarks within sectors, provided the associated funds meet our broader criteria. Our rating process will assess funds relative to the fund managers' objectives but our rating will only be awarded to the funds best meeting the outcome investors are seeking.

Square Mile recognises that although there are technical differences in the approach of providers, the cost of many funds are now very similar. We do not believe that it is possible to materially differentiate between the top products; hence the funds will be rated as "Recommended".

### Information Contained in Square Mile Factsheets

We believe that advisers should be aware of the following factors during their due diligence process and these will be included on the Square Mile factsheets:

- Investor outcome that the product will meet
- Index tracked
- Fund structure & domicile
- Fund pricing & dealing time
- Fund's fair pricing policy
- Swing pricing/anti-dilution policy
- Stock lending policy
- Standard clean costs on platforms
- Technical differences in the index tracked

### Our Process in More Detail

1. Screen the universe for realistically priced products. 20 bps is a typical cut off, though some latitude is ascribed to less liquid asset classes and regional markets.
2. Screen out funds below £50m in size
3. Consider the fund managers' commitment to running passive strategies for the long term.
4. Collate the historic gross daily performance record
5. Adjust performance to reflect the current fee schedule
6. Calculate the 36 day moving average for 12 month rolling data

We consider funds primarily on their 1-year daily rolling performance records over 3 years. Additionally tracking errors are examined. We seek funds that have consistently generated acceptable net relative returns for investors. We will consider funds that have shorter records (minimum of 12 months) where we believe that there are compelling reasons to do so.

The formulation of the rating rests upon quantitative data. However, the data is qualitatively assessed. We concede that this introduces an element of subjective judgment, though in general, Square Mile would much prefer to be approximately right than precisely wrong.

### An example

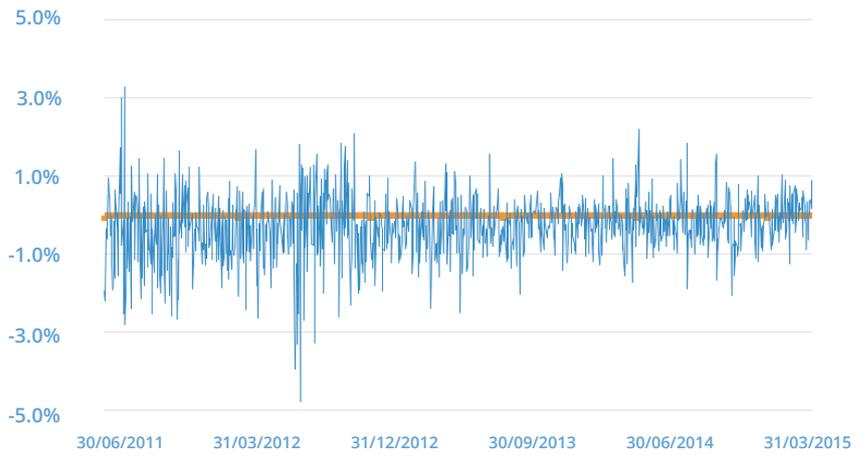
Chart 1 shows Fund A relative performance versus the FTSE All Share index plotted using 12 month rolling data.

Note the apparent volatility of returns relative to the index, especially during the period of the Euro crisis in 2011/12. Fund A is priced at midday, while the FTSE All Share index value is determined at the close of business.

We can look through this volatility by considering the 36 day moving average of the fund's relative performance.

Chart 1

Fund A v FTSE All Share, rolling 12 month daily



Source: FE

Chart 2

Fund A v FTSE All Share, rolling 12 month daily, 30 day moving average



Source: FE



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