Quarterly Investment Briefing
Quarter 1 2018

First Actuarial LLP

Discussion topic – picking winners isn't easy!

The Financial Conduct Authority (FCA) recently investigated whether fund ratings, provided by investment consultants, provide value to clients. The Competition and Markets Authority (CMA) further developed the FCA's investigation and published their working paper in March this year.

In this quarter's Investment Briefing, we present the CMA's main findings and our views on the subject.

CMA's Working Paper and Background

In its study, the FCA estimated that funds highly rated by investment consultants in their sample, outperformed their benchmarks by 0.1% per quarter (before fees). In comparison, funds which were not highly rated outperformed their benchmarks by 0.08% per quarter (before fees).

This difference was not statistically significant, leading the FCA to conclude that 'the investment consultants in our sample were historically not able to pick products that significantly outperformed other products'[1].

The CMA refined FCA's analysis, focussing only on actively managed funds. Their key findings were as follows[2]:

- The average outperformance of 'buy-rated' funds was 0.23% higher than the benchmark per quarter (before fees).
- However, for the same funds after fees, the CMA found no statistically significant evidence of outperformance.
- These results held for all asset classes considered, except hedge funds.
- For hedge funds, the CMA found that, on average, buy-rated hedge funds outperformed their benchmark and outperformed unrated hedge funds to a statistically significant degree.

Both the FCA and CMA studies did, however, note the following additional benefits of investing in funds that are buy-rated:

- Investment consultants' due diligence and shortlists can be valuable to investors.
- Performance monitoring of fund managers, often an intrinsic part of the manager selection process, is a useful service to trustees.

[1] FCA Asset Management Study Final Report Annex 5, Appendix 1: Investments consultants' manager rating performance sensitivity, June 2017

[2] Investment Consultants' Market Investigation Working Paper: Asset Manager Product Recommendations, March 2018

Our View

Performance of an individual fund will be attributable to many factors, including chance. Deciding in advance which investments will subsequently outperform is notoriously difficult. Therefore, the CMA's findings do not surprise us. However, the additional benefits associated with buy-lists, that both the FCA and CMA acknowledge, should not be underestimated.

Our rating process aims to screen out those funds that are at a higher risk of failing to meet their objectives. Some of the reasons for which we screen out a fund are listed in the table alongside.

For some asset classes, avoiding these pitfalls can lead to rated funds outperforming their peers. We suspect, for instance, that within the hedge fund universe, investment consultants screened out funds with very high fees. This, in itself, may explain the 'statistically significant' outperformance.

In other asset classes, the screening process may exclude funds which subsequently perform well. Nevertheless, we believe there is merit in avoiding funds where we have concerns. The benefit of some ratings may only materialise in times of severe market stress. For example, most Liability Driven Investment (LDI) funds have good risk management processes but some are better placed than others to survive extreme gilt market conditions.

Another consideration in recommending funds is the way in which they complement other holdings within a pension scheme's wider investment strategy. If the other assets are growth-focussed and expected to be volatile, an allocation to a fund offering lower expected returns, but lower volatility, might be appropriate.

A subsequent assessment of the fund's achieved returns may suggest it has disappointed, but if the fund has exhibited low volatility, it may have fulfilled the task it was selected for.

Finally, we continually monitor our 'buy-rated' funds and we believe this ongoing governance should reassure our clients that their schemes' assets have not simply been invested and forgotten.

In summary, we suggest that the fund ratings should be seen as an exercise in due diligence. We consider this process to be essential before recommending funds to our clients. We do not, however, claim to be able to pick all the winners!

Some Reasons to Avoid a Fund

- The fund manager doesn't have the required expertise and resources.
- The fund manager doesn't carry out sufficient due diligence on the assets the fund owns and companies it finances.
- The fund's objectives are not aligned with the requirements of the client.
- Financial and operational risks are not managed well.
- The important people in the fund management team are not committed for the long term and are likely to leave.
- Fees and other costs cause an excessive drag on performance.

Small print

First Actuarial disclaimer

The information contained in this briefing is, to the best of our knowledge and belief, correct at the time of writing. However, First Actuarial cannot be held liable for any errors contained herein and the recipient accepts that the information stated is provided on an "as is" basis. This briefing is for general information only. It does not and is not intended to constitute advice. Specific advice should always be sought from the appropriate professional on all individual cases.