IMPERIUM CAPITAL

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Skilled investors and where to find them

Weekly Digest

20 May 2019

– *Lorenzo La Posta*

"Past performance is no guarantee of future results" is a warning to always be mindful of. However, despite that not being a guarantee, it does still carry useful information and is effectively an objective, quantifiable, permanent datum about a strategy. Being able to analyse, decompose and interpret it properly is therefore of utmost importance.

We believe that past performance is somewhat indicative of future results, but only if looked at with the right lens. Outperformers fill a continuous spectrum ranging from "lucky" to "actually good" (the opposite obviously holds for past underperformers) and we focus our efforts on identifying managers with proven, solid, persistent skills, who are most likely to replicate past performance in future scenarios with different market conditions, risk drivers and economies. While luck can fade instantly, quality cannot.

When screening for good investors, we produce proprietary attribution (to names, sectors, regions, market cap, risk factors and fundamental factors) and trading reports, which we analyse and then discuss with managers themselves to have a complete understanding of the motivation and consistency (with style, philosophy and process) of any active position. We discuss sizing, conviction, risk and expected return of most positions and compare those with the implementation and outcome of each, to make sure the manager's ability to identify value adding trades is likely to persist. Such an attention to detail is crucial when selecting active managers, especially for those running highly concentrated portfolios of 30 to 50 names where tracking error is high and excess returns are volatile. We often mention Information Ratio (IR) as an ex-post measure of risk-adjusted relative performances of an active manager. Despite this being a widely used, meaningful measure, it is purely backward looking and has little predictive power for future IRs. An investor could outperform their benchmark in multiple ways: just a couple of securities could skyrocket and compensate for a disappointing remainder of the portfolio, a few unintended bets could work out surprisingly well, their style could be in strong favour or instead many justified, calibrated and conviction-driven positions could be successful. We believe most skilled investors will fall under the latter category.

Thus, for past performance to inform the manager selection process alongside other qualitative, fundamental and quantitative analyses we perform here at Momentum, we must carefully decompose it into its drivers. The starting point can be the fundamental law of active management[1]: $IR = IC * \sqrt{B} * TC$. An active manager's value added (Information Ratio) depends on their ability in forecasting excess returns (Information Coefficient), the number of independent bets undertaken (Breadth) and the extent to which they can express unconstrained views (Transfer Coefficient). Among the three, TC tends to be very stable while $\sqrt{B}$ can vary substantially with changing market conditions (hence being hard to predict), so the factor where manager selectors tend to focus the most is naturally IC. This last factor effectively indicates how correct a manager tends to be in their predictions, so commonly used proxies for it are the percentage of bets that proved correct or the accuracy of returns predictions. Once isolated and properly measured, the information coefficient is thought to be sufficiently persistent in time to be a solid long-term value-adder, as there is high chance a skilled manager will stay so in time.

[1] Richard C. Grinold, The Journal of Portfolio Management, Spring 1989, 15 (3) 30-37

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The **Marketplace**

- US increases tariffs on China, escalating trade tensions
- Partial rebound for global equities after last Monday's slump
- Brent crude rose 2.3% to $72.2 a barrel
- Gold fell 0.9% to $1275.9 per ounce

Market **Focus**

US

- US factory production fell in April. Falls were led by declines in machinery and motor vehicles. Manufacturing output and industrial production both fell by 0.5%
- The major US equity index fell 1.7% on the week despite making gains from last Monday's substantial drop. Solid earnings from Cisco and Walmart as well at AT&T aided the partial recovery though ongoing trade concerns remain the dominant narrative
- US 10-year treasury yields fell to a three-month low as investors sought a haven from ongoing trade disputes. The yield is currently standing at 2.4%
- China announced retaliatory tariffs of an additional $60 billion on US goods leading to last Monday's market slump. Companies with large exposure to Chinese supply chains faired the worst with Apple shares notably falling by 6%

Europe

- President Trump has delayed his decision to apply a 25% tariff to European automobiles for a further six months
- European equities recovered to return 1.1% last week after hitting a two-month low last Monday
- Italian Deputy Premier Matteo Salvini is set on a showdown with the EU over his plan to impose a 15% flat tax in Italy which could breach EU treaties over its budget and deficit obligations

UK

- UK equities rose 2.4% on the week after also hitting a two-month low last Monday
- Brexit Talks between the Conservatives and the Labour party have broken down. Jeremy Corbyn has indicated that the party will vote against Theresa May's deal in June
- GBP fell to a three-month low against the US dollar and fell 1.4% against the Euro last week amid signs of political paralysis around a Brexit deal being reached

Asia/Rest of The World

- Chinese equities continued to fall last week with the benchmark index falling 1.9%.
- Tensions rise in the Gulf around US sanctions on Iran. Saudi stocks fell by 2.6% on the week
- Japan's main index fell 0.4% last week as the cabinet office set a 'worsening' downgrade marker on the overall economic outlook
- Turkish equities fell by 2% on the week

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

Asset Class/Region	Currency	Currency returns			
		Week ending 17 May 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	-0.7%	-2.8%	15.7%	6.6%
United Kingdom	GBP	2.4%	-0.3%	11.2%	-1.4%
Continental Europe	EUR	1.6%	-1.9%	15.5%	-0.2%
Japan	JPY	0.3%	-3.9%	5.2%	-12.0%
Asia Pacific (ex Japan)	USD	-2.9%	-6.4%	6.5%	-8.9%
Australia	AUD	1.4%	1.2%	14.7%	9.0%
Global	USD	-0.4%	-2.6%	14.2%	1.6%
Emerging markets equities					
Emerging Europe	USD	1.4%	-3.0%	7.4%	-0.9%
Emerging Asia	USD	-3.7%	-8.0%	4.4%	-12.4%
Emerging Latin America	USD	-4.8%	-7.8%	-0.3%	-5.3%
BRICs	USD	-3.1%	-7.6%	7.6%	-9.2%
MENA countries	USD	-2.7%	-6.0%	6.6%	5.1%
South Africa	USD	-3.8%	-5.5%	6.8%	-13.2%
India	USD	0.7%	-3.9%	4.7%	4.3%
Global emerging markets	USD	-3.6%	-7.6%	4.1%	-10.8%
Bonds					
US Treasuries	USD	0.4%	0.8%	2.9%	6.6%
US Treasuries (inflation protected)	USD	0.2%	0.2%	4.1%	4.4%
US Corporate (investment grade)	USD	0.4%	0.4%	6.4%	7.9%
US High Yield	USD	-0.1%	-0.6%	8.3%	6.1%
UK Gilts	GBP	0.9%	1.3%	3.1%	6.1%
UK Corporate (investment grade)	GBP	0.6%	0.5%	5.1%	5.5%
Euro Government Bonds	EUR	0.4%	0.5%	3.0%	3.9%
Euro Corporate (investment grade)	EUR	0.1%	-0.1%	3.9%	3.4%
Euro High Yield	EUR	0.0%	-0.9%	5.8%	1.9%
Japanese Government	JPY	0.1%	0.2%	1.5%	2.4%
Australian Government	AUD	0.6%	1.0%	5.6%	11.1%
Global Government Bonds	USD	-0.1%	0.6%	2.1%	2.8%
Global Bonds	USD	-0.1%	0.4%	2.6%	3.1%
Global Convertible Bonds	USD	-0.6%	-1.6%	5.9%	-0.7%
Emerging Market Bonds	USD	0.3%	0.6%	5.8%	6.2%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 17 May 2019	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	1.2%	1.8%	17.9%	20.2%
Australian Property Securities	AUD	3.0%	2.6%	10.9%	16.1%
Asia Property Securities	USD	0.4%	-1.7%	10.6%	1.0%
Global Property Securities	USD	0.6%	0.2%	13.9%	8.4%
Currencies					
Euro	USD	-0.6%	-0.5%	-2.4%	-5.4%
UK Pound Sterling	USD	-2.3%	-2.4%	0.3%	-5.8%
Japanese Yen	USD	-0.2%	1.2%	0.4%	0.6%
Australian Dollar	USD	-1.8%	-2.5%	-2.4%	-8.5%
South African Rand	USD	-1.8%	-0.6%	-0.4%	-12.9%
Swiss Franc	USD	0.1%	0.8%	-2.6%	-1.0%
Chinese Yuan	USD	-1.4%	-2.7%	-0.6%	-8.0%
Commodities & Alternatives					
Commodities	USD	1.2%	-1.4%	8.1%	-8.5%
Agricultural Commodities	USD	2.0%	-1.3%	-6.2%	-15.0%
Oil	USD	2.3%	-0.8%	38.3%	-8.9%
Gold	USD	-0.9%	-0.6%	-0.2%	-1.2%
Hedge funds	USD	0.0%	-0.5%	3.1%	-4.3%

Source: Bloomberg. Past performance is not indicative of future returns

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