

Shopping for information ratio

Weekly Digest

30 July 2018

– *Lorenzo La Posta*

With the advent of cheap ETFs and passive solutions, investors are increasingly focusing on cost minimisation whilst disregarding the quality reduction this often comes with. Having benchmark-like returns for a low price can be an attractive and safe choice, but this is often a suboptimal solution for clients who could access funds with potentially higher fees that are more than compensated for by additional value.

Building a portfolio is as close to cooking a meal as you can get in the investment management industry. After all, coming up with a list of ingredients and a recipe to engineer them into a good meal is not too far from defining an asset allocation and constructing a robust portfolio. In this light, grocery shopping is equivalent to manager selection: choosing what specific tomatoes one should buy for that night's dinner requires attention to quality and price, as much as selecting the right manager for a specific asset class does. The optimal tomato will be the one with the smallest price per unit of quality.

While assessing an item's price is an easy task at the supermarket, in finance this typically requires more detailed calculations. Today's standard measure is the OCF, the acronym for ongoing charges figure, that includes the AMC (the annual management charge) and other operating costs. On top of the OCF, the investor is also paying for trading costs and sometimes for performance fees or one-off charges. All these figures sum up to a total cost that can be a substantial proportion of the fund's gross performance.

Assessing a manager's quality is even harder, as to the man on the street this is a largely unobservable and sometimes unstable characteristic. While being aware that past performance is no guarantee of future results, one could

simplistically gauge a fund's quality by analysing its risk-return profile. The information ratio provides a quick but insightful measure of a manager's skill: it equals the active return divided by the tracking error, with the former being the outperformance with respect to its benchmark and the latter being the volatility of returns around this benchmark. Thus, a high information ratio indicates a high active return per unit of risk taken relative to benchmark, and vice versa.

Total costs often depend upon the type of strategy and can vary substantially. For instance, fundamental buy-and-hold strategies typically have lower turnover than quantitative strategies, resulting in smaller trading costs. Does it mean that one should always prefer a buy-and-hold to a quantitative? We would say no. If the quantitative strategy more than compensates for its higher costs with better risk-adjusted performance, then the rational choice would be to select that strategy.

As a consequence of intense competition in financial markets, the regulatory push for more transparency and an intense focus on investment costs, too many managers are shifting their focus from value add to cost reduction, offering cheap tomatoes at a discount. By contrast, at Momentum we strive to provide our clients with the highest quality for the best price. Each fund we analyse is carefully evaluated for its added value (the information ratio being just one of many characteristics we assess) with an unbiased radar spanning from purely passive to highly active funds. Then, as high fees are not a necessary nor a sufficient condition for high quality, we will only include a manager in our portfolios if the quality-to-cost trade-off is amongst the best of its peers.

The Marketplace

- Brent crude oil finished the week at 74.3, up 1.7%
- Gold was down 0.3% standing at \$1222 per ounce
- A mixed week for tech stocks
- Trade war shows signs of cooling

Market Focus

US

- The Dow Jones was up 1.6% closing at 25451
- The Nasdaq fell 0.7% closing the week at a relatively flat 7296 after a volatile week
- The US GDP reading shows the economy rose 4.1% in Q2
- The S&P rose 0.6% to 2818.8
- Facebook saw a 19% collapse in its share price last Thursday, that's over \$119bn of its market capitalisation. Amazon saw gains of 3.2% and Intel fell 5.7%.

UK

- Expectations of a rate rise are imminent

- Sterling fell 0.7% against the dollar in July. Many analysts are disappointed in the progress being made around Brexit leading them to take short positions
- The FTSE 100 was up 0.3%, standing at 7701.3

Europe

- The Eurostoxx 50 rose 2% to 3527
- ECB set to hike rates in September
- Euro area composite PMI rose to 54.9 in June from 54.1 in May
- President Juncker met with President Trump last week and agreed a ceasefire on the looming trade war, with both sides offering concessions to reach a goal of 'zero tariffs' in the future

The rest of the world

- The Nikkei was up 0.9% at 23714.5
- The Bank of Japan has bought up 1.6 Trillion Yen of its 10 year as it's yield hits 18 month highs, tripling in three weeks.
- The Hang Seng was up 2% on the week to 28804.

Asset Class/Region	Currency	Currency returns			
		Week ending 27 July 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	0.6%	3.8%	6.2%	15.4%
United Kingdom	GBP	0.4%	0.9%	2.3%	7.0%
Continental Europe	EUR	1.9%	4.2%	2.8%	4.5%
Japan	JPY	1.8%	2.6%	-1.2%	11.5%
Asia Pacific (ex Japan)	USD	1.5%	1.5%	-2.7%	5.4%
Australia	AUD	0.2%	1.7%	6.1%	13.7%
Global	USD	0.8%	3.3%	3.7%	11.9%
Emerging markets equities					
Emerging Europe	USD	3.2%	2.0%	-6.6%	3.0%
Emerging Asia	USD	1.9%	1.4%	-3.7%	5.4%
Emerging Latin America	USD	3.1%	10.4%	-1.9%	2.4%
BRICs	USD	2.2%	2.2%	-2.5%	9.7%
MENA countries	USD	-0.1%	2.0%	11.1%	9.8%
South Africa	USD	2.4%	4.4%	-11.8%	2.9%
India	USD	2.7%	5.3%	0.7%	6.7%
Global emerging markets	USD	2.1%	2.6%	-4.2%	4.6%
Bonds					
US Treasuries	USD	-0.4%	-0.5%	-1.6%	-1.1%
US Treasuries (inflation protected)	USD	-0.5%	-0.7%	-0.8%	1.2%
US Corporate (investment grade)	USD	-0.1%	0.7%	-2.6%	-0.7%
US High Yield	USD	0.3%	0.9%	1.1%	2.5%
UK Gilts	GBP	-0.5%	0.1%	0.4%	1.6%
UK Corporate (investment grade)	GBP	-0.2%	0.4%	-1.5%	-0.1%
Euro Government Bonds	EUR	-0.3%	-0.2%	0.3%	1.2%
Euro Corporate (investment grade)	EUR	0.1%	0.4%	-0.3%	0.7%
Euro High Yield	EUR	0.3%	1.5%	-0.3%	1.3%
Japanese Government	JPY	-0.9%	-0.7%	0.0%	0.5%
Australian Government	AUD	0.0%	0.1%	2.0%	3.2%
Global Government Bonds	USD	-0.4%	-0.5%	-1.5%	0.1%
Global Bonds	USD	-0.3%	-0.2%	-1.7%	0.1%
Global Convertible Bonds	USD	-0.2%	-0.1%	-0.2%	0.7%
Emerging Market Bonds	USD	0.3%	2.2%	-4.0%	-2.6%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-0.8%	-1.2%	-0.7%	-0.4%
Australian Property Securities	AUD	-0.6%	0.9%	1.2%	7.9%
Asia Property Securities	USD	2.7%	1.9%	-1.0%	5.5%
Global Property Securities	USD	0.5%	0.2%	-0.7%	3.9%
Currencies					
Euro	USD	-0.4%	-0.2%	-3.0%	-0.1%
UK Pound Sterling	USD	0.0%	-0.6%	-3.0%	0.3%
Japanese Yen	USD	0.8%	-0.1%	1.6%	0.4%
Australian Dollar	USD	-0.1%	0.1%	-5.3%	-7.1%
South African Rand	USD	2.1%	4.2%	-6.1%	-1.3%
Swiss Franc	USD	0.1%	-0.2%	-2.0%	-2.9%
Chinese Yuan	USD	-0.6%	-2.8%	-4.4%	-1.2%
Commodities & Alternatives					
Commodities	USD	1.3%	-2.6%	3.0%	11.9%
Agricultural Commodities	USD	1.2%	0.7%	0.0%	-5.4%
Oil	USD	1.7%	-6.5%	11.1%	44.3%
Gold	USD	-0.3%	-2.3%	-6.1%	-2.6%
Hedge funds	USD	-0.2%	0.2%	-0.6%	1.7%

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The Rex Building, 62 Queen Street, EC4R 1EB*

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