

# Fund Research & Selection Process



## OVERVIEW

Having established the model asset allocation for our client and the missing elements from their portfolio, we source the missing elements or funds as follows:

- Start with the fund universe of 40,000 + funds
- Filter this by fund type; unit trust/OEIC, life or pension according to tax wrapper
- Filter this by sector or category, e.g. European equity funds
- Filter this by established funds with at least a three year track record
- Filter this to those funds that have consistently performed above the sector or category average
- Then investigate each of the remaining funds for its own Risk Metrics characteristics, e.g. risk profile, reasons for out-performance, comparison with peers etc.
- The **CY Factor** is calculated and applied
- Resulting in the CY fund panel or 'best buys' list

## FUND FILTERING

To initially arrive at an unbiased shortlist of funds in a given IMA/ABI sector we use the independent investment fund research tool **fundSIFtA**. This starts with the universe of over 40,000 funds to which the following filters are applied as standard:

- Investment, life or pension funds, as appropriate to tax wrapper
- IMA/ABI sector e.g. European equity funds
- UK Domiciled funds
- Sterling denominated
- Retail funds only
- At least a 3 year history to confirm established track record
- Above (sector) average performance over 1, 2 and 3 years

## INDIVIDUAL FUND ANALYSIS

Funds in the resulting shortlist for each Sector are then analysed using their individual Risk Metrics figures. These figures are highlighted in **Green**, **Amber** or **Red**, known as 'traffic light' reports.

- Green highlighted figures are considered good,
- Amber highlighted figures are considered acceptable whilst
- Red highlighted figures are considered less acceptable

This analysis using the 'traffic light' reports aims to identify those funds with consistent performance for the right reasons. The Risk Metrics used are:

- **Past performance:** measured over eight three year periods ending on the last day of month before the date of the report and 3, 6, 9, 12, 15, 18 and 21 months before that date.
- **Volatility:** Fluctuations in value measured as standard deviation. Bonds will typically be between 1 and 2 and equities between 4 and 8, though emerging markets funds could be as high as 30. Of all the measured it is volatility which changes most quickly, reflecting changes in market conditions.
- **Beta:** Sensitivity to market movements. A beta of 1 means parity with the relevant index and beta ratings usually lie between 0.5 and 1.5. A fund would be perceived to be less risky (green) if it had a beta of <1.0 (being less volatile than the market) and more risky (amber) if the rating were >1.0 (accentuating market movements). A fund with a beta of  $\geq 1.4$  would be considered aggressive (red). A fund with a very low beta would be a very specialist fund whose constituents bore no relation to the market benchmark or one whose manager paid no regard to benchmarks.
- **Alpha:** Measuring the value added by the manager. Alpha is less difficult to achieve in bull markets. In current markets, alpha of >0 could be considered acceptable (amber) and  $\geq 0.3$  could be considered good (green). With bond funds alpha readings are less reliable because capital appreciation is not the main objective.

- **Sortino Ratio:** Measuring the extent to which the return from investing in equities has exceeded what could have been achieved from a risk-free cash investment, without exposing the fund to undesirable downside volatility. In bear markets equity funds are likely to have negative Sortino. In current markets, Sortino of  $\geq 0$  could be considered acceptable (amber) and  $\geq 0.1$  good (green).
- **Information Ratio:** Measuring the extent to which the fund has beaten its benchmark, without incurring greater volatility than the benchmark. In current markets, IR of  $\geq 0$  could be considered acceptable (amber) and  $\geq 0.25$  could be considered good (green). In interpreting an IR reading, it might be necessary to have regard to the constituent holdings of a fund.

Those with predominantly green traffic light presentation over each of the 8 three year rolling periods are worthy of further investigation. This effectively eliminates the ‘flash in the pan’ funds that had one very good year and subsequently failed to maintain similar performance.

### Equity Funds

The main characteristic of equity funds is capital growth, which is why we analyse the individual funds focusing on Alpha to measure the value added by the fund manager. Typically, those funds with more than one red traffic light indicator in each of the following risk metrics are immediately discounted:

- Performance
- Volatility
- Alpha

Next those funds with 4 or more amber or red and amber ‘traffic light’ Alpha indicators are discounted.

### Fixed Interest Funds

The same filters are applied to equity, property and fixed interest funds. However, these three asset types display different characteristics, be it income, growth or a combination.

The predominant characteristic of fixed interest funds is income not growth and as such they are expected to be less volatile than equity or property funds. Therefore adding Alpha is not the main aim of the fund manager. Rather than focus on Alpha, as we do with equity funds, we use the Sortino Ratio which measures the extent to which the return has exceeded what could have been achieved from a risk-free cash investment, without exposing the fund to undesirable downside volatility.

### Property Funds

There are two main types of property funds; those which invest in shares in property companies which act more like equity funds and should be analysed as equity funds and those which invest directly in bricks and mortar whose main characteristic is (rental) income and should be analysed in a similar way to fixed interest funds.

### THE CY FACTOR

Having arrived at a more manageable short list, the average performance figures for the 8 three year rolling periods are divided by the equivalent volatility average for the same periods. This determines the **CY Factor** for each fund, which is effectively the average return per unit of volatility. It enables us to see which funds, when compared to their peers in each sector, have performed better but taken a higher level of risk (volatility) to achieve the performance or which funds have taken a higher level of risk but underperformed when compared to similar funds with less volatility.

The resulting ‘best buys’ list or ‘panel’ is utilised where possible. Although it may be necessary to step outside this in some cases, for example where the selected or existing tax wrapper/ product has limited fund choice options, when a ‘best fit’ solution will be researched on an individual basis.

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