

Weekly Digest

Week ending **23 October 2016**

The perils of choosing a market benchmark

Monday's (24 October) FT refers to research published by index provider S&P Dow Jones that concludes "99 per cent of actively managed US equity funds sold in Europe have failed to beat the S&P 500 over the past 10 years". While we know that active equity strategies come under fire from time to time for offering poor value for money for clients, this outcome seems to be particularly extreme. Surely, given a large enough sample, even a random choice of stocks would from time to time beat the index as long as the fee charged is not too great?

The article then reports that the research found that "only two in every 100 global equity funds have outperformed the S&P 1200 since 2006". This is interesting not least because it uses a global equity index that is rarely used as the benchmark for the hundreds of global equity managers that we research. The majority of managers we know manage their mandates against the MSCI World Index. As with the above, the assertion that only 2% of global equity managers managed to outperform over 10 years seems difficult to understand. Clearly the devil is in the detail and it is difficult to draw firm conclusions until we have seen the S&P's research, but it is worth noting that, in the ten years to the end of September, the S&P Global 1200 index has outperformed the MSCI World index by approximately 64 basis points. This is a small difference, but it could be crucial because if a manager is trying to outperform one benchmark, it seems unfair to compare them to a different benchmark. Indeed, taking this analysis to an extreme, let's assume that all of the managers sampled are trying to beat the MSCI World and that they have achieved that outcome, but none of them have beaten it by more than 63 basis points. At one level they have done well compared to their benchmark, but because they failed to beat the index by more than 63 basis points, they 'underperform' the S&P index.

This neatly demonstrates the perils of choosing a market benchmark. As an investor it is very difficult to know what will best suit your needs. Consider two managers that both kept pace with their benchmarks. Arguably neither has done a better job, but the manager that chose, for whatever reason, the S&P 1200 as their benchmark will be 64bps ahead of the other manager. Expecting a client to choose between these two benchmarks is asking too much. The differences between them are small and the performance differential over the past ten years could be the result of arbitrary or one off factors. These sorts of considerations are also relevant for smart beta benchmarks – they may be 'smarter', but do they speak to client needs? Our view is that they do not and that is why benchmarks are a useful means for assessing the efficacy of a strategy, but we know that few clients care what an index does; they care about results. That is why we focus solely on investing to achieve an outcome because that is what most investors actually need; it seems strange to strive for anything other than what they actually require.

The research raises important questions over the efficacy of active managers on average, but the managers of our core portfolios, spend a lot of time attempting to identify the exceptional rather than settling for average. They agree that it is extremely difficult to identify genuine talent amongst the swaths of active strategies available and that is why they dedicate substantial resources to identifying investors that they believe to be a cut above the rest. The research quoted by the FT will doubtless be used as another justification for passive investing, and the managers do make use of passive strategies where appropriate, but the one oft-overlooked fact of passive vehicles is that they are, by definition, guaranteed to underperform their reference benchmark. Not a sensational headline, but important nonetheless.

The Marketplace

- China's economy grows 6.7% in Q3
- European bank shares rise following uneventful ECB meeting
- UK CPI jumps month-on-month
- US dollar strengthens as company earnings season commences
- Portugal's sovereign bond rating avoids decisive downgrade

Market Focus

China

- The Chinese economy experienced 6.7% growth over the third quarter. It matches growth figures for the first and second quarters, and means that annual GDP growth is primed to meet the government's 6.5% target.
- Other data releases showed fixed asset investment for the year to September rising one-tenth from August to 8.2% year-on-year. Retail sales and industrial production numbers were also up: 10.7% and 6.1%, respectively year-on-year (as of the end of September).
- The Shanghai Composite index rose 0.9% for the week, with global emerging market equities up by 1.6%.

Europe

- The European Central Bank's (ECB's) meeting on Thursday yielded no policy changes, with the main refinancing rate kept at zero. The lack of a planned extension of the bank's EUR 80 billion per month QE programme garnered the most attention, with investors now expecting an extension announcement at the ECB's December meeting.
- The Euro Stoxx Banks index surged 2.1% on Friday thanks to the removal of uncertainty, whilst the Euro's weekly depreciation of 0.8% versus the dollar to USD 1.09 helped continental European equities to a 1.3% weekly rise.
- Canadian rating agency DBRS announced on Friday that it would maintain its BBB rating for Portuguese government debt after previously expressing concerns over Portugal's low growth and high debt levels. This makes it the only agency to give the country an investment grade rating, and more importantly means the country's debt is still eligible for purchase via the ECB's bond buying programme.

UK

- The Consumer Price Index (CPI) reported its largest month-on-month rise since June 2014, surging from 0.6% in August to 1.0% in September. This is in line with economists' predictions that prices will increase following sterling's fall in value since the Brexit vote.
- The Retail Price Index, which includes the cost of mortgage interest payments, rose to 2.0% year-on-year in September, from 1.8% in August.

US

- The US dollar rose by 0.7% against a basket of major currencies last week. This follows the release of the latest CPI data which matched analysts' expectations (+0.3% month-on-month), as well as comments from the Federal Reserve Vice-chairman Stanley Fischer that the central bank is very close to its goals of full employment and its 2% inflation target. Broadly positive financial reports from US companies (especially banks) also helped.

James Klempster (CFA) & Oliver Bickley

Asset Class/Region	Currency	Currency returns			
		Week ending 21 October 2016	Month to date	YTD 2016	12 months
Developed Market Equities					
United States	USD	0.4%	-1.2%	6.0%	7.7%
United Kingdom	GBP	0.2%	1.9%	16.5%	15.0%
Continental Europe	EUR	1.3%	1.4%	-2.4%	-0.6%
Japan	JPY	1.3%	3.2%	-9.9%	-8.6%
Asia Pacific (ex Japan)	USD	0.7%	-0.3%	11.9%	8.0%
Australia	AUD	-0.1%	-0.1%	6.2%	8.2%
Global	USD	0.5%	-1.4%	4.1%	3.8%
Emerging Market Equities					
Emerging Europe	USD	0.7%	0.7%	15.5%	1.1%
Emerging Asia	USD	1.1%	-0.1%	12.8%	6.8%
Emerging Latin America	USD	4.1%	9.4%	44.6%	33.1%
BRICs	USD	1.6%	2.4%	19.4%	11.2%
MENA countries	USD	-0.3%	-0.1%	-3.7%	-11.0%
South Africa	USD	3.2%	-3.2%	18.9%	-2.3%
India	USD	1.0%	0.6%	9.6%	3.9%
Global Emerging Markets	USD	1.6%	0.9%	17.1%	8.6%
Bonds					
US Treasuries	USD	0.4%	-0.8%	4.6%	3.4%
US Treasuries (inflation protected)	USD	0.6%	-0.2%	7.5%	6.2%
US Corporate (investment grade)	USD	0.5%	-0.1%	9.1%	7.5%
US High Yield	USD	0.6%	1.1%	16.4%	11.1%
UK Gilts	GBP	0.5%	-2.4%	11.9%	11.0%
UK Corporate (investment grade)	GBP	0.5%	-2.3%	11.0%	11.3%
Euro Government Bonds	EUR	0.3%	-0.9%	5.4%	5.5%
Euro Corporate (investment grade)	EUR	0.3%	-0.2%	5.8%	6.3%
Euro High Yield	EUR	0.6%	1.2%	8.3%	7.6%
Japanese Government	JPY	0.1%	-0.3%	5.2%	6.1%
Australian Government	AUD	0.0%	-1.7%	5.1%	4.7%
Global Government Bonds	USD	0.0%	-2.8%	7.7%	5.5%
Global Bonds	USD	0.0%	-2.2%	6.8%	4.6%
Global Convertible Bonds	USD	0.2%	-1.3%	1.8%	0.4%
Emerging Market Bonds	USD	0.5%	-0.7%	14.9%	13.6%

Asset Class/Region	Currency	Currency returns			
		Week ending 21 October 2016	Month to date	YTD 2016	12 months
Property					
US Property Securities	USD	0.4%	-3.8%	6.5%	6.2%
Australian Property Securities	AUD	-1.9%	-5.6%	4.4%	7.5%
Asia Property Securities	USD	2.7%	-1.9%	7.7%	4.8%
Global Property Securities	USD	0.8%	-3.9%	6.6%	5.4%
Currencies					
Euro	USD	-0.8%	-3.2%	0.3%	-4.0%
UK Pound Sterling	USD	0.4%	-5.7%	-17.0%	-20.7%
Japanese Yen	USD	0.3%	-2.4%	15.9%	15.5%
Australian Dollar	USD	-0.1%	-0.7%	4.4%	5.5%
South African Rand	USD	2.5%	-1.8%	10.7%	-3.3%
Swiss Franc	USD	-0.3%	-2.2%	0.9%	-3.4%
Chinese Yuan	USD	-0.4%	-1.4%	-3.9%	-6.1%
Commodities & Alternatives					
Commodities	USD	-0.1%	1.3%	10.7%	-2.3%
Agricultural Commodities	USD	0.3%	2.4%	2.1%	-2.1%
Oil	USD	-0.3%	5.5%	38.9%	8.2%
Gold	USD	1.2%	-3.8%	19.3%	8.5%
Hedge funds	USD	0.4%	0.0%	1.2%	0.2%

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