



Weekly Digest

Week ending 17 December 2017

Tracking into underperformance

Whoever introduced the tracking error measure to evaluate investment managers' risk has to share some blame for today's mediocre performance of the active management industry. Tracking error measures the dispersion of portfolio returns around the returns of its benchmark. The closer the portfolio tracks the benchmark, the lower it's tracking error; and the more unique the portfolio, the higher it's tracking error. Perhaps this makes some sense as a risk metric, as a higher tracking error can lead to larger deviations from the benchmark, but obsessing about it and demanding low tracking errors, as seems to be the case for most fund allocators (consultants, platforms etc.), is counterproductive. Perhaps the reason so many active managers end up underperforming is not for lack of skill but as a result of their portfolio construction decisions to lower portfolio tracking error.

In order for managers to reduce tracking error, they need to design portfolios that will closely track their benchmarks and be highly diversified so as to remove any stock-specific risks. Basically, a focus on tracking error incentivises the manager to turn into a closet tracker and doing this while charging active fees will almost inevitably result in disappointing performance. Delivering outperformance when you cannot be different from the benchmark is a gargantuan task. Historically, investors asked managers to be benchmark-like and then they were surprised when managers produced benchmark-like returns!

So, why do investors demand for managers' portfolios to look very similar to their index and why do investors care about tracking error as a measure of risk? An index was never designed to be invested in. Weighting a portfolio by the market cap of the included companies, not taking into consideration risks, correlations or diversifications, is not an optimal portfolio by any means. An index can be a

good representation of the opportunity set and the risks that one should expect by allocating to that asset class, but deviating from it should not be the risk investors should care about most.

What are the risks that investors should care about then? Ultimately they should be the risks that matter most to clients: losing money or not meeting a certain level of growth required to fulfil their investment goals (buying a house, paying for a decent standard of living in retirement etc). These risks are more likely to be expressed in absolute terms rather than relative. You can't "eat" relative performance whereas you can make good use of absolute returns.

Some argue that the active management industry is dead, given the unsatisfying performance and the ever-greater availability of low-cost passive alternatives. Portfolio manager disagrees because the wide use of passive funds and smart beta strategies might just be the thing that will save the active management industry. Today's proliferation of passive funds is forcing managers to be truly active and manage portfolios that are significantly different from their benchmarks. Active managers will run more concentrated portfolios, and as a result, produce more alpha again.

Portfolio managers have always looked for managers that have conviction in their skill set and are willing to be different from their benchmarks because we know that this is the only way to deliver excess returns over the long run. Approach to risk management takes a holistic view of each portfolio and is a lot more focused on absolute risks which are more aligned with the clients' actual risks, i.e. limiting absolute drawdowns and maximising the probability of achieving their long-term financial goals.

Jernej Bukovec (CFA)

The Marketplace

- Federal Reserve raises bank rate
- Eurozone manufacturing PMI hits 20 year high
- Japan and the EU finalise free-trade agreement
- Democrats win Senate seat in Alabama
- UK CPI inflation hits five year high

Market Focus

US

- As markets anticipated, the Federal Reserve increased the federal funds target range by 25 basis points to 1.25%-1.50%. In addition, the Fed now expects 2018 GDP growth to be 2.5%, up from a previous forecast of 2.1%.
- Democrat Doug Jones beat Republican Roy Moore to win a Senate seat in Alabama, the first Democrat to do so in 25 years. This narrows the Republican majority in the Senate to 51-49.
- Republican US tax reforms continue to make progress, with the House of Representatives and Senate producing a compromise tax bill. If progress continues as planned, the bill is expected to be voted on in the Senate tomorrow, in the House on Wednesday, while finally being signed on Thursday by President Trump.
- The US manufacturing Purchasing Managers' Index (PMI) rose to an 11 month high of 55.0.
- Core Consumer Price Index inflation during November was slightly weaker than expected at 0.1% month-on-month versus a 0.2% expectation, while year-on-year was at 1.7%.
- Equity markets rose 0.9% during the week while Treasuries also rose, advancing 0.3%.

UK

- The Bank of England's Monetary Policy Committee voted 9-0 to hold the base rate at 0.50%.
- November retail sales (excluding fuel) beat expectations, rising 1.2% month-on-month versus a 0.4% expectation.
- The unemployment rate in October was slightly higher than expected at 4.3% versus a 4.2% consensus. Wage inflation rose in line with expectations at 2.5% year-on-year, although real wage growth remains negative. In November CPI inflation edged up to 3.1%, the highest rate in five years.
- UK equities rose 1.3% during the week. Gilts rose 1.4%, partly impacted by EU diplomats suggesting the next phase of Brexit negotiations will be more difficult. Sterling fell 0.6% in the week versus the US Dollar.

Europe

- The Eurozone manufacturing PMI rose to a 20 year high of 60.6, beating expectations which anticipated a fall to 59.7. Within the Eurozone, Germany stood out with its manufacturing PMI rising to 63.3, the highest on record.
- Japan and the European Union finalised a free trade agreement after four years of negotiations, eliminating tariffs on 95% of products traded between the regions.
- Continental European equities fell 0.6% while the euro rose 0.1% versus the US Dollar.

Oliver Cooper

Asset Class/Region	Currency	Currency returns			
		Week ending 15 Dec. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.9%	1.1%	21.2%	20.0%
United Kingdom	GBP	1.3%	2.2%	8.7%	10.9%
Continental Europe	EUR	-0.6%	0.0%	12.0%	13.0%
Japan	JPY	-0.6%	0.1%	20.5%	18.7%
Asia Pacific (ex Japan)	USD	0.8%	0.1%	33.0%	32.5%
Australia	AUD	0.1%	0.5%	10.3%	13.1%
Global	USD	0.6%	0.4%	21.3%	21.1%
Emerging markets equities					
Emerging Europe	USD	2.0%	1.9%	16.7%	19.1%
Emerging Asia	USD	0.5%	-0.1%	38.8%	38.0%
Emerging Latin America	USD	0.5%	-0.1%	18.4%	23.3%
BRICs	USD	0.2%	-0.4%	37.2%	39.1%
MENA countries	USD	0.9%	1.2%	-1.3%	0.4%
South Africa	USD	1.5%	-3.5%	20.7%	27.4%
India	USD	1.4%	1.9%	35.7%	36.1%
Global emerging markets	USD	0.7%	-0.2%	32.3%	33.2%
Bonds					
US Treasuries	USD	0.3%	0.6%	2.7%	3.6%
US Treasuries (inflation protected)	USD	0.2%	0.6%	2.9%	4.6%
US Corporate (investment grade)	USD	0.5%	1.0%	6.5%	7.9%
US High Yield	USD	0.0%	0.1%	7.3%	7.9%
UK Gilts	GBP	1.4%	1.8%	2.3%	5.5%
UK Corporate (investment grade)	GBP	1.1%	1.6%	4.8%	7.5%
Euro Government Bonds	EUR	-0.3%	0.2%	1.3%	2.1%
Euro Corporate (investment grade)	EUR	-0.1%	0.3%	3.0%	3.7%
Euro High Yield	EUR	0.0%	-0.2%	6.7%	7.2%
Japanese Government	JPY	0.1%	0.1%	0.2%	0.6%
Australian Government	AUD	-0.1%	-0.2%	4.2%	4.8%
Global Government Bonds	USD	0.3%	-0.2%	6.5%	8.1%
Global Bonds	USD	0.3%	-0.1%	7.0%	8.5%
Global Convertible Bonds	USD	0.5%	-1.7%	8.7%	9.4%
Emerging Market Bonds	USD	0.4%	0.6%	8.2%	9.9%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	1.2%	0.7%	4.9%	8.4%
Australian Property Securities	AUD	1.8%	1.7%	3.7%	8.5%
Asia Property Securities	USD	0.4%	0.0%	24.7%	24.3%
Global Property Securities	USD	1.0%	0.7%	14.9%	18.2%
Currencies					
Euro	USD	0.1%	-1.1%	11.8%	13.0%
UK Pound Sterling	USD	-0.6%	-1.4%	7.8%	7.3%
Japanese Yen	USD	0.7%	-0.2%	3.8%	4.9%
Australian Dollar	USD	1.9%	1.1%	6.3%	4.0%
South African Rand	USD	3.5%	3.8%	3.8%	5.8%
Swiss Franc	USD	0.2%	-0.7%	2.8%	3.9%
Chinese Yuan	USD	0.2%	0.1%	5.3%	5.1%
Commodities & Alternatives					
Commodities	USD	0.0%	-1.4%	0.2%	1.3%
Agricultural Commodities	USD	-0.4%	-2.0%	-5.5%	-6.0%
Oil	USD	-0.3%	-0.5%	11.3%	17.0%
Gold	USD	0.5%	-1.4%	8.8%	11.1%
Hedge funds	USD	-0.2%	-0.3%	4.9%	5.0%

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