

Beta testing

– Richard Stutley, CFA

Last week I listened to a prominent psychologist talk about how people perform everyday tasks. Contrary to popular belief, there are very few things people can do automatically without devoting some thought to them; try reading a book while walking down stairs and you are likely to run into trouble. Hence, when I hear investors say they spend very little time thinking about their beta decision (selecting passive managers), I worry their portfolios could be in for a similar accident. With the explosion of passive strategies in the market place, it is important to spend time getting this decision right; we certainly do.

Passive strategies have popularised the latest innovation in pooled investment structures: the Exchange Traded Fund (ETF). This hybrid structure includes features of both listed investment companies, whose shares can be traded throughout the day but not necessarily redeemed at their net asset value (NAV) or 'fair' value, and mutual funds, which accept subscriptions and redemptions at NAV but can only be bought and sold at certain times.

Before seeking beta via an ETF however, ask yourself whether you need these features and whether it is worth paying (an often) higher management fee for them. Assuming the management charge is in fact lower, make sure to factor in trading costs. Prices depend on the number of brokers vying for your business, their familiarity with the underlying basket of securities and the availability of hedging instruments. If you're using an agency broker to source competing quotes, this then introduces another layer of costs.

Next, consider how your strategy goes about tracking the reference index. It may buy the index constituents in their corresponding weights (physical replication), or instead it may enter into a swap with a bank (synthetic replication). 'Physical replication' I hear you say, 'it's a no brainer!' But it's harder than it sounds: there are ways to trade more or less efficiently, particularly around index rebalance dates

and ex dividend dates. Then there is the temptation to hold fewer stocks than the index in order to manage costs; together these things introduce execution risk.

Synthetic replication was pilloried in the wake of the financial crisis, as investors came to realise just how lax the rules on collateral were. The rules may have been tightened, but for many investors there is no way back. Look a little closer however and you'll find your physical replication strategy isn't that dissimilar. Most physical replication strategies lend the stock they own in order to earn fees. How significant is this lending activity? One manager I spoke to recently described an upper limit of 50% of the Fund's assets as being 'conservative'. Securities lending introduces the same kind of counterparty risks as entering into a swap.

The clearest advantage of synthetic replication is down to tax. Countries including the US and France charge high levels of withholding tax on income paid to foreign investors. This can be avoided by entering into a swap with a local bank and the saving can be meaningful, of the order of 60 basis points per annum in the case of the US. While the above considerations do not provide sufficient reason to invest in synthetic strategies on their own – and we typically elect to use physical replication instead – they are worth bearing in mind.

At Momentum we use passive funds in areas of the market where we think quoted prices are broadly efficient – i.e. they incorporate all available information, leaving little on the table for active managers to exploit. Using passive funds in this way helps to avoid unnecessary costs, which in turn improves our chances of delivering on our target outcomes for clients. However, we do so after spending time analysing how different strategies work; their advantages and their inherent risks. Because clearly we're not in the business of falling down stairs.

The Marketplace

- Softer-than-expected US economic data
- UK Parliament rejects no-deal Brexit
- Brent crude advanced 2.2% ending the week at \$67.2 per barrel
- Gold ended the week up 0.3% to \$1303 per ounce

Market Focus

US

- US manufacturing output fell for a second straight month in February, down 0.4%
- Consumer prices rose 1.5% in February compared with the same month a year ago, falling from January's 1.6% and below market expectations of 1.6%
- US large-cap equities had their best weekly performance of the year last week, advancing 2.9%
- The technology sector performed best while industrials lagged, weighed down by a sharp decline in Boeing shares, falling 10% on the week, following a second fatal accident involving its new 737 Max 8 airliner
- Softer-than-expected inflation pushed the yield on the benchmark 10-year Treasury note four basis points lower, ending the week at 2.59%

UK

- British Parliament undertook a series of votes this week to clear a path toward Brexit. Prime Minister May's proposed EU withdrawal deal was rejected for a second

- time by an overwhelming majority of 149. Parliament then surprised the government by voting 312 to 308 to reject a no-deal Brexit under any circumstances. Finally, MPs voted by 413 to 202 – a majority of 211 – for Prime Minister May to ask the EU for an extension of the March 29th Brexit deadline
- On the back of the series of votes the British Pound rallied 2.1% and 1.3% against the US dollar and Euro respectively
- UK equities rallied 1.8% on the week

Europe

- Industrial production in the euro area rose 1.4% from the previous month in January 2019, rebounding from a decline of 0.9% in December and beating market expectations of a 1% rise
- Continental European equities had a strong week, advancing 2.8%

Rest of The World

- The Bank of Japan left its ultra-low policy rates and asset purchases unchanged, in line with forecasts. The central bank noted that while it expects the country's economy to maintain its moderate expansion, concerns remain over the impact of the global slowdown on exports and factory output
- Growth in China's industrial production fell to a 17-year low in the first two months of the year and the jobless rate rose
- Brazilian equities rose 3.9% in the week on the prospects for a pension reform bill that, if passed, is expected to help control government debt

| Asset Class/Region | Currency | Currency returns | | | |
|-------------------------------------|----------|-----------------------------|------------------|----------|-----------|
| | | Week ending 15 Mar. 2019 | Month to date | YTD 2019 | 12 months |
| Developed Market Equities | | | | | |
| United States | USD | 2.9% | 1.4% | 13.0% | 4.2% |
| United Kingdom | GBP | 1.8% | 2.4% | 8.6% | 5.7% |
| Continental Europe | EUR | 2.8% | 2.3% | 12.9% | 2.5% |
| Japan | JPY | 1.9% | -0.3% | 7.3% | -6.0% |
| Asia Pacific (ex Japan) | USD | 2.0% | 0.6% | 10.5% | -8.2% |
| Australia | AUD | -0.4% | 0.6% | 10.7% | 8.9% |
| Global | USD | 2.8% | 1.2% | 12.4% | 0.8% |
| Emerging markets equities | | | | | |
| Emerging Europe | USD | 2.3% | 0.2% | 9.5% | -7.3% |
| Emerging Asia | USD | 2.5% | 0.9% | 10.2% | -11.4% |
| Emerging Latin America | USD | 4.5% | 1.1% | 11.9% | -3.7% |
| BRICs | USD | 3.5% | 2.6% | 14.1% | -8.1% |
| MENA countries | USD | 1.0% | 0.1% | 5.7% | 5.8% |
| South Africa | USD | 1.3% | -2.3% | 3.8% | -23.7% |
| India | USD | 5.2% | 8.8% | 6.6% | 5.5% |
| Global emerging markets | USD | 2.7% | 0.7% | 9.7% | -10.9% |
| Bonds | | | | | |
| US Treasuries | USD | 0.1% | 0.7% | 0.9% | 3.6% |
| US Treasuries (inflation protected) | USD | 0.6% | 0.9% | 2.3% | 2.4% |
| US Corporate (investment grade) | USD | 0.4% | 0.9% | 3.5% | 3.7% |
| US High Yield | USD | 0.7% | 0.3% | 6.6% | 5.0% |
| UK Gilts | GBP | -0.1% | 1.3% | 1.4% | 2.8% |
| UK Corporate (investment grade) | GBP | 0.3% | 1.3% | 3.2% | 2.6% |
| Euro Government Bonds | EUR | -0.1% | 0.9% | 1.6% | 2.0% |
| Euro Corporate (investment grade) | EUR | 0.4% | 0.7% | 2.5% | 1.6% |
| Euro High Yield | EUR | 0.8% | 0.6% | 4.8% | 1.0% |
| Japanese Government | JPY | 0.1% | 0.2% | 1.1% | 1.8% |
| Australian Government | AUD | 0.3% | 0.8% | 2.7% | 7.5% |
| Global Government Bonds | USD | 0.4% | 0.5% | 0.9% | -1.3% |
| Global Bonds | USD | 0.4% | 0.5% | 1.4% | -0.8% |
| Global Convertible Bonds | USD | 1.3% | 0.3% | 6.3% | -2.3% |
| Emerging Market Bonds | USD | 1.0% | 0.4% | 5.4% | 2.3% |

| Asset Class/Region | Currency | Currency returns | | | |
|---------------------------------------|----------|-----------------------------|------------------|----------|-----------|
| | | Week ending 15 Mar. 2019 | Month to date | YTD 2019 | 12 months |
| Property | | | | | |
| US Property Securities | USD | 1.9% | 1.4% | 14.0% | 17.4% |
| Australian Property Securities | AUD | 0.7% | 4.5% | 12.3% | 17.7% |
| Asia Property Securities | USD | 2.6% | 1.9% | 10.8% | 2.8% |
| Global Property Securities | USD | 2.1% | 1.7% | 12.1% | 7.5% |
| Currencies | | | | | |
| Euro | USD | 0.7% | -0.5% | -1.2% | -8.2% |
| UK Pound Sterling | USD | 2.1% | 0.1% | 4.2% | -4.9% |
| Japanese Yen | USD | -0.4% | -0.1% | -1.6% | -4.9% |
| Australian Dollar | USD | 0.6% | -0.2% | 0.6% | -9.3% |
| South African Rand | USD | 0.1% | -2.4% | -0.2% | -17.4% |
| Swiss Franc | USD | 0.5% | -0.5% | -2.0% | -5.4% |
| Chinese Yuan | USD | 0.1% | -0.3% | 2.5% | -5.8% |
| Commodities & Alternatives | | | | | |
| Commodities | USD | 1.7% | 0.4% | 9.3% | -1.4% |
| Agricultural Commodities | USD | 2.0% | 0.7% | -0.4% | -10.5% |
| Oil | USD | 2.2% | 1.7% | 24.8% | 3.1% |
| Gold | USD | 0.3% | -1.0% | 1.6% | -1.3% |
| Hedge funds | USD | 0.3% | 0.2% | 2.9% | -4.1% |

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