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Know What You Are Buying

The headline of this article should be obvious. If you don't know what you are buying, how could you possibly know what to expect from your purchase? This is a fact of life, not just investing. A friend recently bought their first puppy. Having never had a dog before, they thought they knew what they wanted, but after conversations with a couple of breeders they realised they didn't! Different dogs have different needs from their owners; what you ideally want from a dog and what breed of dog is ideal for you might not be compatible. After changing their mind on which breed, it transpired that they were pointed towards a pup from a litter of 7, and were recommended "one of the middle ones" because usually the first born is the alpha and even though the pup is only with their mother for a matter of months before becoming part of a new family it will have a number of characteristics or traits that will stay with it for life.

I'm not a pet owner and this conversation amazed me. Of course, it makes sense when you give it a bit of thought, but once again, think of the title – "know what you are buying." Bring this around to investments, and understanding their complexity, it arguably makes sense to purchase passive funds. Investing is relatively simple. Buy something and hopefully over time it becomes worth more than was paid. But there are risks along the way; risks specific to the investment itself, but also risks to the wider economy, politics, currency, income and so on.

Explaining to a client the nuances between active v passive can be complicated. Many investors are new to investing and passive investing could be seen as a great first step to the education process. On top of that, it is cheap and can provide a great deal of diversification. The financial services profession is wonderful at taking an easy subject and making it complex. The use of derivatives for instance, smart beta, gearing and other clever ways to use financial engineering make it much more difficult to understand.

Picking up on the smartbeta argument, this muddies the waters between active and passive management and should make investors tread very carefully. Over the last couple of years, the rise of smartbeta products has mushroomed and the smartbeta fund du jour has definitely been the rise of themes. I am not saying anything is wrong with investing in themes, but most smartbeta funds follow custom benchmarks and unless you know how the custom benchmark is calculated, you could be opening yourself up to a number of risks that might be overshadowed because "the fund you are investing in tracks an index…" Many smartbeta fund themes can be quite specific.

I was recently asked by a client to look at one such theme fund. It was a "global luxury" fund and the performance over the last year was stunning – returning over 60%. Delving a little deeper (as I didn't

know the product well) I found out the fund had 79 holdings, so arguably it could be considered diversified. From a geographical perspective, the top 5 country allocations saw the US as the largest exposure with a little over 1/3 of the assets, France almost one quarter, Germany 1/10th, the UK came in fourth at 6.36% and Switzerland rounded off with a 6.15% weight. So, from a geography perspective, quite broadly diversified too.

One of the reasons index investing is considered simple is they are rules based. A typical index is market cap weighted, but this isn't necessarily so when it comes to smartbeta or theme funds and once again, this is where you need to understand what you are buying. Back to the luxury fund example. It took seconds to find the index the fund was tracking – the S&P Global Luxury Index. S&P have been involved in index calculations and their underlying methodology(ies) for a very long time. After all, they probably can lay claim to ownership of the most quoted index in the world, the S&P500. The Global Luxury index is quite different.

The investment objective for the index is (obviously) part of the methodology and the methodology (which if you want to read all about it, you can do so here) extends to seventeen pages. Most investors generally stop at the objective though which is below:

The S&P Global Luxury Index measures the performance of 80 companies engaged in the production, distribution, or provision of luxury goods and services drawn from the S&P Global BMI (the "Index Universe").

Very quickly a few questions are raised. Why 80 stocks? (although in all honestly the same could be said for the 500 in the S&P500, or 100 for the FTSE 100 or 40 in France's CAC40 or 30 in the German Dax Index and so on). There are more than 80 companies listed in the global luxury sectors for instance which means that stocks can get promoted and relegated from this index, very much like the FTSE 100, CAC40, S&P500 and so on, but 80 does seem like a very random number. The index is rebalanced annually which is a lot less frequently than the mainstream indices and this can cause large changes to index weights when reallocation time comes along.

Apart from those observations, "engaged" "distribution" and "provision" are all quite subjective. Also, so is the word "luxury." This is a global index. Luxury means vastly different things in different parts of the world. Luxury means different things in the same country, or even different parts of the same city, so this index – to me at least – becomes incredibly subjective. The index "rules" are changing. Not all indices are calculated in the same manner. They don't have the same universes; they are not starting from the same point.

Unfortunately, the investment objective doesn't stop there:

Index constituents are weighted by float-adjusted market capitalization (FMC) multiplied by a luxury exposure score, subject to the single stock weight caps defined in Index Construction.

It is nice to see some rules applied, as you would expect from an index. Weights are float-adjusted and market cap driven. But then comes more subjectivity – "multiplied by a luxury exposure score". The methodology goes on to state that the luxury exposure score (which scores stocks with a 1.00, 0.75, 0.50 or 0.25) then applies a maximum weight for inclusion in the index which once again brings more complexity into investing.

As a “luxury” fund, it arguably makes sense that the majority of the assets are in the consumer discretionary sector (a little over 80%) with the remaining allocation focused towards the consumer staples classification, but on closer thought, why? If luxury can mean different things to different people, it can mean different things to different corporations. “Luxury” is massively subjective. “Global Luxury” therefore must be even more subjective. Should a Global Luxury index be so concentrated in these two sector classifications?

Looking at the 10 largest holdings, there are names there that you would probably expect to see – LVMH, Moet Hennessy, Kering (owner of Cartier) Hermes, Richemont and so on. But there are names in the top 10 that I think are questionable, with Nike and Tesla being two. I’m sure many of you would disagree with me suggesting both companies are luxury companies, but once again, this really highlights is the subjective nature of the index. These two companies represent over 11.50% of the index. The top 10 account for 56.00% of the index, the top two 17.00%. The tenth largest is Diageo (another potentially questionable inclusion when considering “luxury”) at 3.38%, so the remaining 70 stocks in the index account for 44%: quite a tail.

Back to Tesla. In the past 12 months, the share price has trebled from less than $200 to about $600 where it is today (via a couple of months north of $800). With the allocation in the index being more than 8.00%, how much of the total return from the index has been directly attributable to this one stock?

If there are questionable names in the top 10 with regard to luxury, it surely makes sense there are questionable names in the other 70 stocks that constitute the index?

There are tens of thousands of funds available for investors across active, passive, smartbeta, exchange listed, open-ended and closed ended offerings. The principle when it comes to investing is simple, the reality is far from it. All investments have their strengths and weaknesses and provide opportunities as well as risks. Investing in funds is not easy as there are always moving parts that change the dynamic and this brings us back full circle – know what you are buying.

Market Snapshot (28.05.21 – 04.06.21)

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FTSE 100	7069.04	↑0.66%	UK	0.79	↓0.38%	£/$	1.4150	↓0.28%	Brent Crude	$71.82	↑3.12%
S&P 500	4229.89	↑0.61%	US	1.56	↓1.52%	£/€	1.1634	↓0.03%	Gold	$1891.40	↓0.65%
NIKKEI 225	28941.51	↓0.71%	Germany	-0.22	↓18.21%	€/$	1.2170	↓0.16%			
DAX 30	15692.90	↑1.11%	Japan	0.09	↑7.59%	£/¥	155.0100	↓0.60%			
CAC 40	6515.66	↑0.49%									

Figures quoted are in local currency.
Source: FE Analytics & Financial Times

Week Ahead

Monday –
Tuesday – Japan: GDP (QoQ) (Q1)
Wednesday – US: Crude Oil Inventories
Thursday – Euro Area: ECB Interest Rate Decision
Friday – UK: Manufacturing Production (MoM) (Apr)

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