Issue three hundred and forty-two

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Should you change managers?

A key argument put forward by investors in passive funds is "knowing what you are getting" – an index fund – for instance the FTSE 100 – has a set of rules that are known to all (more information here - https://en.wikipedia.org/wiki/FTSE_100_Index) - and contains roughly 100 stocks (not always 100 mind you, but for the sake of this piece let's call it 100), weighted by market capitalisation, rebalanced on a quarterly basis and incredibly well known. Formulas are involved and everything! On the other hand, an active fund investing in the UK stock market (with the same benchmark) might at one look have 60 stocks, a month later 45, and then on a third pass have 72 stocks. The fund's largest holding might not have the largest market capitalisation. The fund might have biases towards a particular investment style such as momentum, or value for instance. At one time, the fund might be managed by person A and a second review could be managed by somebody else. Dividends might come from unusual sources; the allocation to the sub categories of the index (i.e. mining, banks, and consumer discretionary) can be different to the index and subject to change.

I could go on. It could be argued that going passive is an easy option. Active managers have the potential to beat the index, and many do; passive do not. That is a simple fact. But, how many active managers consistently beat the index is a valid argument thrown back. But, this piece is not about active v passive – plenty of that has already been written about. This piece is about the monitoring - what you do once you've built your portfolio.

If you have a formulaic approach to portfolio construction – i.e. my 10% allocation to UK (whether active or passive) will never stray outside of 9.80% or 10.20% then great. A rule to follow. Once the allocation rises above the number you cut back, once it falls below you add. But, do you cut back to 10% exactly if it has gone to 10.20%, or do you cut to 10.19% and keep riding the outperformance? If a weight falls to 9.80%, do you see extra value and increase to 10.19% etc?

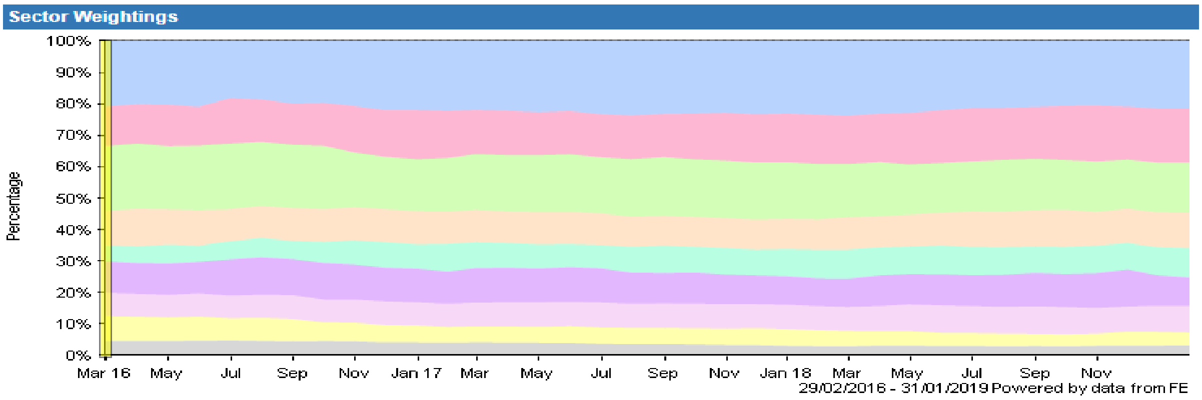
If you don't have a formulaic approach to weighting a holding, what are the reasons to make changes? Not just increase or reduce allocations, but selling asset A to buy asset B. Assuming both assets are in the same asset class (so the decision is not driven by asset allocation reasons) just some of the reasons are below:

- Performance
- Change of lead Manager
    - Changes in underlying team
- Change of approach (although in all honesty this generally doesn't happen if the lead manager hasn't changed)
- Volatility (either increase or decrease thereof)
- Portfolio activity

- Correlation (i.e. if you own more than one holding in the same asset class, are they moving together thus not creating enough diversity)

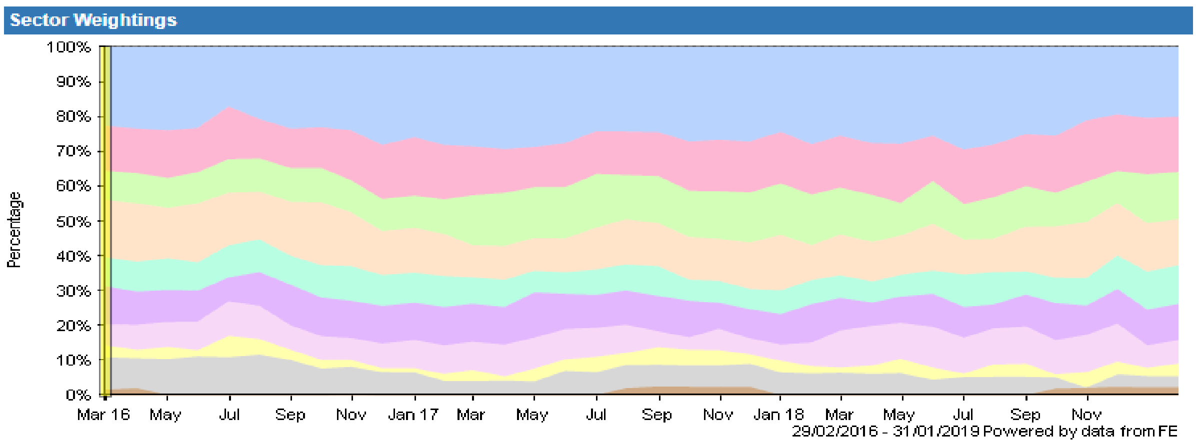
If you looked at each bullet point in isolation, there are lots of routes to go down, and I will not go into every point for the sake of keeping this article below 90,000 words. But, for instance, you might want to change due to performance being really strong over the short term as you believe the ability to continue this trend is unlikely and therefore moving the capital to the next best idea. Alternatively, you bought a fund to deliver to a certain set of expectations and it didn't meet those expectations. What time period are you looking at when considering these variables? How similar / different is the replacement investment choice? What was the reason the asset was bought in the first place? Maybe the performance is good for the investment approach, but bad for the present market environment. If this is the case, should you sell due to "performance" reasons? This is a great case in point – again – for using passive funds – this decision is taken away from you as you have outsourced the decision.

But, as the sand chart shows below, the characteristics of the index change over time and as a passive investor, you have no control over this.



Although this chart – sourced from Financial Express - only covers the last 3 years, the changes at sector level can be quite significant. For example, at the end of February 2016, the oil and gas sector accounted for 12.50% of the FTSE 100. At the end of February 2019, this had risen to 17.14% - approaching a 40% change in only 3 years… As a passive investor you have to accept this.

The chart below – an active fund managed with a high allocation to FTSE 100 stocks – has quite a different sand chart to the index over the same time frame.



Although the first chart has a greater smoothness of asset weight allocation compared to the second, it doesn't necessarily mean the first will, or has performed better than the second. It also doesn't mean that the returns from the first compared to the second are smoother either. It doesn't tell you whether you should increase or reduce your allocation to the fund / index. It doesn't tell you how the characteristics of the fund help to diversify other risks taken with other investments for instance. Sometimes holding a fund or an index that "underperforms" actually adds value to the overall portfolio construction.

I love to use analogies; goalkeepers do not score goals, but they are a very important part of a team. The metrics of their success should not be the same as those of an attacker for example. So "performance" means something different in this analogy. Should you therefore compare the goalkeeper instead to other goalkeepers? Possibly. But as a Manchester City fan, before the arrival of Pep Guardiola our goalkeeper was Joe Hart – a multi-capped international and one any premier league team would be happy to have in their squad. But, when Pep arrived, he wanted a goalkeeper that played the way he wanted the team to play, not the traditional way a goalkeeper played, which meant bye bye Joe.

Sometimes you need to consider the team, sometimes the individual. This might mean actively trading holdings, and other times not changing at all. Sure – winning the match is important, but surely winning the season is more so. Whether you do that with the same 11 you started with, or whether you employ squad rotation is up to you, but knowing what you are doing and why is just as important.

Market Snapshot 19.04.19 – 26.04.19)

Market Snapshot (19.04.19 – 26.04.19)			10 Year Bond Yields			Currency			Commodities		
FTSE 100	7428.19	↓1.26%	UK	1.14	↓4.67%	£/$	1.2919	↓0.56%	Brent Crude	$71.57	↓3.61%
S&P 500	2939.88	↑1.10%	US	2.50	↓2.34%	£/€	1.1588	↑0.29%	Gold	$1284.90	↑0.90%
NIKKEI 225	22258.73	↑0.26%	Germany	-0.02	↓191.30%	€/$	1.1149	↓0.88%			
DAX 30	12315.18	↑0.65%	Japan	-0.04		£/¥	144.1700	↓0.89%			
CAC 40	5569.36	↓0.40%									

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

Week Ahead

Monday –
Tuesday – Germany: CPI % m/m
Wednesday – United States: FOMC – Fed Funds Rate %
Thursday – Eurozone: Manufacturing PMI index
Friday – United States: Unemployment %

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