

Beta testing

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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.

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Market Focus

- » 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

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/Asia

- » 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

Currency returns					
Asset class/region	Currency	Week ending 15 March	Month to date	YTD 2019	12 months
Developed markets 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%

Source: Bloomberg. Past performance is not indicative of future returns.

Currency returns					
Asset class/region	Currency	Week ending 15 March	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%

Source: Bloomberg. Past performance is not indicative of future returns.

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