

# Weekly Digest

Week ending 13 August 2017

## Finding talent – is it worth the effort?

Yesterday was the final day of the IAAF World Athletics Championships and Londoners, once again, had the privilege of seeing the world's best athletes compete for the ultimate trophy of being crowned the World Champion. While watching them compete, we can say for certain; they are all extremely dedicated and hardworking, but only the most talented win the medals. In sport, talent is a prerequisite for success. Coaches know this and are willing to go through lengthy selection processes to find and identify the talent to work with, before molding them into champions. Clearly, searching for talented sports people is well worth the effort. You would never be able to compete with Mo Farah, no matter how much time and hard work we dedicated to running. How does this translate to the investment management industry; is looking for talent worth the effort?

Given the huge flows we have seen in recent years from active towards passive funds, the initial answer seems to be a certain "No!". More and more capital allocators are deciding to forgo the talent search altogether and opt out of active management in favour of passive investing, suggesting that finding talent is either too difficult or not worthwhile.

Disappointing performance from active managers and downward pressure on fees are two reasons often cited for the recent indexing revolution. But when people talk about disappointing performance of active managers, they often think of average manager performance or the proportion of managers underperforming their benchmarks. However, when managers of the core portfolios are looking for talented investment managers, they are not trying to find an average manager, nor do they need a majority of them to outperform as they only need to find a few outstanding managers to build a well-diversified portfolio. By focusing their efforts on identifying talented managers, drawing on experience gained by meeting hundreds of managers over the years and applying reasonable criteria and judgments, the portfolio managers can drastically improve the odds of finding top-quality managers that are likely to generate outperformance.

Active managers are currently going through a phase where outperformance is far more difficult to generate, which is being exacerbated by the trillions of US Dollars that have been flowing into ETFs and other passive strategies. The managers believe

this underperformance is a cyclical phenomenon and will eventually turnaround, as it has in the past. They have observed similar periods of extended underperformance in the mid 70's, late 80's and again in the late 90's during the tech bubble, and in each case the period of underperformance was followed by significant outperformance.

The portfolio managers believe that finding talented investment managers is a task well worth pursuing. There are certain asset classes, where evidence suggests that even the best managers struggle to add significant value and in such cases, they are happy to invest in passive index funds. However, in a majority of market segments they can identify persistent market inefficiencies, where a highly talented investment manager will deliver superior returns. The value-added by finding a superior investment manager can be substantial, especially over the long term. For example, a 2% higher return p.a. for a pension portfolio would, over 35 years, double the amount you would otherwise have.

So, how do the managers go about finding talent? The starting place for their manager research is the framework that encapsulates the traits of an excellent investment manager. They look for managers with a sound investment philosophy that is implemented in a disciplined manner, by experienced individuals that are supported and motivated to produce consistent outperformance over the long term by an appropriate firm structure. In addition, in any investment process it is vital to know what you are looking for, regardless of the asset class. For example, within equities the managers do not attempt to meet all managers, but rather focus our research on specific manager 'styles' - value, momentum and quality. They believe that these styles offer the best probability to succeed over time.

Even through this difficult period for actively managed equity strategies, the majority of our selected managers have delivered outperformance in recent years. This supports the manager's position that, given dedication with the right resources, it is possible to add significant value through manager selection. Furthermore, if and when flows to passive strategies slow or reverse they would expect even average results to improve markedly, with the marginal investor likely being more concerned about fundamentals than the average ETF!

## The Marketplace

- Oil prices finished the week -0.6% with Brent standing at USD 51.8
- Gold was up 2.4% and silver was up 4.9% on the week
- Global government bond yields continue to fall
- Bitcoin breaks the \$4000 barrier
- Global markets react to rising tensions between US and North Korea

## Market Focus

### US

- The S&P 500 Index was down 1.4% on the week closing at 2441, last Tuesday marked 73 trading days without a move <1%. Thursday saw a fall of 1.45% on the back of North Korean threats
- The Dow Jones was up +1% closing at 21858
- Nasdaq closed the week at 5831 on the week, down -0.12%
- The VIX volatility index jumped 55% from below 10 to 15.5

### UK

- Manufacturing stagnated in Q2 notably with vehicle production down 6.7%. Over the same period, Industrial output fell 0.4% and construction declined 1.3%
- BoE downgrades its growth outlook as the economy grew by 0.3% in Q2, a sign for continuing low interest rates

- UK's trade deficit widens to a nine month high of £4.6bn - a surprise given the weaker pound
- Sterling stands at a near eight year low against the Euro at around 1.1, GBP also extended its drop against USD standing at 1.3
- UK Equities down 2.2% with the FTSE closing at 7310

### Europe

- The European volatility index (Vstox) was up 26% to 18.9
- June trade reports published for France and Germany slightly weaker than expected on both imports and exports
- The Euro Stoxx 50 closed the week +2.9% at 3438.7
- Merkel's CDU party lead on 38% in German opinion polls for the federal elections.

### Asia

- The Nikkei was down 1.1% to 19729.7
- The Hang Seng index closed the week down -2.5% at 26883.5
- Japan's GDP for Q2 was up 1%, beating expectations
- Nuclear tensions escalate between the US and North Korea: Asian markets fell and then rebound at the beginning of this week as fears were slightly abated
- China's July exports at 7.2% year on year, lower than 11% expected. Imports were also down so trade deficit was stronger overall. Factory inflation rises 5.5% over the last three months

*Jernej Bukovec (CFA) & James Jones*

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Asset Class/Region	Currency	Currency returns			
		Week ending 11 August 2017	Month to date	YTD 2017	12 months
<b>Developed Market Equities</b>					
United States	USD	-1.4%	-1.1%	10.0%	13.3%
United Kingdom	GBP	-2.2%	-0.3%	5.5%	9.8%
Continental Europe	EUR	-2.4%	-1.0%	7.3%	12.9%
Japan	JPY	-0.9%	-0.1%	7.7%	25.7%
Asia Pacific (ex Japan)	USD	-2.3%	-2.4%	23.0%	18.3%
Australia	AUD	-0.4%	-0.4%	2.8%	7.9%
Global	USD	-1.5%	-1.1%	12.1%	13.8%
<b>Emerging markets equities</b>					
Emerging Europe	USD	-1.0%	0.1%	9.1%	18.5%
Emerging Asia	USD	-2.8%	-2.7%	26.5%	20.8%
Emerging Latin America	USD	-0.8%	0.2%	19.5%	12.5%
BRICs	USD	-2.2%	-1.6%	24.8%	23.2%
MENA countries	USD	0.5%	0.7%	5.1%	12.1%
South Africa	USD	-0.9%	-2.5%	12.5%	0.4%
India	USD	-4.0%	-3.4%	27.2%	19.4%
Global Emerging Markets	USD	-2.2%	-2.1%	22.8%	17.5%
<b>Bonds</b>					
US Treasuries	USD	0.5%	0.7%	2.9%	-1.4%
US Treasuries (inflation protected)	USD	0.6%	0.8%	2.2%	0.3%
US Corporate (investment grade)	USD	-0.1%	0.1%	4.6%	2.0%
US High Yield	USD	-0.8%	-0.7%	5.3%	8.9%
UK Gilts	GBP	1.1%	1.7%	2.3%	-4.2%
UK Corporate (investment grade)	GBP	0.6%	1.1%	4.4%	-0.2%
Euro Government Bonds	EUR	0.4%	0.8%	0.1%	-3.2%
Euro Corporate (investment grade)	EUR	0.2%	0.5%	1.9%	0.6%
Euro High Yield	EUR	-0.4%	0.0%	5.2%	7.5%
Japanese Government	JPY	0.1%	0.2%	-0.2%	-2.4%
Australian Government	AUD	0.2%	0.6%	3.1%	-1.4%
Global Government Bonds	USD	0.8%	0.8%	6.7%	-2.4%
Global Bonds	USD	0.5%	0.6%	6.7%	-0.4%
Global Convertible Bonds	USD	-0.5%	-0.7%	8.1%	5.6%
Emerging Market Bonds	USD	-0.3%	0.1%	6.9%	2.1%

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Asset Class/Region	Currency	Currency returns			
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<b>Property</b>					
US Property Securities	USD	-2.2%	-2.5%	0.7%	-5.5%
Australian Property Securities	AUD	-1.0%	-0.1%	-6.3%	-12.9%
Asia Property Securities	USD	-1.1%	-0.2%	20.5%	12.4%
Global Property Securities	USD	-1.7%	-1.6%	9.2%	1.2%
<b>Currencies</b>					
Euro	USD	0.6%	0.1%	12.4%	6.1%
UK Pound Sterling	USD	-0.1%	-1.3%	5.3%	0.4%
Japanese Yen	USD	1.6%	1.3%	7.3%	-6.5%
Australian Dollar	USD	-0.4%	-1.1%	9.7%	2.5%
South African Rand	USD	0.0%	-1.5%	1.9%	-0.2%
Swiss Franc	USD	1.1%	0.5%	5.9%	1.4%
Chinese Yuan	USD	0.9%	1.0%	4.4%	-0.5%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	-0.1%	-1.0%	-3.8%	2.4%
Agricultural Commodities	USD	-2.0%	-3.4%	-2.4%	-2.0%
Oil	USD	-0.6%	-1.0%	-8.3%	13.2%
Gold	USD	2.4%	1.5%	11.7%	-3.9%
Hedge funds	USD	-0.6%	-0.7%	2.8%	4.3%

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