UK EQUITIES

WAYS TO OUTPERFORM A CROWDED MARKET

IN A CROWDED MARKET OF UK EQUITY FUNDS, WHAT HELPS WEALTH MANAGERS DECIDE WHICH ONES TO INVEST IN?

BY SAM ANTROBUS

With just under £165 billion of funds under management as at September 2016, the Investment Association's (IA) UK All Companies sector remains by some distance the nation's biggest. But against a backdrop of cascading macro concerns, does big necessarily mean beautiful?

In a market as crowded as UK equities, it is easy to assume that wealth managers face something of a welcome problem when it comes to separating the wheat from the chaff.

For many investors, however, trawling through the country's largest investment sector comes with a range of pitfalls.

While Andrew Merricks, head of investments at Skerritts, would not compare picking a UK equity fund with searching for a needle in a haystack, he still sees plenty of difficulties in the current environment.

One metric he uses cautiously when weighing up the merits of a UK equity fund is that of performance. In his view, ascertaining the reasons behind performance is far more important than headline figures on factsheets and prospectuses.

'Take this year, for example – you've had plenty of people coming round saying how we should buy this fund or tracker, but several of them have only done well because they've held onto mining, oil and banking stocks – essentially, all the things that have done poorly over the last few years,' he explains.

'As an investor, you have to make a decision as to whether you want to chase these particular sectors, and you have to view past performance with a certain selectivity. For example, have these managers had one lucky strike? Or have they done well in a smaller fund, but tailed off as it's got bigger? There are a range of reasons for past performance and although you can't ignore it, you have to establish why.'

Considering consistency

Mark Williams, investment manager at Charteris, also believes that while performance is an important feature, it is not the only aspect investors should be paying attention to.

He points out a change in management can often leave little to go by in terms of judging performance moving forward, and investors must not fall into the trap of being attracted to awards and ratings that may have been achieved by a different management team.

Williams also suggests investors need to be vigilant as to why funds have changed hands. Although management houses may believe in their long-term view, performance can often see a boost without the new management team doing much but waiting for the tides of markets to turn.

'Some investment houses deliberately seek funds that performed badly the previous year as they potentially see more capital gain in the recovery of that fund. They may believe in their long-term strategy, but that certain market conditions worked against the fund in the short term,' Williams explains.

'For example, currency dropping rapidly has helped emerging market stocks soar, but left UK-centric retailers – such as Next – massively underperforming through the year-to-date.'

Others, such as Epoch Wealth Management's head of investments James Barber, prefer to put the hard data of past performance well under the microscope. In his view, it is important to gauge performance fluctuations throughout the market cycle to ascertain how different funds can work within a wider strategy.

'Consistency of performance under given scenarios is definitely important, particularly when viewed on a risk-adjusted basis,' he explains. 'By this, we simply mean identifying managers that will perform relatively well in certain market environments – and by association, underperform in other market environments – and blending strategies with a bias towards our own base case scenario, but without an over-reliance on one specific outcome.'

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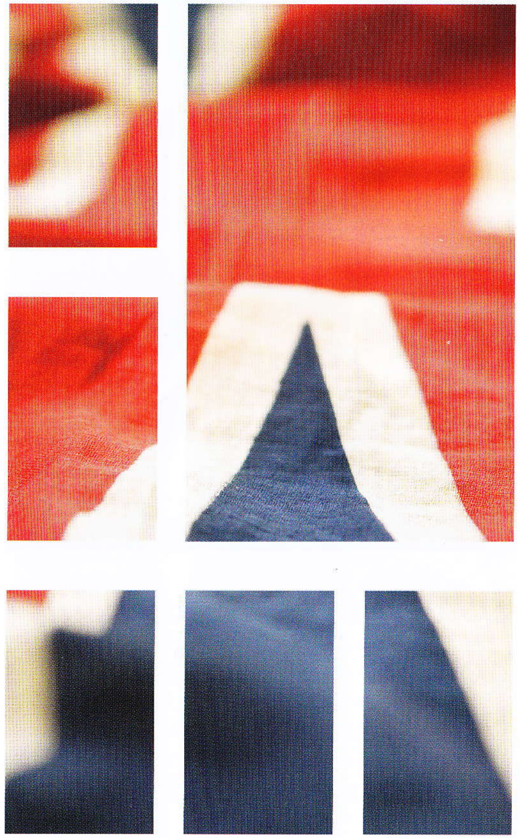

Hiding behind style

Yet, this notion of how certain fund strategies and managers only perform well within specific parts of the cycle leaves Merricks baffled. He

Continued on page 30

places little emphasis on management style when weighing up UK equity funds and believes some managers hide behind the concept of style.

'Managers who say they can only manage in a growth market, or that they stick to their guns because their processes have worked in the past – this has always puzzled me a bit,' he adds.

'We're in a different environment now after 2008 – I don't think there's any doubt about that – and managers have to move with the changes or risk being permanent underperformers. If you're in the UK All Companies sector, then live up to it. Strangely, investors don't want funds that only go up in certain cycles.'

In a low-growth and uncertain market environment, performing across market cycles becomes a need, rather than a want from investors.

Robert Love, head of research at independent financial research firm Asset Intelligence, broadly agrees with Merricks, suggesting that a blended approach arguably offers the best way of tackling today's UK equity market.

'The consideration of style fundamentally depends on investors' requirements when analysing funds,' he says. 'We typically advocate a blended approach with any overall stylistic biases carefully considered, given overall portfolio objectives, market conditions and expected outlook.'

Management style remains important for Williams, however, who sees it as a crucial factor when analysing potential new funds to invest in. He believes a style gives investors an insight as to how a management team views the markets and will flavour which stocks they want to have inside the fund.

'Are they yield hunters? Will they not have strong views on sector weightings as their portfolio of stocks is providing consistently high levels of yield to reward investors? What does the fund do to make it "stand out" in this crowded market? A manager's style can be a factor that makes a fund really stand out from the rest,' Williams explains.

'We have seen examples of highly thought-of managers setting up new products and investors have followed them to these new products because they specifically want their expertise – even though the new product has no track record to speak of.'

Market experience

While the importance of a stylistic trait is a point of contention with some investors, others – such as Barber – prefer to view style through the prism of market cap.

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Mark Williams
Charteris

In his view, it is not so much about whether a manager or team is contrarian, but more about how experienced they are within different segments of the market.

'We tend to analyse UK equity managers according to style or market-cap size as a starting point. For example, earlier in the year we specifically wanted to increase exposure to large-cap value-orientated UK strategies, so we shortlisted managers specifically operating in this space before completing more detailed analysis,' Barber says.

'In this respect, we do not give weight towards different styles, rather we will proactively identify the quality managers operating within each management style.'

So once all these factors have been taken int account, where does this leave investors in the current market environment?

Merricks sees real value in the balanced approach of Liontrust's Citywire AAA-rated Anthony Cross and Julian Fosh.

Merricks has a holding in the pair's co-managed Liontrust UK Smaller Companies fund. He praises the fund's ability to perform over a variety of cycles.

Love also appreciates the Liontrust duo. 'We have been admirers of the Cross and Fosh franchise at Liontrust, which follows their disciplined process,' Love says.

'By understanding the fund managers' proce and philosophy, you can be comfortable in retaining these funds during periods of relative underperformance.'

Merricks is also a big fan of the Castlefield Fund Partners SDL UK Buffettology fund. The fund is run by Keith Ashworth-Lord, who was Citywire A-rated in October.

'We've been in the UK Buffetollogy fund, which is in the UK All Companies sector. It's a good performer because it invests across all market caps with restrictions and discipline,' Merricks explains.

'What we don't like are all-cap funds that are 50% FTSE 100 companies. You might as well jus go for the index in that case.

'Very few large-cap managers outperform no and the outperformance comes from stock-picking in the mid-to-small caps, as well as the growing AIM market. The latter used to be frowned upon, but now offers some good opportunities for managers to pick up.'

Small caps in favour

Barber likes Mark Niznik of Artemis and believes his UK Smaller Companies fund has ar array of good risk characteristics. Niznik was Citywire + rated in October.

But it is not just the positives that Barber is looking out for in a UK equity fund. He sees opaqueness as a real red flag and also views shady communication from some fund management houses as a particularly importan feature to be wary of.

'When managers do not feel accountable or responsible to update investors on strategy, this is something that really puts us off,' Barber says

'Given the fees investors pay to fund managers, I do not think it is unreasonable to expect a certain level of communication in term of what they are doing.'