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Assessment of Value: What to consider when considering performance

Ready for Next

ASSESSMENT OF VALUE

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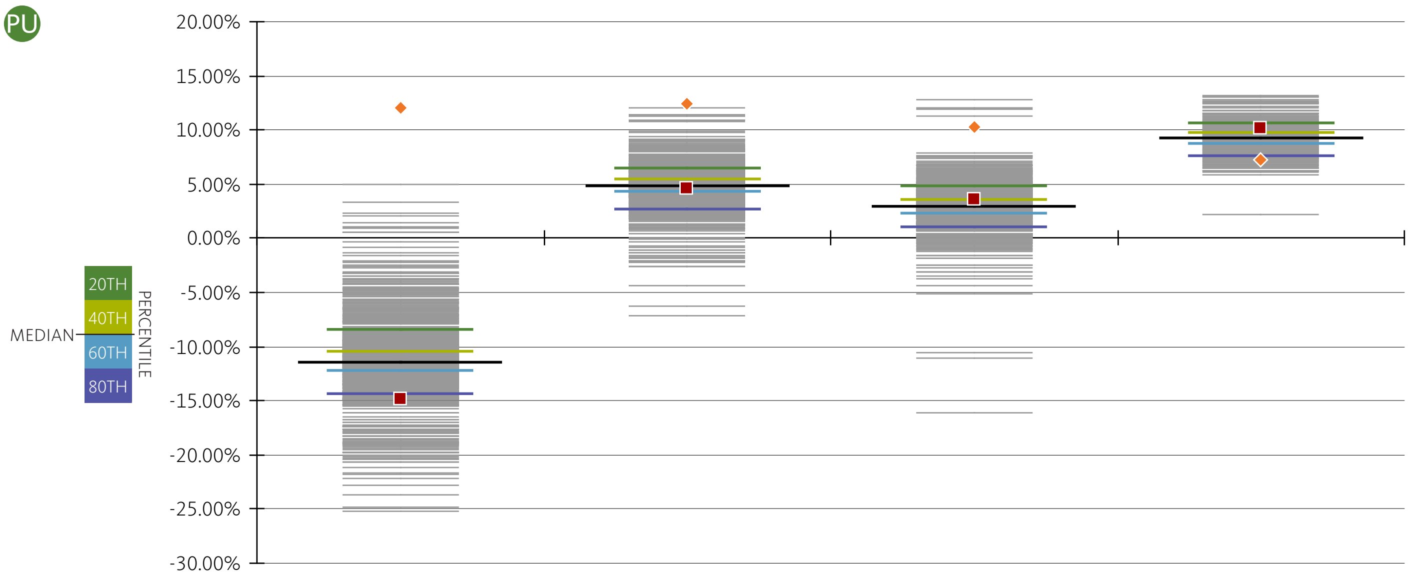
As we continue to understand how management companies will work through the Assessment of Value (AoV) process Broadridge will first review tools available for independent non-executive directors (i-Neds) and Executive Directors (EDs) to understand and evaluate the performance of each fund. According to the FCA’s rule a review of each share class’s net performance is a requirement of the AoV rule. In addition the review for range and quality of service likely includes some comparison of performance and risk. Beyond specifically requiring the review of net performance the FCA gives no other insight on how to look at performance. As with all aspects of the AoV rule Broadridge believes that prior to implmentation the management company and the i-Neds should agree on the process for the performance review.

One of the common themes Broadridge has heard related to the review of performance is that comparative performance can be difficult at times. As part of their Asset Management Market Study the FCA has noted the lack of clear and consistent performance benchmark reporting. With a new rule in place (FCA Policy Statement 19/4 https://www.fca.org.uk/publication/policy/ps19-04.pdf) Broadridge believes that comparative performance to the benchmark disclosed in a fund’s prospectus, the relevant IA sector, as well as other funds with the same (or very similar) benchmark is a relevant and realistic criteria to be reviewed during the AoV process.

Beyond looking at the net performance of a fund and various comparative performance metrics the evaluation of risk measures is a tool that can be useful to evaluating the value a fund provides to investors. By evaluating the right risk measures the board can be given an indication of how skilled the portfolio management team is, how closely (or not) a fund may be tracking an index, and how much overall risk is being taken to provide investment returns. A fund exceeding its benchmark performance with high relative risk may in fact not be providing value to an investor if the fund presents itself as minimizing risk to investors. Understanding the data is important, of equal importance is understanding what the fund says it will do and how it will do it for investors.

Figure 1

Total return performance annualised periods–universe



	One Year Ended 31/12/18	Three Years Ended 31/12/18	Five Years Ended 31/12/18	Ten Years Ended 31/12/18
ABC Fund 1 ■	-14.86%	4.56%	3.64%	10.12%
Rank	468/557	256/464	151/374	68/210
MSCI AC World TR GBP Index ◆	11.99%	12.45%	10.25%	7.28%
High	**5.02%**	**12.04%**	**12.79%**	**13.18%**
Low	**-25.16%**	**-7.15%**	**-16.06%**	**2.21%**
Median —	**-11.44%**	**4.87%**	**2.94%**	**9.27%**
Average	**-11.32%**	**4.65%**	**2.86%**	**9.26%**
20th Percentile	-8.46%	6.55%	4.80%	10.71%
40th Percentile	-10.43%	5.48%	3.65%	9.75%
60th Percentile	-12.22%	4.28%	2.37%	8.81%
80th Percentile	-14.30%	2.76%	1.10%	7.67%

WHAT DATA SHOULD WE LOOK AT?

Whilst the FCA is clear that as part of the AoV process net performance must be reviewed they do not provide specifics as to the timeframe needed for that review, or what else that review should entail. Based on Broadridge's work with U.S. boards for over 30 years we believe that displaying multiple time periods for performance is informative. In most cases we will display one-, three-, five-, and ten-year performance and if a fund has not been around for longer time periods we will include since-inception performance. With up to four time periods to look at, which is the most important, if that can be determined? To start the review of performance we recommend looking at the five-year net return, unless there is a specific recommended holding period provided by the fund, as this time period allows for the evaluation of a fund's performance over multiple market cycles and does not focus on short-term events that may impact a review of one-year returns. The inclusion of additional time periods allows for a review of consistency of approach as well as the ability to review the impact of any changes that have occurred to the management philosophy in the shorter time periods.

Beyond looking at point in time performance comparisons, a review of performance consistency, or the fund's batting average against its benchmark for an extended period of time, can prove useful when evaluation performance. A fund with

Figure 2

Performance consistency

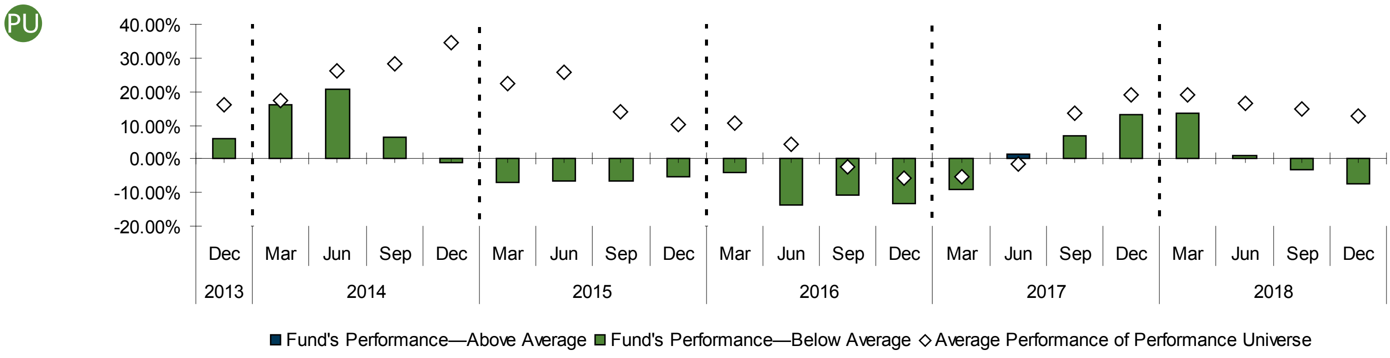
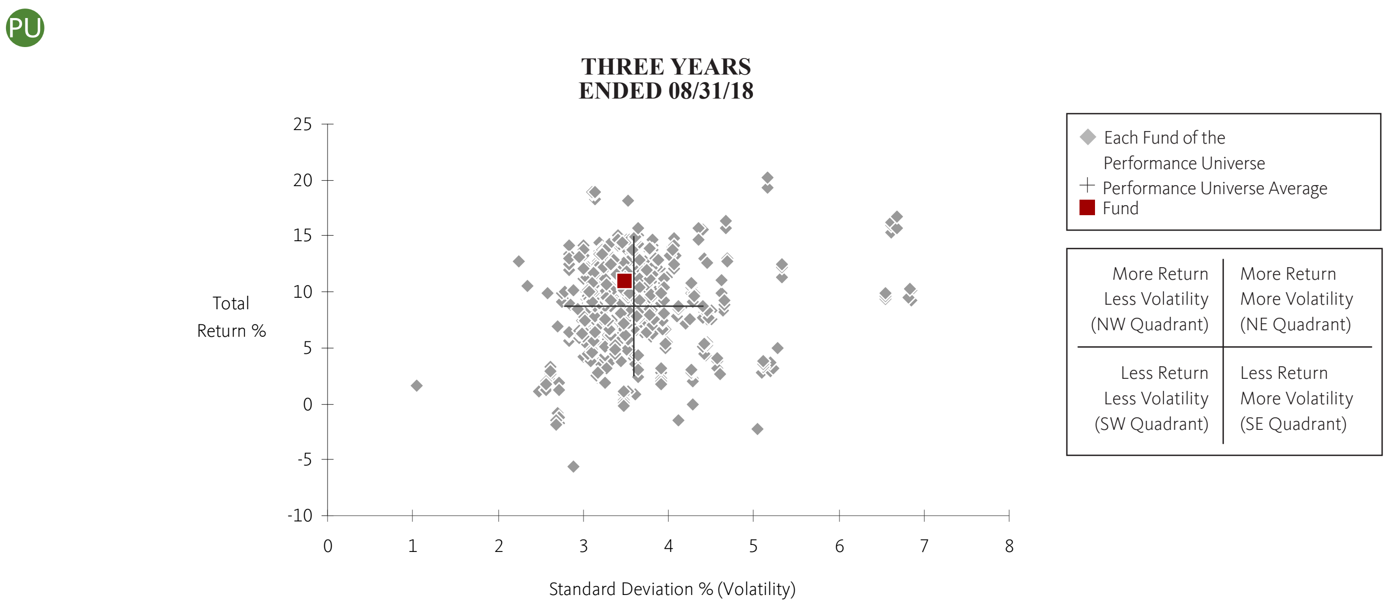


Figure 3

Volatility vs. total return

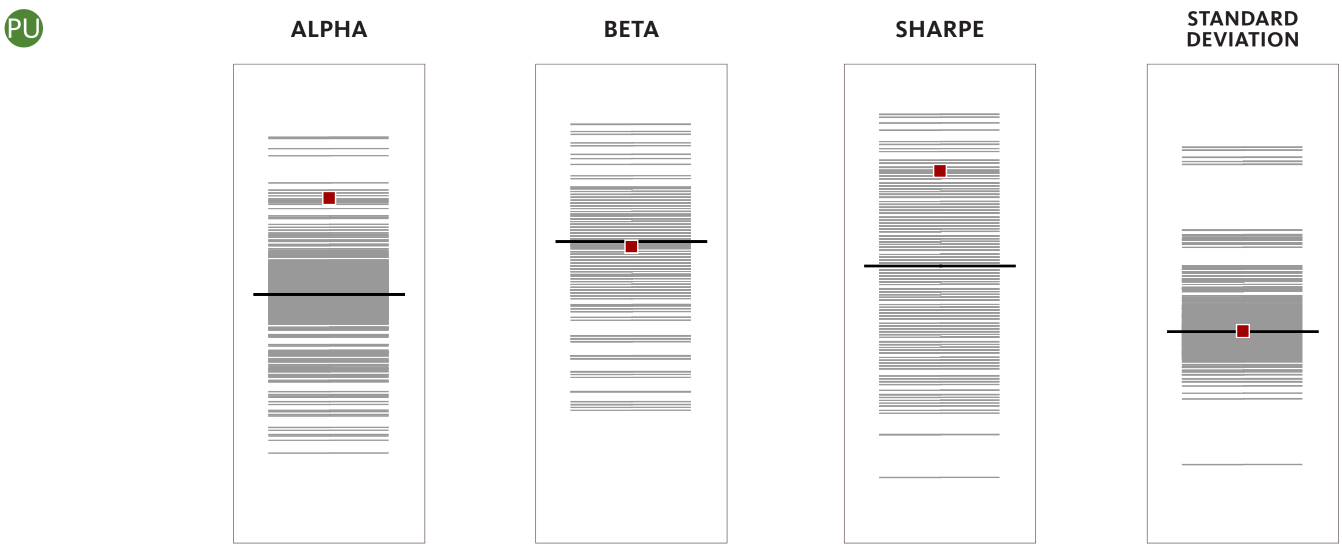


a healthy batting average (percentage of time on a rolling monthly or quarterly basis, usually for a five-year time period, the fund has outperformed the benchmark) is likely to be considered to provide greater value than a fund that at a point in time is outperforming its benchmark but has returns that are very volatile.

For unique funds there may be a need to pull in additional data and risk measures for evaluation of a fund. A fund that is intended to protect in a down market cycle may benefit from the inclusion of downside deviation or max drawdown as part of the performance review. Throughout the AoV process both the i-Neds and EDs should consider funds with a unique mandate and determine if special evaluation metrics are required.

Figure 4

Risk/return measure: three-year periods–universe



Fund ■	0.60
Rank	12/571
High	1.09
Low	-1.45
Median —	-0.18

Fund ■	1.01
Rank	329/571
High	1.46
Low	0.41
Median —	1.03

Fund ■	0.12
Rank	30/802
High	0.31
Low	-0.86
Median —	-0.18

Fund ■	3.50
Rank	392/802
High	6.86
Low	1.04
Median —	3.48

ASSESSING RISK

Performance evaluation is incomplete without understanding how much risk was involved in producing those returns. Risk may be defined in many ways, such as the probability of incurring a loss of capital or a loss beyond a predetermined amount or incurring loses relative to an index, but generally speaking it's the probability an investment's return will differ from the expected return.

While some risks may be defined before an investment is made (called ex ante risk) conventional fund governance is backward-looking and evaluates the outcomes (ex post) rather than the expectations. To that end, academics and practitioners have developed a multitude of calculations and statistics designed to explain or add context to fund performance and of those we find that five or six are regularly used. In order of their frequency in advisor contract renewal materials in the U.S. and a brief defintion:

Standard deviation - The workhorse of risk measures, it quantifies the variation or dispersion of a time series and is usually calculated over 36 months of total return performance. It may be compared to that of an index or a peer group median (and often both) to assess how volatile a fund's performance has been.

Modern Portfolio Theory ("MPT") statistics alpha, beta, and Sharpe. Several others are used as well but we've seen these three most commonly found together.

Alpha - Often called the active return of an investment it is calculated relative to a fund's benchmark. If a fund's return is even higher than its risk adjusted return, it is said to have "positive alpha."

Beta - This measures a fund's volatility compared to its benchmark, such that a fund with a beta of 1.15 is expected to be 15% more volatile than its benchmark. Beta is typically around 1.0 and can be positive or negative.

Sharpe ratio - The ratio of excess return over standard deviation, it compares fund returns to a risk-free rate such as 3-month T-bills or gilts and not relative to its benchmark. Higher ratios are considered better.

R-Squared - Often (though not always) used alongside the MPT statistics, it is the basis from which we can judge the relevance of alpha, beta, tracking error, and information ratio. It is calculated as the percentage of a fund's movements explained by the benchmark, where figures closer to 1.0 give us more confidence about the other calculations.

Tracking error - The standard deviation of the difference between fund returns and the index, sometimes thought of as a fund's index-relative consistency.

Other risk measures that are utilsed in evaluating funds, but at a less frequent pace are listed below.

Information ratio - Similar to tracking error but less common, it is the excess return of the fund versus its benchmark divided by its tracking error. It's sort of two tests in one: the degree of outperformance and the consistency of outperformance.

Active share - A relatively new entrant to the field of performance evaluation, it is the percentage of a portfolio that differs from its benchmark, where high active share means the fund is less like its index. Scores ranges from 0 to 100 and it uses of portfolio holdings and index constituents and weights for calculation. It is not readily available for non-equity funds and is somewhat limited as it looks at portfolio holdings at a specific point in time.

Upside and Downside capture - Upside shows how a fund performed relative to its benchmark by dividing the fund's monthly return by the benchmark return each month the benchmark was up, then multiplying all figures to get an "average" capture as a percentage. Downside capture is similar but only for those months when the benchmark was down.

WE HAVE ALL THIS DATA, NOW WHAT?

One concern with looking at data is how much is too much and does looking at various performance measures make it difficult to evaluate performance and the value given to a shareholder. Broadridge recommends starting with a single time period to use as the primary measure of fund performance, typically five-year net return. This comparison should be reviewed against each fund's primary benchmark as well as a competitor group, typically the IA Sector average. If a fund is performing well against these two measures, then typically a fund can be considered to be performing as expected and providing value. However, if a fund is underperforming against these two metrics, additional review of the performance will be useful for assessing value. Broadridge recommends a two-pronged approach when reviewing an underperforming fund. The first assessment is to evaluate various risk measures against the five-year period. Do the risk measure results correspond to what the fund states it is going to do as part of its investment objective? If so, then perhaps the fund is providing the value an investor is expecting. The second area of review for the i-Neds and the full board to consider is looking at other performance periods and overall trends. Does the fund's more recent performance improve, indicating that work being done by the portfolio management team is rectifying areas of concern? In addition to more recent time periods, reviewing how the fund has performed on a rolling quarterly basis may indicate if the five-year period is being weighed down by one or two excessively bad periods and otherwise is performing as expected. In a scenario like this once again it may be decided that the fund is providing value.

Fund	% of funds beating index Net Return	% of funds beating index Gross Returns
Active	28.1%	56.3%
Passive	10.5%	51.8%

Another factor to consider when reviewing a fund's performance against a market index is the challenge a fund has from the very beginning to exceed the performance of an index. Whether the fund is an actively managed fund or a passively managed product there are costs required to run the fund. A market index has no costs associated with it and therefore a fund with net performance (performance after all costs, including transaction charges, have been reduced from returns) even close to that of its market index is providing reasonable returns for investors. Given that indexes are not available for all funds in the UK, pending the new FCA requirement, we have generated data looking at funds in the U.S.. For the five-year period ended 31st December, 2018, returns for funds beating their index are shown below.

Underperformance against a benchmark requires an understanding by the board of what is occurring. Underperformance against a benchmark and underperformance versus a comparative group, especially for multiple time periods, will require a more detailed evaluation and discussion to determine what, if any actions need to be taken to provide investors greater value.

The evaluation of performance is difficult and requires both art and science to determine if a fund is providing value. Directors need to look beyond just the performance metrics we've outlined as useful throughout this paper and also understand the intent and focus of each fund. This will mean spending time reading and understanding the investment objective as stated in the prospectus and other investor-centric materials. Performance evaluation also will require a dialogue between the board and the asset manager to make sure the fund is being managed in line with the stated objective. It is possible for a fund to underperform both its benchmark and competitors while still providing value while it is equally important for a fund to exceed it benchmark and competitors while in fact not providing the value an investor expects because it is not being managed in accordance with its stated investment objective.

PREPARING FOR THE UNKNOWN

One part of the Assessment of Value work that management companies and i-Neds will need to undertake is the actual review of data and comparison groups to help determine if there is value for investors. A second major component to AoV, especially this first cycle, is related to the process. Management companies and i-Neds have never been through this evaluation before and effort spent now on the process to make sure everything is ready starting October 1, 2019 (or whenever your funds fiscal period ends) will make the work easier, more informed, and actionable. As part of this series Broadridge will be providing ideas on focus areas to make the process better.

THREE TO SIX MONTHS FROM FISCAL YEAR END

1. Once sample content and design are finalised do a dress rehearsal of the process with a subset of funds. This will allow for an understanding of the amount of time the process will take as well as areas where additional focus may be needed.

2. Engage i-Neds in formal training process, not just of what to review during the AoV process but also fund industry specific topics, as well as firm specific on-boarding and knowledge transfer.

3. Review data to be utilised within reports to ensure the accuracy with any third party vendors being used to source data.

4. Integrate feedback from i-Neds after the review of the dress rehearsal; if their suggestions aren't being incorporated provide feedback for reasons why.

Comments and questions from readers of this whitepaper are welcome. Additionally, if you would like to have more detailed data presented related to your funds we can incorporate that into a study. Please direct any feedback to:

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Broadridge, a global fintech leader with over $4 billion in annual revenue listed on the S&P 500 index, provides communications, technology, data and analytics. We help drive business transformation for our clients with solutions for enriching client engagement, navigating risk, optimizing efficiency and generating revenue growth.

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