The Tempest or Much Ado About Nothing?

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"All the world's a stage, and all the men and women merely players; they have their exits and their entrances"
As You Like It by William Shakespeare, who died 400 years ago on 23 April 1616

Q1 2016 Private Client Portfolio Performance Review

After a tough year in 2015, when private clients saw their investment portfolios deliver returns in line with or below inflation, 2016 began with a few market commentators predicting a financial market tempest. In early January RBS issued advice to their clients to brace themselves for a "cataclysmic year" caused by a global deflationary crisis, with major stock markets expected to fall up to 20% and oil prices plummeting to $16 a barrel. Andrew Roberts, head of European research at RBS, said "Sell everything except high quality bonds. This is about return of capital, not a return on capital. In a crowded hall, exit doors are small".

For the long term investor, who perhaps only checks their portfolio valuation once a quarter, the prognosis at the end of the first quarter of 2016 would have been that the scaremongering of RBS was much ado about nothing. The table below reveals that over the three months ended March 2016, whilst most investor portfolios were down modestly the results have been far from cataclysmic.

Private Client Index (PCI)	Risk relative to World Equities	GBP (% Return)	USD (% Return)	CHF (% Return)	EUR (% Return)
ARC Cautious PCI	0 – 40%	0.19	0.37	(1.13)	(0.79)
ARC Balanced Asset PCI	40 – 60%	(0.09)	(0.64)	(2.29)	(2.42)
ARC Steady Growth PCI	60 – 80%	(0.16)	(0.98)	(3.09)	(3.72)
ARC Equity Risk PCI	80 – 110%	(0.42)	(1.31)	(3.93)	(5.40)

Looking at various financial market indices, in Sterling terms UK equities were flat; global equities were up around 2%; Sterling government bonds delivered 4% return; and the oil price, far from collapsing towards $16 a barrel actually increased by $1 to $38 a barrel.

But, quarter end snapshots hide evidence of an underlying market turbulence that has been creating significant disquiet for financial market participants. During the quarter, the valuation range for equities was circa 12%, with nearly half of all trading days seeing UK equity market moves of 1% or more. Those investors with a nervous disposition could be forgiven for wishing that they had followed the advice of RBS and headed for the (apparently) safe harbour of Gilts.

Daily Market Gyrations (GBP terms)	Trading Days Above 1% Change	Max Loss From 31 Dec (%)	Valuation Range (%)	Biggest Daily Gain (%)	Biggest Daily Loss (%)
UK Equities	45%	(9.7)	11.6	3.1	(3.5)
International Equities	37%	(11.1)	12.6	3.4	(2.2)
Gold	34%	0.0	24.1	4.6	(2.0)
Commodities	33%	(4.0)	11.2	2.9	(2.9)
UK Government Bonds	6%	0.0	6.0	1.5	(1.1)

However, with 30 year Gilts yielding just 2.3% per annum such a move would probably be a mistake. The father of value investing, Benjamin Graham, writing after the Great Depression, suggested that in the short term the stock market is rather like a voting machine but in the long term it is a weighing machine. Gilts surely do not offer great value although they may become more popular as they offer less volatility.

The answer for most private client investors is to invest with discretionary managers who adopt a multi-asset class approach to investing with the intention of smoothing the gyrations of particular markets and seeking out the pockets of value that exist in asset classes, sectors and geographies. The table below clearly shows the advantages of a multi-asset class portfolio during periods of significant market volatility. For Cautious portfolios no trading day would have been recorded with greater than a 1% change in valuation. For equity risk portfolios, less than 1 in 4 days would have seen the portfolio value move more than 1% as compared with nearly 1 in 2 days for a purely UK equity portfolio.

Daily Market Gyrations (GBP terms)	Trading Days Above 1% Change	Max Loss From 31 Dec (%)	Valuation Range (%)	Biggest Daily Gain (%)	Biggest Daily Loss (%)
GBP Cautious PCI	0%	(2.6)	3.4	0.9	(0.6)
GBP Balanced Asset PCI	3%	(4.8)	6.0	1.6	(1.2)
GBP Steady Growth PCI	11%	(6.0)	7.8	2.0	(1.6)
GBP Equity Risk PCI	23%	(7.3)	9.7	2.4	(2.0)
UK Equities	45%	(9.7)	11.6	3.1	(3.5)

In summary, the first quarter of 2016 has certainly not been a tragedy but neither has it been a comedy. It has been more akin to a historical play in which the actors have made their entrances and exits, with the main lesson to be learned being that whilst the past might inform the present it does not predict the future.

Does Choice of Actor Matter?

With increased volatility in financial markets has come a greater concern by investors surrounding the investment style being adopted by discretionary managers for their clients. Are managers actively seeking to add value for their clients or are they hiding behind “benchmarks”? Are private client investors receiving value for money from their discretionary managers or is the European Securities and Markets Authority (ESMA) accurate when they claim that as many as one in seven funds are closet index trackers charging active management fees?

ARC has investigated this question using the universe of 48 discretionary private client managers who have been submitting data for the calculation of the ARC PCI for 5 years or more.

The results are interesting as they suggest that last year (2015) there was far less dispersion in the pattern of returns than has been the case when a longer time period (5 years) is considered. In other words, over the last year or so, it appears that investment philosophy; style; and process has not created a material differentiation in end result. But, history suggests that this outcome will not persist.

The analysis has used correlation to measure the extent to which each discretionary manager’s performance tends to correspond to other managers performances. Correlation is measured on a scale from +1 to -1. A correlation of +1 represents perfect unison, with up and down movements synchronised and in proportion. Correlation of zero represents complete independence, with the up and down movements of one variable having no relation to those of the other. Correlation of -1 represents perfect unison but this time with the two moving in opposite directions. Index-tracking funds aim to have a correlation with their benchmark close to +1. Hedge funds aim to have a correlation with market indices close to zero.

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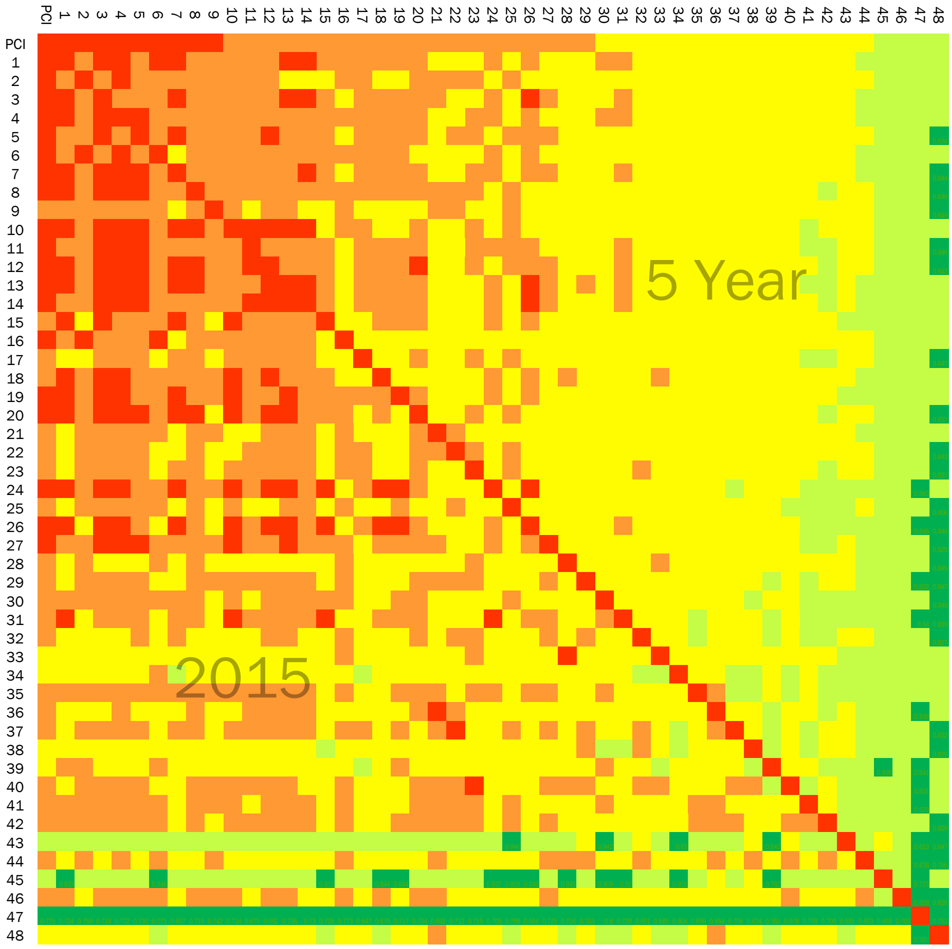
The chart below plots the correlation "heat map" for average outcomes in the ARC GBP Steady Growth PCI universe for 48 discretionary private client managers relative to one another over 1 and 5 years. High correlation is shown as red and low correlation in green with shades of red and green in between. Thus, red squares indicate two managers whose return patterns tend to be very similar in terms of direction, whereas green squares indicate managers whose performance characteristics tend to be quite different. For example, over 5 years, manager 48 at the far right of the chart has a predominance of green squares. This implies that this manager is running their portfolios in quite a contrarian manner when compared to the rest of the peer group.



To give a sense of the way in which all managers seem to have been pointing in the same direction in 2015 consider the "square count" for the two periods:

Correlation	2015 (%)	5 Years (%)
	11	2
	36	20
	40	54
	8	21
0.82	5	3

The cumulative data reveals that perhaps half of the discretionary managers having very similar performance characteristics in 2015 but over the longer period the figure is more like 1 in 5 managers:

Correlation	2015 (Cumulative %)	5 Years (Cumulative %)
	11	2
	47	22
	87	76
	95	97
0.82	100	100

Conclusions

- Q1 2016 saw significant intra quarter volatility but financial markets ended the quarter roughly where they had started it. The predicted cataclysm did not occur and it was less the tempest and more much ado about nothing!
- By having a multi-asset class portfolio, private client investors saw the effect of the gyrations of various financial markets successfully mitigated.
- In 2015 (and the first quarter of 2016) the performance impact of differing investment styles and approaches seems to have been much lower than has typically been the case. We do not expect that to last and believe that financial markets are moving from a voting machine phase to a weighing machine phase; the sooner this happens, the better.

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A full list of Data Contributors to PCI is available at www.suggestus.com