PRIVATE CLIENT INDICES

Bonds Bamboozle Benchmarking

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ASSET RISK CONSULTANTS

Cecil Graham: ***"What is a cynic?***
Lord Darlington: ***"A man who knows the price of everything, and the value of nothing."***
Cecil Graham: ***"And a sentimentalist, my dear Darlington, is a man who sees an absurd value in everything and doesn't know the market price of any single thing."***
— Oscar Wilde, Lady Windermere's Fan

Q3 2016 Private Client Portfolio Performance Review

Equity and bond markets rallied in July, fuelled by speculation that central banks would extend the supportive monetary policy post-Brexit, and a degree of positive correction after pre-Brexit nerves. Bond yields fell again, with the 10 year US Treasury note reaching its lowest level ever. Sterling fell to new lows against the US Dollar and the Bank of England cut the interest rate by 0.25%. August saw a very narrow trading range on developed equity markets, but the Far East and Emerging markets enjoyed a strong month. As the summer came to an end, global equity markets resumed their ascent to fresh highs as the U.S. Federal Reserve delayed an increase in short term interest rates, despite significant pressure to do so. There was also a surprise in oil markets as OPEC proposed a cut in oil production, leading to a boost in the price of oil. Ongoing depreciation of Sterling sent equity markets towards new highs in Sterling terms and the companies of the FTSE 100 felt a tailwind on their international earnings. Smaller companies also benefitted as investors hunted for yield in an ever more difficult environment.

For private client portfolios, this translated into a positive quarter across all four PCI currencies and all four PCI risk categories as can be seen in the table below. The impact of Sterling depreciation can clearly be seen in the data.

Private Client Index (PCI)	Risk relative to World Equities	GBP Q3 2016 Return (%)	USD Q3 2016 Return (%)	CHF Q3 2016 Return (%)	EUR Q3 2016 Return (%)
ARC Cautious PCI	0 – 40%	3.1	1.6	1.0	1.6
ARC Balanced Asset PCI	40 – 60%	4.9	2.7	1.9	2.0
ARC Steady Growth PCI	60 – 80%	6.4	3.4	2.7	2.8
ARC Equity Risk PCI	80 – 110%	7.2	4.4	3.4	3.6

So despite the shock of Brexit and the various political and economic clouds gathering on the investment horizon, private client portfolios in Q3 2016 made useful progress across the spectrum despite the impression of doom and gloom being peddled by the media.

Three Year Performance Numbers

The three year numbers also continue to look strong and investors who have been willing to ignore the periodic swings in sentiment that have characterised financial markets over recent years have seen a material uplift in their real wealth.

Private Client Index (PCI)	Risk relative to World Equities	GBP 3 Year Return (%)	USD 3 Year Return Return (%)	CHF 3 Year Return Return (%)	EUR 3 Year Return (%)
ARC Cautious PCI	0 – 40%	11.9	6.3	3.9	6.7
ARC Balanced Asset PCI	40 – 60%	16.7	7.4	8.6	9.7
ARC Steady Growth PCI	60 – 80%	20.7	8.6	11.0	13.9
ARC Equity Risk PCI	80 – 110%	22.5	10.2	14.8	15.9

Yet, anecdotal evidence from meetings held with managers and with private clients by ARC suggests that many private clients have a feeling of disappointment over the level of returns that have been achieved by their discretionary managers over the last few years. There is a sense of opportunity foregone and a questioning of whether a "passive" index-tracking strategy would serve them better.

The Benchmark Problem

The strange fact is that, despite private client portfolios delivering positive returns over the last three years, many investors may be left feeling short-changed as their portfolios are likely to be well behind typical composite index benchmarks. By way of illustration, consider the performance of Sterling portfolios versus the four FTSE WMA Private Investor Indices which are described as "calculations which indicate the returns that investors might expect from their portfolios".

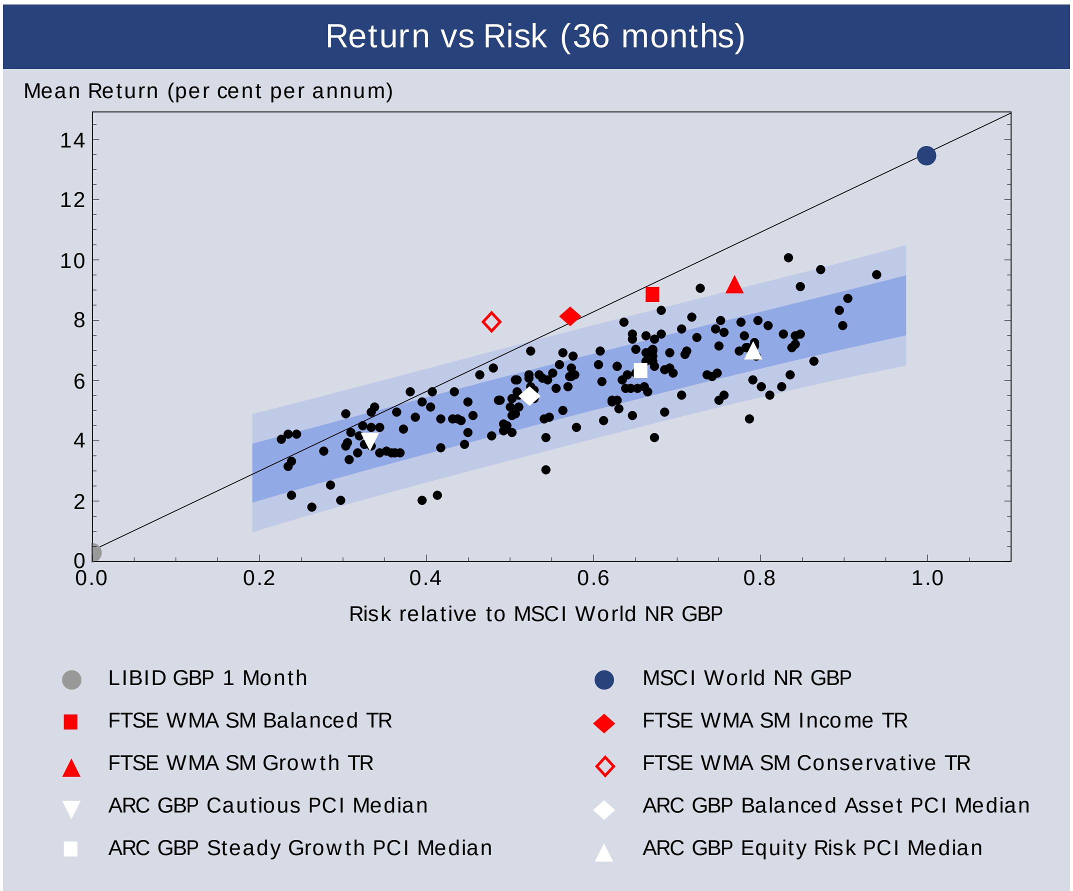
Private Client Index (PCI)	GBP 3 Year Return (%)	WMA Index	GBP 3 Year Return Return (%)	Difference (%)
ARC Sterling Cautious PCI	11.9	WMA Conservative Index	26.8	**(14.9)**
ARC Sterling Balanced Asset PCI	16.7	WMA Income Index	27.4	**(10.7)**
ARC Sterling Steady Growth PCI	20.7	WMA Balanced Index	29.8	**(9.1)**
ARC Sterling Equity Risk PCI	22.5	WMA Growth Index	31.1	**(8.6)**

The difference between the actual returns experienced by private client portfolios and the theoretical returns of the FTSE WMA Private Investor Indices has clearly been very significant. Does this mean that discretionary investment managers have been performing collectively poorly or might there be another explanation? Indeed, from a practical perspective, should a private client part company with their discretionary manager because that manager has failed to deliver returns more in line with the FTSE WMA benchmarks?

The Sharpe chart opposite plots (in red) the four WMA Private Investor Indices versus the ARC Sterling PCI Universe of 69 Data Contributors and in excess of 100,000 underlying private client portfolios.

Firstly, note that the risk-adjusted return of the four WMA Private Investor Indices is superior to nearly all the Data Contributor averages (shown by the black dots).

Secondly, even the lowest risk WMA index has a risk of around 0.5 times world equity markets.



It is reasonable to extrapolate that the majority of Sterling private client portfolios run by discretionary managers will have failed to deliver a return above or even in line with typical benchmarks employed by the industry, with the under-performance becoming wider as the non-equity content grows. Hence the feeling by private clients that discretionary managers have not been doing as well as might have been expected.

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Cynics or Sentimentalists?

As part of the delivery of the PCI service to Data Contributors, ARC visits all Data Contributors every quarter to discuss the results. These meetings provide a valuable insight into industry trends; insight that we share directly with clients. One trend that has been evident over the last few years has been a consistent view that government bonds have not offered an attractive risk-return trade-off and the risk budget for bond exposure is better expended on credit risk than duration risk. This prevailing view has led to the majority of private client discretionary managers maintaining an underweight exposure to longer-dated government bonds and an overweight exposure to shorter dated corporate debt.

The reasoning for this tactical asset allocation has been that since mid-2011 the nominal yield on the 10 year Gilt has been below 3% and since mid-2012 the nominal yield has, on occasion, dropped below 2% per annum. Then in Q3 2016 the nominal yield moved substantially below 1% per annum. At the long end of the curve, the yield on the 30 year Gilt dropped below 3% in late 2014 and below 2% in Q3 2016. As yields approach zero, the effect on price of moves in the nominal yield becomes more exaggerated. Thus, the 3 year return from the longer dated Gilt index (maturity >15 years) has been circa 50%, around 10 times the return from short-dated Gilts (maturity < 5 years).

With the typical bond component for composite benchmarks, the FTSE Actuaries All Stocks Gilt index, being up circa 25% over the last three years, most discretionary managers have seen the non-equity portion of their portfolios underperform significantly.

But, when asked whether they would do anything different faced with the same scenario again, most discretionary managers robustly defend their decision to hold shorter duration bonds claiming that their job is to invest not speculate.

Oscar Wilde described a cynic as someone who knew the price of everything and the value of nothing. By contrast, a sentimentalist sees the value of everything but knows the price of nothing. It appears that the majority of private client discretionary managers are in fact cynical sentimentalists! They know the price of government bonds and are not prepared to buy such assets for their clients when they offer no value. As many PCI Data Contributors have told us over the last few years, to invest in a government bond offering a negative real return and in many cases a negative nominal return as well is speculation not investment as holding that asset to maturity offers no prospect of delivering what every private client is seeking, namely a return above inflation.

Conclusion

Despite positive returns in Q3 2016 for all risk categories across all four PCI currencies, many private clients have been left feeling that their managers both could and should have delivered higher returns. This feeling has been growing over the last few years as returns from private client portfolios have lagged behind index-based composite benchmarks.

Never has peer grouping been more important for understanding how well your portfolio is doing because, in seeking to protect private clients and avoid speculation, discretionary private client managers have deliberately allowed the structure of private client portfolios to diverge significantly from the asset allocation of conventional baskets of indices. Having an underweight exposure to longer-dated government bonds may have been the rational response of “cynical sentimentalist” managers but it has carried a short-term performance cost as low government bond yields have trended ever lower and during Q3 2016 reached historical lows.

In this unusual and unprecedented environment, it is fair to say that bonds bamboozle benchmarking. Instead, considering portfolio performance versus the peer group should be the primary guide in helping to understand if a portfolio is performing in line with expectation.

For further information:

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