FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

21st October 2016

Actively Passive

The financial press this week didn't dwell too much on the 29th anniversary of one of the earliest tumultuous financial events, that many of us recall - the stock market crash of 1987, so neither will we, except to acknowledge the significance of the event and that it changed the markets for some time to follow and for many of us, how we interpret and price portfolio risk and diversification. Instead we thought we'd have a look at an ongoing and likely never ending debate surrounding Active or Passive investing styles, which is best, and if there are only two styles really? We'll also touch on Blackrock Inc.'s release on the topic this week and consider why we are noting steady growth in the use of structured product investments within portfolios.

We know that "Passive Investing" or index tracking asset management is booming. Blackrock Inc. confirmed that view this week when they announced that their assets topped US$ 5,120,000,000,000! Or $5.12 trillion in less *Austin Powers* terms. Their Q3 net inflows alone, a staggering $55 Billion of which over $51 Billion was into its iShares ETF business. The iShares business accounts for roughly a quarter of their $5 trillion managed assets, but the trend is evident. The Wall Street Journal (WSJ) also noted that passive mutual funds and ETF's ownership of the S&P500 had more than doubled to 11.6% since 2005 and one manager alone controls 5% or more, in almost all constituents.

Interestingly, around half of Blackrock's Active equity funds have underperformed their benchmark over 12 months to the end of September and therein lies one reason for the growth in index tracker funds. The image of a swashbuckling fund manager regularly taking on the masses backing their view to regularly outperform their benchmark is an investor's ideal. However, as the WSJ points out *"there is a simple destructive idea taking over Wall Street: that stock pickers can't pick stocks well-or at least well enough for their fees".* Not a view we share at Fortem Capital as we know many of our readers do outperform regularly, however the flow of investment monies from active to passive mandates is undisputable. Active investing has worked better than passive indexing in certain market conditions. During the market downturns of 2001-02 and 2008-09, active managers generated better-than-market returns for their clients. So in volatile times when correlation breaks down, active managers can add more value.

However, we'd suggest that correlation has increased amongst geographical, size or industry equity classes in the current low rate global equity market, and would propose that the real absolute performance differential derives from the asset allocation decision rather than whether an active manager has beaten the chosen benchmark index in most cases. Choosing the benchmark index though isn't easy either, as the Streetwise section of the WSJ observed, *"the S&P Dow Jones Indices alone have over one million indices to choose from- ranging we'd suggest from the S&P 500 to the Dow Jones Islamic Market Peru Small Cap Technology Index."* Then there are debates around what's the best constituent weighting methodology? Market Capitalisation (S&P500); Price Weighted (Dow Jones Industrial Avg.) or Fundamentals such as the increasingly popular FTSE RAFI US 1000.

The trustee of client monies with an open mandate have to allocate between asset classes, then geography, then size or industry, then select best benchmark methodology, and finally decide active or passive… it makes our derivatives knowledge, modelling and structuring seem simple by comparison!

Product	Participation
Topix Supertracker, 6yr, GBP daily hedge, 70% EKIP, final year averaging	206%
S&P 500 Booster, 6yr, USD, 60% EKIP, 2.30x participation between 85-115% of initial strike	230%

Rates (bps)		
	Current	Week Chge
GBP 1yr	55.50	-0.70
GBP 3yr	62.10	-0.50
GBP 5yr	72.00	-2.10

Equity Indices (%)		
FTSE 100	7051.83	0.55%
S&P 500	2151.13	0.85%
Nikkei 225	17,184.59	1.95%
Eurostoxx 50	3073.78	1.61%

Currencies (%)		
GBPUSD	1.2214	0.19%

5yr Credit Spreads (bps)		
Citigroup	76.67	-3.78
Credit Suisse	131.27	-8.67
Deutsche	217.73	-4.19
GS	91.75	-3.44
HSBC	75.70	-5.65
JPM	62.59	-0.89
MS	86.64	-4.66

Commodities (%)		
Gold	1265.99	1.20%
Oil	50.88	0.26%

3m Implied (vol pts)		
FTSE 100	13.31%	-2.22%
S&P 500	13.22%	-1.20%
Nikkei 225	17.51%	-1.99%
Eurostoxx 50	19.02%	-1.95%

5yr Implied (vol pts)		
FTSE 100	19.65%	0.04%
S&P 500	20.99%	0.00%
Nikkei 225	18.92%	-0.39%
Eurostoxx 50	20.01%	0.21%

Source Bloomberg / Partner Banks
Data as at 21st October, 12.30pm

Upcoming events	
End of Oct	Various Eurozone inflation and monetary statistics released
28th Oct	US GDP (prelim)

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In summary, the significant growth in assets managed passively has not gone unnoticed and has implications for all. Even passive managers will seek to enhance performance through stock lending or attempt to better the index rebalancing levels or utilise futures at advantageous times and to manage cash flows.

So tracker funds have significant appeal to many:

(i) costs are considerably lower than actively managed funds and
(ii) they typically deliver what they say on the can so there is some confidence that when one has chosen their benchmark, they then should actually receive that benchmark return.

Structured investment products, we suggest, offer similar benefits to index tracker funds:

(i) Structured Products deliver lower cost exposure, where all costs are known in advance
(ii) If held to maturity they will deliver precisely what they stated at the start*

So Structured Products offer a low cost investment and a certainty of performance to initial proposal. If a structured investment product says it will deliver twice the upside of the Topix index in GBP, then assuming the Bank Issuer remains in place *(credit risk)* the investment return will be precisely that, no more and no less, to investors.

Structures deliver one further critical advantage; the investor can define the precise risk and return profile based on future performance of their reference underlying, effectively crystalizing the hidden inherent value of that underlying index, indices, stocks in a manner to augment their personal investment view, but that's for another day…

**Subject to credit of Issuer, see credit risk www.fortemcapital.com*

Disclaimer

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