BreedElliott

happiness through sensitive financial planning

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Selecting Individual Funds

The purpose of this month’s newsletter is to explain how we go about selecting individual funds to hold in clients’ portfolios.

As you already know, we believe that asset allocation is the most important factor in determining the future returns from any given investment portfolio. We also believe that carefully managing the mix of assets in an investment portfolio is an important part of how we add value to a client’s overall financial planning in the long-term.

You will be aware that a key feature of our regular review meetings is the ‘rebalancing’ of the asset allocation within an investment portfolio into line with the agreed benchmark.

However, having an effective process for the selection of individual funds can have a beneficial impact on the overall return from a portfolio and we are taking the opportunity in this newsletter to explain that process.

The challenges

There are a number of challenges we face when selecting individual funds and we have summarised the main ones below.

- The number of funds - we can select from over 3000 funds!
- Past performance - as we are constantly reminded, past performance is not an accurate guide to future performance.
- Active fund management – if we are going to pay more for active fund management, we want to feel sure that the fund is being actively managed and is not simply mirroring its index/benchmark.
- The fund manager - fund management groups and individual fund managers change over time and we need to keep track of these changes and to monitor their impact.

Our beliefs

Partly to help us to deal with these challenges and partly to have a sure foundation for the development of our fund selection process, we hold the following beliefs:

1. The choice of individual funds will not have as significant an impact on future investment returns as the asset allocation.
2. It is impossible for us to consistently select those funds that will be the best performing funds in the future.
3. Managed funds that invest in a selection of different assets and vary their asset mix without reference to us reduce the effectiveness of our control and management of the asset allocation within a client's portfolio. Therefore, we tend to avoid investing in such funds unless they are specifically selected by the client or we decide that a mixed asset product or fund is most suitable.
4. Multi-manager funds tend to charge clients more without any firm evidence that they produce superior returns. Therefore, we tend not to recommend such funds unless specifically requested by a client.
5. Actively managed funds that aim to generate better returns than their benchmark Index by genuinely looking to diversify their portfolio away from the Index, offer the potential to provide better returns than passively managed funds, such as index trackers or exchange traded funds, which aim to track their benchmark, or so-called actively managed funds that just mirror the Index.

6. However, in the more efficient, developed markets such as the UK and US, where information is so readily available, it can be more difficult for an actively managed fund to 'steal a march' on other actively managed funds and on passively managed funds, which simply aim to track an index. Therefore, in the developed markets, we may recommend passively managed funds when clients are either cost conscious or when they are prepared to accept returns which slightly underperform any chosen Index in a consistent manner.

Our process

- **Fund Research**

The first step is to create a shortlist of funds from the galaxy of funds available. To do this, we work with a company of specialist research consultants who use qualitative and quantitative measures to identify funds that they rate, which represent approximately 10% of the fund universe.

- **Fund Sectors**

Once we have this shortlist, we further reduce the number of funds by removing the multi-asset and multi-manager funds in accordance with our beliefs as set out above.

We then divide the remaining funds (which total approximately 300) into the various sectors defined by the Investment Association. Sector definitions are mostly based on assets, such as equities, property and fixed interest and may also have a geographic focus. They enable investors and their advisors to compare funds on a like-for-like basis.

Our shortlist of funds is broken down into 25 different sectors.

- **Our Investment Committee**

We now have a shortlist of approximately 300 funds which have all been rated by an independent research consultancy, divided into 25 different sectors.

Our Investment Committee consists of our five partners and we allocate five different sectors to each partner. Their role is to conduct further research into the funds within their allocated sectors and to monitor and review the performance of these funds on a quarterly basis.

From their research, they will highlight two or three funds within each sector which they believe offer the best potential for outperforming the sector average in the future.

The Investment Committee meets every month. As part of our discussions, we will review our fund selection process and identify any significant changes in fund selections since our last meeting.

- **Constructing new portfolios**

When we are constructing a new portfolio of funds for a client, the most important consideration is agreeing a suitable asset allocation benchmark with the client based upon their risk profile and investment objectives.

Once the asset allocation benchmark has been agreed, we will select individual funds from our shortlist which have been highlighted by our fellow partners through the Investment Committee as offering the best potential for future outperformance.

The combination of these various funds within the portfolio will achieve the asset allocation benchmark. We will provide our client with important information about each of the individual funds selected.

- **Reviewing existing portfolios**

At a typical review, we will first confirm with our client their risk profile and investment objectives for their portfolio and agree the asset allocation benchmark going forward. We will then review the selection of individual funds held within the portfolio. To keep things simple, we use a traffic light system as follows:

A green tick indicates that we believe that the fund will continue to generate returns which are better than its sector average and that we recommend holding the fund.

An amber exclamation mark indicates a concern that future returns may not be as competitively strong as in the past. However, we still recommend holding the fund.

A red cross indicates that we believe that the fund will not generate competitive returns going forward and that we recommend switching to an alternative fund within the same sector.

As stated in ‘Our beliefs’ above, it is impossible for us to consistently select those funds that will be the best performing funds in the future. However, we are confident, based upon many years’ experience of managing this process, that the majority of individual funds held within any given portfolio will generate returns which are above the sector average over the next 12 months.

Summary

We hope you have enjoyed learning more about our fund selection process. If you have any further questions, please do not hesitate to ask us.

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Market	Value at the start of 2018	Current situation	Comments
Interest Rates (BOE base rate)	0.25%	0.50% at 30.06.18	The official bank rate is 0.5%
House Prices (Nationwide)	House prices increased by 2.6% in 2017	House prices up by 0.5% at 30.06.18	UK annual house price growth has slowed to a 5 year low.
UK Share Prices (FTSE 100)	7142.83	7587 at the close on 30.06.18	The FTSE 100 starts the third quarter of 2018 in 'negative territory'.

Helping you to manage your money

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