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Close Tactical Select Passive (TSP)

Monthly fund manager update

February 2019

Review

2019 has, so far, been very good with equity markets rallying in sterling terms in January and February despite sterling strength. All of the funds in the range were positive in February: Growth managed to outperform its IA peer group, and Conservative and Balanced marginally underperformed theirs.

Most developed market equities were up over 2% apart from Japan, which was down around -1% over the month in GBP terms. Additionally, we have seen some divergence between equity performance in Asia Pacific and Emerging Markets with the former up about 1% and the latter down about -1%.

The impact of currency hedging was noticeably felt in our European large-and mid-cap equity exposure. Due to sterling strength, the best performing fund in February was the currency-hedged UBS MSCI EMU ETF surging +4%, while an unhedged peer, Xtrackers DJ EuroStoxx 50, delivered a more modest +2.8%.

Fixed Income was mixed. The sterling corporate bond market was flat and Gilts down almost -1%. Bonds with longer duration such as Lyxor FTSE Actuaries UK Gilts (-0.95%) and iShares Core Corporate Bond (-0.05%) underperformed shorter duration ETFs like the iShares GBP Corporate Bond 0-5 year (0.31%), which was also the best performing Fixed Income investment, and Lyxor FTSE Actuaries UK Gilts 0-5 year UCITS ETF (-0.12%).

Alternatives performed as one might expect. Those less correlated to equities, including Invesco Physical Gold (-1.57%) and JPM Managed Futures (-1.92%) fell, while assets more correlated to equities such as infrastructure, rose circa 2%.

General positioning

Despite remaining overweight to Equities we are cognisant that some markets look relatively expensive and may move to neutral. However, markets are delicately poised and if major geo-political events end positively there might be a further rally. We may tactically add to the UK which has relatively attractive valuations and is largely unloved; this move would be to reduce or close our underweight to the UK which has prevailed during rather protracted Brexit negotiations. Otherwise at a regional level, we remain overweight Europe, Japan and EM and neutral US.

Within Fixed income we continue to favour investment grade corporate bonds over Gilts and prefer short duration to long. However, we have started to narrow the gap between corporate bonds and gilts. Meanwhile in alternatives, we are keeping with gold as a safe-haven asset, which should provide some protection from market volatility as proven last year.

Monthly article: Inside passives – Smart Beta

Passives are big business – and in fact now top ~$5 trillion globally.1 To most investors they mean low cost investing, providing a way to invest in hundreds of the world's best known companies and get the return of the market/index/ sector2 (or 'beta'). Our Tactical Select Passive range fulfils this brief and is growing in popularity.

Investment Managers at Close also recognise that passives can diversify exposure, provide access to markets where we have no direct expertise or facilitate a tactical trade where controlling costs is crucial to improving our clients' returns. This is why they may be used across other services to complement different strategies - an example of expertise being shared across our business.

Performance to make you smart

With our TSP range, we also attempt to outperform an index by using Smart Beta. We loosely define this term as any strategy with a strong academic methodology aiming to isolate certain characteristics of the market and allow investors to broaden their set of asset allocation tools. Funds which try to tilt their exposure towards Value, Growth, Income or Momentum, for example,

might all be called Smart Beta. In particular, low interest rates prevailing for an exceptionally long time has propelled the growth of income-biased Smart Beta funds.

One such fund we currently like is the Powershares S&P 500 High Dividend Low Volatility ETF by Invesco. It distils the S&P 500 into a much more concentrated portfolio of just 50 stocks which meet their high-dividend low-volatility methodology. Another example is the First Trust US Equity Income ETF whose criteria for inclusion include a dividend yield 1.5 times the index median and a debt-to-equity ratio of no higher than 90%.

Whilst these ideas focus on stock selection, there are new strategies using derivatives to financially engineer a desired outcome. BMO's Enhanced Income USA Equity ETF does this through writing call contracts on stocks it owns within the S&P 500 Index: these 'covered calls' receive a premium in return for offering the buyer the right to purchase the underlying stocks at a later date and an agreed strike price. It targets enhancing the yield of the index by 2 to 4% p.a.

Have your beta and eat it?

Of course, there is no such thing as a free lunch and the rub here is the cost. These three strategies cost between 0.3% and 0.55% p.a. compared to standard off-the-shelf trackers which may cost as little as 0.07% p.a.. So the key question we fixate on is; will the addition of a Smart Beta fund in our portfolios actually deliver the returns and experience we anticipated after the cost of buying and selling it? There are others questions too: is the methodology proven? In which markets might a strategy not work? How will its inclusion impact the portfolio's volatility? Are there any unintended consequences of using it instead of something else?

All of these questions require complex and sophisticated scrutiny, monitoring and reporting to ensure we understand the risks created in what is still essentially a passive strategy. We must be able to explain in forensic detail the performance of every holding so we know what is adding to or detracting from our numbers.

Expert game – value added

We believe in the seasoned judgement of our Investment Managers, analysts and researchers in asking searching questions. Our passives Fund Manager, Weixu Yan, is part of a broader team of around 70 experts who share ideas and ask tough questions about whether we are still adding value in a risk-appropriate way.

In short, to truly understand Smart Beta and how it fits into a portfolio which may be passive, active or a blend of the two, you need experts to help you to navigate a fast-moving and ever more complicated segment of the passives market. For the cost of getting it wrong undermines the trying to be smart in the first place.

Close TSP discrete performance as at 28 February 2019

	YTD	2018	2017	2016	2015	2014
Close TSP Conservative	**3.4**	**-4.2**	**6.5**	**14.3**	**1.9**	**8.2**
IA £ 20-60% Equity	3.6	-5.1	7.2	10.3	1.2	4.9
Close TSP Balanced	**4.3**	**-5.3**	**9.1**	**17.6**	**2.5**	**7.3**
IA £ 40-85% Equity	4.7	-6.1	10.0	12.9	2.7	4.9
Close TSP Growth	**5.2**	**-5.5**	**11.8**	**16.4**	**1.8**	**7.0**
IA £ Flexible Investment	4.9	-6.7	11.2	13.8	2.0	4.9

Source: FE Analytics 05.03.2019; all are X Acc share classes; performance is total returns, net of fees with dividends reinvested.

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