galileocapital
Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – September 2017

Note from Theo and Warren

Strengthening our investment team

Our business has been on a steady growth path over the last few years and in that time, we have tried to strike the balance between providing the best service possible, with the need to bolster our investment skills as the needs of our clients have become more complex.

In particular, we have experienced a dramatic increase in demand for offshore investment solutions from our clients. To that end, we have been adding to our expertise in the offshore arena. As an example, we now make use of external experts to assist us with international markets and especially fund research.

We are particularly excited to have the Chief Investment Officer of Analytics, Andries Kotzee, on our investment committee. He has extensive international investment experience having worked with Momentum Investment Consulting in London since 2008. By incorporating Andries and his team into our investment committee, we can use the resources of a large investment house without problems created by a large corporate.

We are regularly reminded that our clients don't want to be another number in a corporate machine and so we continue to find ways to grow our investment services while maintaining our focus on providing the best service possible. We believe it is important to have a small company ethos, as this is what keeps us focused on our clients.

We now have a great combination of good financial planners backed up by a very strong investment team that can provide a range of world class global and local investment solutions for our clients. We will continue to expand our investment expertise while maintaining our small company ethos – this is a work in progress, and we will keep you updated as we continue.

- Theo and Warren

Do you remember what stock market growth feels like?

We were very pleased with the returns generated by the JSE in the month of July. The All Share Index jumped by 7% in one month, which raised the return of the JSE to 7.59% for the 12 months to the end of July. This reinforces our view that it is nearly impossible to predict what markets will do, so it's always better to stick to a sound asset allocation strategy rather than try to time markets.

Investors who have been worrying about their portfolios and the pedestrian returns they've seen from the JSE over the last three years, will be relieved to see that the JSE continued to perform in the month of August with a jump of 2% for the month.

It is interesting to note that the JSE has generated a return of 13.12% per year for the last five years while cash has generated 6.32% p.a. over the same time. This shows that cash is a very attractive asset class over short periods when things are uncertain, but it's a lousy investment over longer periods of time.

We are not forecasting that the JSE will continue to perform strongly in the months ahead but we are confident that you can expect the market to deliver growth over the long term.

Digging into "SMART BETA"

Last month I touched on the topic of differences between active and passive asset management. I also noted that, notwithstanding the excellent record of passive asset management in outperforming active managers (particularly in the unit trust space) there were areas in which simple strategy tweaks enhanced performance.

I should also note that several studies I've seen point towards value-add by fund managers – until costs come along and scoop off most of the benefit. This leads me to remind you of one of the fabulous benefits of ETFs: they have very competitive and scalable cost structures.

The traditional homily is that higher risk equals higher rewards. This is certainly across all asset classes. However, within equities alone, the evidence is not so compelling.

For many years, econometricians tried to tell us that risk (as measured by volatility of returns, and called "beta") was directly related to returns. The evidence of many years since shows that this is a questionable 'truth'. As an alternative there are many drivers (or "factors" or "styles") of returns: value (how cheap is the share?), momentum (shares that do well can keep doing well), quality (repeatability of earnings plus robust balance sheets), small-cap companies, low-volatility and several others of varying merits.

The attempts to work with these drivers is what lies behind smart beta. Smart beta is an investment approach that's a sort of middle ground between active and passive management. Smart beta funds tend to use mechanistic index methods, using either single styles of the kind discussed above, or blends of several to achieve various outcomes. The greater the number of styles, the more diversification is obtained – provided the styles are not highly correlated to one another.

These factors are not going to eliminate market risk, but they interact with the equity market bull and bear, GDP and interest rate cycles in different ways. This seems to make a case for some allocation, but care must be taken to fully appreciate the impact on the portfolio.

Each fund contributes tracking error (or active risk vs an index) which can pull portfolios in different ways. This tracking error, which provides diversity, also means that the fund is, by design, not going to track exactly in line with market indices – it will outperform or underperform the overall market at different stages.

Styles are cyclical. For instance, when value is winning, momentum can lag – or vice versa. Multifactor ETFs should generate superior risk-adjusted returns, but they also add complexity to portfolio management. Investors should know what they're buying, while paying attention to the impacts of these products on their active risk levels and aggregated style exposures.

Investors should also appreciate the persistency of styles. Style effects are cyclical, but rotations in outcome can be lengthy, producing extended periods of under- or over-performance. As it says in the stunt movies – "don't try this at home".

Smart beta funds only got going properly in the US in 2011. This means that the track records are relatively short, but the early synopsis of the results of the collective sector summed together were that multifactor funds collectively produced better-than-market returns vs. SP500, albeit with more volatility. Nearly all produced positive alpha (market independent returns).

This is encouraging, but is not statistically conclusive. More importantly, it offers a multitude of ways in which one can scale the range between the tortoise and the hare – and set a risk budget accordingly.

Smart beta funds have limited availability on the JSE, but in international markets there is a wide range of choice. Clients of Galileo Asset Managers can access these funds through their SwissQuote platform accounts.

- Warwick Lucas, Chief Investment Officer, Galileo Asset Managers