FUND RESEARCH & SELECTION

OVERVIEW

We carry out our main fund research and selection process twice a year. To remove any bias, we initially source funds to populate our risk and time weighted portfolios using a data driven screening system. Our fund research and selection process has been in place and progressively refined since July 2007. The process is as follows:

- Start with the fund universe of 40,000 + funds.
- Filter this by fund type; unit trust/OEIC, life or pension according to tax wrapper.
- Filter this by sector or category, e.g. European Equity funds.
- Filter this by established funds with at least a three-year track record.
- Filter this to those funds that have consistently performed above the sector average.
- Then investigate each of the remaining funds for its own Risk Metrics characteristics.
- The **CY Factor** (see explanation below) is calculated and applied, with funds ranked accordingly.
- Then investigate each of the highest-ranking funds for distinguishing factors, e.g. reasons for out-performance, manager tenure, charges, investment style, fund size, asset allocation, risk profile, availability with different providers/platforms, and short-term past performance.
- Resulting in the 'best' overall fund being selected for the CY fund panel or 'best buys' list.

FUND FILTERING

To initially arrive at an unbiased shortlist of funds in a given Investment sector we use the independent investment fund research tool FE Analytics. This starts with the universe of over 40,000 funds, to which the following filters are applied as standard:

- IA sector e.g. European Equity funds.
- UK Domiciled funds.
- Sterling denominated.
- At least a 3-year history to confirm established track record.
- Above (sector) average performance over 1, 2 and 3 years.

INDIVIDUAL FUND ANALYSIS

Funds in the resulting shortlist for each sector are then analysed using their individual Risk Metrics figures. This analysis aims to identify those funds with consistent performance for the right reasons. The Risk Metrics used are:

- **Past performance**: Measured over eight three-year periods ending on the last day of the month before the date of the review and 3, 6, 9, 12, 15, 18 and 21 months, i.e. quarterly, before that date. Together, these cover a period of just under 5 years.
- **Volatility**: A measurement of how much the fund fluctuates in value, either up or down, measured as standard deviation. Bonds typically exhibit lower volatility than developed market Equities, with Emerging Market Equities typically having the highest volatility. Volatility can change quickly, reflecting changes in market conditions.
- **Beta**: Sensitivity to market movements in a given sector. A fund with a high beta can be expected to closely mirror the movements of its sector, and the opposite is true for a fund with low beta. A high beta suggests the fund has less scope for outperformance compared to the sector, but it will act in a more predictable fashion. A low beta might suggest that there is opportunity for outperformance, but you must question what risk the fund manager is taking to differentiate themselves.
- **Alpha**: Measuring the value added by the fund manager. Taken alongside other measures, achieving an alpha which is greater than the relevant index provides an indication of this value. Alpha is less difficult to achieve in bull markets. With bond funds, alpha readings are less reliable because capital appreciation is not the main objective.
- **Sortino Ratio**: Measuring the extent to which the return from investing in equities has exceeded what could have been achieved from a risk-free cash investment, without exposing the fund to undesirable downside volatility. In bear markets, equity funds are likely to have negative Sortino.
- **Information Ratio**: Measuring the extent to which the fund has beaten its benchmark, without incurring greater volatility than the benchmark. In interpreting an IR reading, it might be necessary to have regard to the constituent holdings of a fund.

THE CY FACTOR

In addition to the above Risk Metrics we use our own metric, the **CY Factor**. This is the average return for each of the 8 three-year rolling periods divided by the average volatility for the same periods. We repeat the exercise over the 4 most recent periods, as well as a Decayed Factor which attributes greater weight to the more recent 3-year periods.

This determines a 'short', 'weighted' and 'long-term' **CY Factor** for each fund, which is effectively the average return per unit of volatility.

From the 'above average' shortlist this measure enables us to quickly identify on a sector by sector basis funds which exhibit strong returns without excessive volatility. We use the industry risk metrics and CY Factor to assess funds as follows:

- **Equity Funds**
  The main characteristic of equity funds is capital growth, which is why we analyse the individual funds with consideration of Alpha to measure the value added by the fund manager. Typically, we look for funds ranked highly in terms of; performance, volatility and Alpha

- **Fixed Interest Funds**
  The same filters are applied to equity, property and fixed interest funds. However, these three asset types display different characteristics, be it income, growth or a combination.

  The predominant characteristic of fixed interest funds is income not growth, and as such they are expected to be less volatile than equity or property funds. Therefore, adding Alpha is not the main aim of the fund manager. Rather than focus on Alpha, as we do with equity funds, we use the Sortino Ratio, which measures the extent to which the return has exceeded what could have been achieved from a risk-free cash investment, without exposing the fund to undesirable downside volatility.

- **Property Funds**
  There are two main types of property funds; those which invest in shares in property companies which act more like equity funds and should be analysed as equity funds, and those which invest directly in bricks and mortar, whose main characteristic is (rental) income and should be analysed in a similar way to fixed interest funds. We use the latter bricks and mortar funds.

- **Alternative Funds**
  Alternative investments generally behave in a different way to the traditional funds above. There are many types of alternative investment, across the risk spectrum. We specifically target and investigate funds which are asset backed, physically or via contracts with strong counterparties and have a history of delivering a consistent income yield. UK infrastructure is one such alternative example.

We then look to select the fund which exhibits the highest CY Factor and strong numbers for those metrics relevant to the fund's sector. Typically, there will be two or three funds which are, on the surface, quite similar. We investigate this shortlist in further detail.

FINAL ANALYSIS

To determine which fund we use to populate our panel we carry out further research, sometimes meeting with fund managers. Our further research takes into account other factors like:

- **Manager Tenure**: Have there been any recent changes in management that could affect performance?
- **Charges**: Is there an initial charge, and are annual charges competitive within the sector?
- **Fund size**: Is the fund too small to be sustainable, or has it grown very rapidly, or is it perhaps too large to be managed effectively if the market changes suddenly?
- **Availability**: Is the fund available via mainstream fund platforms and product providers?
- **Short-term performance**: Is the fund above average over the last 3 and 6 months? If not, why?
- **Style and asset allocation**: Is the fund concentrated, or exposed to a certain style or illiquid assets, that may be vulnerable to anticipated market conditions?

The resulting 'best buys' list or 'panel' is used where possible. It may be necessary to step outside this in some cases, for example where the selected or existing tax wrapper/ product has limited fund choice options. In this case a 'best fit' solution will be researched on an individual basis, using the same process.

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