A Bird's Eye View
Sparrows Newsletter

June 2016

Dear Reader,

It has been two years since we opened the doors at Sparrows Capital. During this time we have looked to build a constructive dialogue to earn your trust and to form the basis of a long term relationship.

They have been an incredible two years!

We would like to thank all of you for your feedback and insight. While we aim to present an investment philosophy that stands out from the crowd, fully reliant on impartial, robust academic research and delivering practical, bespoke, cost effective solutions, we also recognise that we learn a huge amount from our conversations with, and inputs from both clients and intermediaries.

We have been keen to record and share the value of this learning, and so have compiled a set of recurrent observations; I believe that these can greatly help to underline our core investment principles, and to provide a sophisticated framework for future discussions.

Observation 1: Passive investing is complex

The most extreme form of passive investment is 'buy and hold', whereby an investor buys a single diversified index (e.g. a fund that tracks the S&P 500 or the FTSE 100 index) and holds it for decades without doing anything else. His chances of outperforming active traders that are trying to beat this index are surprisingly high.

However, this simplistic strategy is far from being the most efficient way to invest. Buying the S&P 500 tracker produces an inherent risk concentration to a small number of large growth companies; the strategy is prone to high volatility and risk of non-systemic loss.

The risk / reward characteristics of a passive portfolio can be significantly improved by systematically harvesting multiple sources of returns and maximising diversification. At the most basic level, this takes the form of a multi-asset class, global strategy, combining best-in-class ETFs from around the world. At a more sophisticated level, investing in Risk Factors can substantially increase portfolio efficiency, as measured by the Sharpe ratio. Incorporating a rebalancing strategy can further add value by rigidly enforcing diversification and adherence to the strategic risk profile across cycles.

This complexity means that even passive investors can benefit from professional advice in relation to strategic portfolio decisions, market screening due diligence, risk monitoring and rebalancing. A further important benefit of external advice is the effect of reducing behavioural bias. The psychological challenge of maintaining investment discipline through periods of market turbulence should not be underestimated; experience and behavioural finance theory have taught us that it takes great discipline to NOT change the course when it seems like you are running into the perfect storm, and that psychologically driven intervention is all too often the source of significant portfolio underperformance.

Observation 2: ETF investing is not necessarily passive investing

Exchange Traded Funds (ETFs), like mutual funds or hedge funds, are financial instruments that can be used as building blocks to deploy a desired strategy within the capital markets. It is the detail, and way in which these blocks are used, that defines the essence of an investment strategy.

Historically ETFs have been associated with passive, rules based, index led strategies. ETFs are liquid, transparent and cost efficient wrappers which lend themselves well to such investment styles. However, we have seen over time the development of active ETFs (exchange-traded instruments accessing actively managed portfolios) and of hybrids (rules based with some degree of manager discretion). Investors need to fully understand how much discretion is available to the manager or provider in each case.

Furthermore, many active investment managers nowadays use passive ETFs to express market timing trades. Where the manager's value proposition stems from his ability to vary market risk over time, or to adjust sector exposures to capture apparent pricing anomalies, ETFs present a very useful mechanism for such expression. Although such activity may make use of passive vehicles, it most definitely does not fit the definition of strategic passive investing.

Passive, evidence-based investing involves strict adherence to a set of rules which define an empirically proven, persistent opportunity set. The discipline can theoretically be expressed via ETFs, index funds or even via direct rules based investment in underlying stocks or bonds.

Much like in architecture - form follows function – and it is the function in which you use the available instruments that will define you as an investor.

Observation 3: Markets are not always 100% efficient

Our view is that capital markets are generally highly efficient in reflecting information about individual securities and the stock market as a whole. For this reason, asset price movements are not reliably predictable and it is not generally possible to produce above average risk-adjusted returns through stock picking or through market timing.

However, we do not argue that pricing is always perfect, and we acknowledge that markets can act as a behavioural voting machine in the short term. However, the inefficiencies and dislocations that may occur in markets are quickly exploited and removed in the medium to long term.

There are also costs that are involved in capturing trading opportunities. An investor needs to ensure that the identified opportunity will cover his execution costs and compensate him for the additional risk.

Observation 4: A passive approach can co-exist with an active approach

I have often been asked to take a stance in a debate of passive vs. active. Often I have disappointed my audience by challenging the way the discussion is framed: what if it is not an 'or' question but an 'and' question?

The two investment philosophies are indeed very different. An active manager will try to add value through market timing and stock selection skills, while a passive manager will argue that it is mainly through systematic exposure to risk factors that one can achieve an optimised long term risk adjusted return.

But these two philosophies are not mutually exclusive. Investors can benefit from blending the two styles within a portfolio, by building a core strategic liquid exposure to the investable universe, efficiently capturing premia associated with markets and other risk factors, and by accompanying this core with satellite strategies aiming to actively capture 'alpha' in areas where the evidence suggests such opportunities may arise (illiquid assets, private equity etc.). There is no need to risk missing out *beta* while you try to capture *alpha*!

How an individual investor divides his portfolio between these two approaches will differ, as every investor has a different risk appetite and characteristics; but in any event he will benefit from efficient beta harvesting alongside an increased clarity over his targeted alpha sources and performance.

Observation 5: Passive investing does not require an investor to shut down his brain and place his trust in a systematic investment process

Investing passively requires a huge amount of expertise, discipline, research and consideration. The most critical investment decision is the design of the strategic asset allocation. To get that right it is necessary to establish a risk profile, taking account of both risk preferences and financial capacity. The allocation must be able to deliver an outcome that simultaneously targets your investment objectives and matches your risk profile. It is then necessary to identify the building blocks (instruments) that will shape the portfolio efficiently and predictably. Finally, portfolio and instrument performance must be monitored and, if appropriate, managed over time. Each of these decision processes requires significant expertise, as well as critical thinking and common sense.

One of the major benefits of this process is that it protects investors from the behavioural patterns that harm most individual investors when facing the real world: when markets fall sharply fear takes over our brains, and the incentive to sell assets that are falling in value becomes greater and greater. We might know that it is the wrong thing to do at that time, but we still behave as humans do. By formalising a long term strategy and adhering to a disciplined, detailed, robust approach we can actually harvest the long term returns of capital markets, and protect ourselves from the short term anxieties that so often cloud our judgements.

Observation 6: By definition, more than 50% of active managers will underperform the market

I am often surprised by how many investors and investment professionals fall for a common misconception: that 50% of active managers will outperform the markets. This is simply wrong for one reason: fees.

The market return is the average return of all the securities that comprise the relevant market. An investor should never expect to receive the full market return. Even when buying a highly efficient rules-based instrument, like an ETF, there will always be some level of fees and frictional costs involved in holding the market portfolio.

Fees and costs are a drag on portfolio performance, and are a critical element to take into consideration. Owning an ETF can cost as little as 5bpt (or 0.05%) per annum, whereas active management is a far costlier exercise. Many active equity managers will charge a fee in excess of 1% per annum. Such a manager will need to consistently outperform the markets by at least 1% just to cover his fees. The evidence shows that majority of active managers fail to achieve this.

The effect of management fees and transaction costs causes the vast majority of investors to fall far short of the market returns. Active management is expensive, and investors need to ensure that the money spent is well rewarded.

Observation 7: It is possible to measure the success of passive investments in the shorter term

A long term view is essential when adopting any investment approach. However, this does not mean that a passive approach cannot be evaluated on a shorter timeframe. The important thing is to understand what is being measured.

An active approach requires an investor to assess a manager's performance relative to a benchmark, monitoring active share and net outperformance. With a passive strategy a different mind-set is needed. The expectation is for the portfolio to deliver the benchmark (market) return as efficiently as possible, with minimal tracking error and minimum cost, regardless of market conditions. The measurement is of efficiency as opposed to outperformance.

Epilogue

Our very first client came to me with a shocking realisation after going through the Global Financial Crisis of 2008 and 2009, having experienced first-hand the benefits of following a disciplined strategic approach, and having overcome the psychological challenges that come with investing. He said: "*I have just realised what you are here for. Your responsibility is to protect my assets from myself*".

I know very few people who can look deep into themselves and come to that kind of conclusion. I would certainly not argue that what we provide is a bullet proof vest; but the bottom line is that what we do puts our investor's interests above everything else, and those who experience it become our best ambassadors.

It is our mission to ensure that their capital is invested in an insightful, clear and liberating way.

Yariv Haim
Founder and CEO

For more information on our philosophy, process or if you just want to challenge these observations, please get in touch.

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