PRESCIENT
INVESTMENT MANAGEMENT

BALANCED FUNDS – HOW TO AVOID THE SNAKES AND FIND THE LADDERS

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Process matters more than past performance, although past performance is often indicative of a solid process.

Rupert Hare

Such is the dispersion of the investment performance delivered by multi-asset fund managers that Rupert Hare, Portfolio Manager at Prescient Investment Management, likens the process of selecting a balanced fund manager to playing a game of snakes and ladders.

Ladders on the board allow players to move upwards and get ahead faster, while landing on a snake means losing ground and moving back down the board. Players who roll a six get an extra turn.

Indicative of the difficulty in choosing a manager likely to deliver superior future performance is that, over the past six months, funds in the Association for Savings and Investment South Africa (ASISA) SA Multi-Asset High Equity category came up with returns ranging from minus 24% to plus 17%.

Said Hare: “To identify managers likely to provide a smoother ride, investors should place their emphasis on the process managers adopt, rather than past performance. Keep in mind that a poor process can and does lead to poor performance. Although systematic, Prescient Investment Management’s process is completely transparent and does exactly what it says on the tin. We take large amounts of data and distill it down into simple signals that guide our portfolios.”

The Prescient Balanced Fund aims to put itself just above average and is specifically designed to outperform the ASISA category average of the SA Multi-Asset High Equity, if only by small, consistent amounts, so that over the longer run it ends up right at the top.

“We are a systematic manager, so we establish principles for what we believe to be sound investment practice and we program them into our in-house systems. This allows us to simply trade towards model portfolios and spend the majority of our time improving the process. That’s not to say we are a passive manager; our aim is to offer a product that offers the best of both the passive and active worlds,” Hare commented.

Prescient's asset allocation technique is different from most in the market, taking a top-down approach to looking at asset classes with very little attention paid to single stocks.

According to Hare: "Without a doubt, asset allocation should be the main factor that determines investment returns in balanced funds. You can pick a winning stock and the markets sell off -10% while the stock may sell off -5% but you have still made a loss. Or conversely you pick a strong asset class like equities which rally 10%, but the stocks you picked within that bucket only gain 5%. For us, the key within multi-asset is to focus on asset classes rather than individual positions.

"We do this by taking a large part of our exposure in what we see as the most efficient manner through hyper-diversified passive instruments. And while we primarily use ETF index products for efficient access asset classes, we also use derivatives – an area that Prescient prides itself on being particularly strong in."

In terms of the impact of extreme volatility on asset allocation decisions, Hare commented that the Covid-19 sell-off saw volatility extend to levels never seen before. While agreeing with the adage that "diversification is the only free lunch", he pointed out that the recent past is a reminder that there are times when there are very few places to hide and you have to put your lunch in the warming drawer.

"In these highly volatile environments our portfolios are designed to capture significant dislocations in the market by taking measured tilts away from long-term allocations using our models to gain alpha," said Hare.

At what stage should investors who find themselves in an under-performing balanced fund cut their losses?

"You'll hear time and again that past performance is no indication of future results, but to me performance is a large part of what we do," said Hare. "The most important question is: is that performance in line with what you had expected given the process that was explained to you by the fund manager. If not, then it's time to shop around."

Another significant consideration is the dramatic compounding effect of costs on returns, especially in a low return environment. While this hasn't been experienced in a low inflation environment in SA in the memorable past, fund managers who have worked in the US and the UK know all about it.

"Think of a CPI + 6% fund where CPI is zero, or even negative. The expected returns are 6% and if you charge close on 1.5% in fees that's a quarter of the returns going to the manager. Add onto that 0.5% in trading costs and other fees and the result is that what the end investor often gets is a much more diluted version of how the manager runs a fund.

“With time that leads to significant fee compression from investors, which we expect in the coming years, but in the interim the returns of high fee offerings lag benchmarks considerably – especially in full-fee retail offerings.”

The total investment charge (TIC) on the Prescient Balanced Fund is 0.5%[1], more than 1.3% lower than the average peer and even lower than most passive funds, according to Hare.

“As a systematic multi-asset manager, we take away that investment stress by adding value through a sound, transparent process that delivers consistent outperformance over time, avoiding the snakes and ladders game entirely.”

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- Prescient Management Company (RF) Pty Ltd (the manager) is approved under the Collective Investment Schemes Control Act (No.45 of 2002). Prescient Investment Management is an authorised Financial Service Provider (FSP 612) under the Financial Advisory and Intermediary Services Act (No.37 of 2002).
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[1] This figure is for the A2 Class.

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