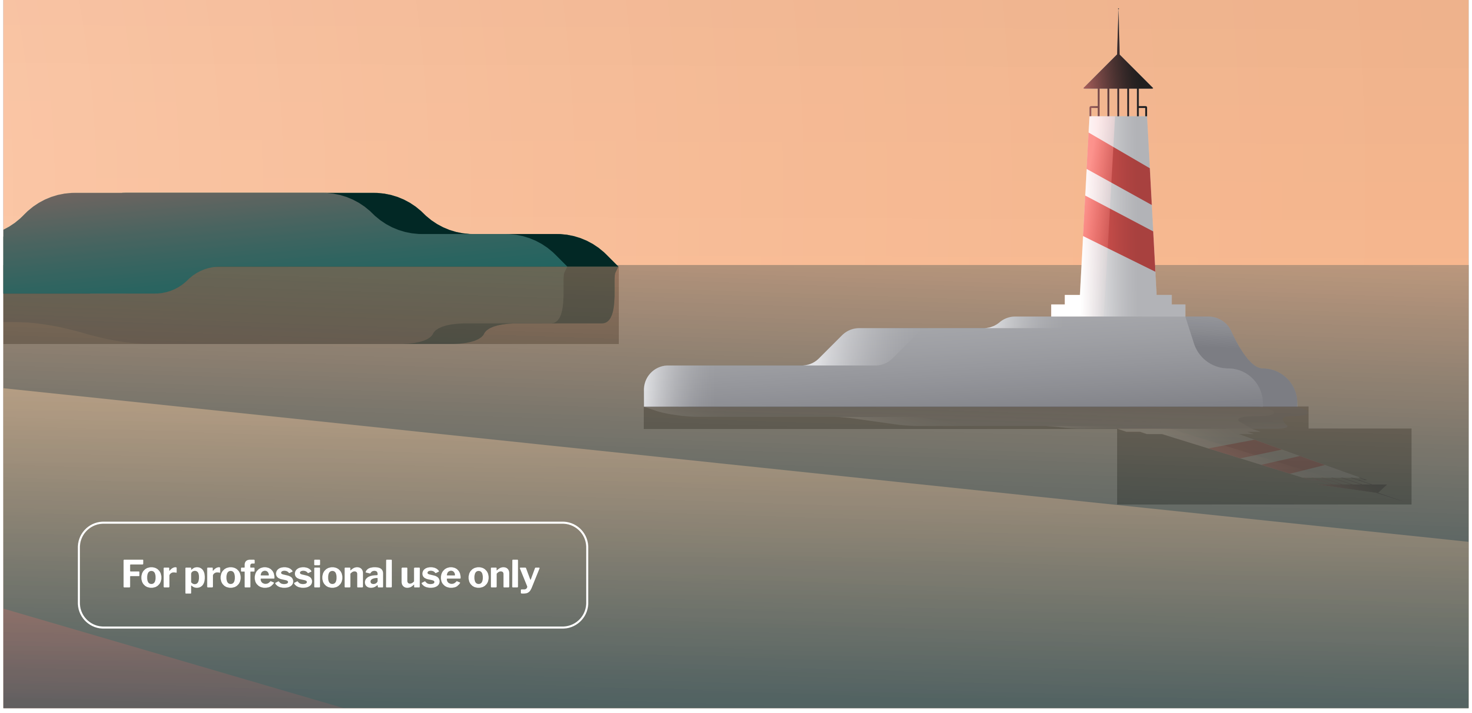
Parmenion
Investment Management

Our Passive Fund Due Diligence process



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Our passive due diligence approach

The concept of passive investing is simple. Investors earn the same return as the chosen fund benchmark, net of costs. Choosing the right passive investment, however, requires careful consideration.

That's why our passive Managed Portfolio Service takes factors beyond simply cost into account.

The tracking error of a fund versus its own benchmark, and both tracking error and tracking difference versus our investment team's internal benchmark for internal risk mapping and client reporting are key measures.

We also assess each fund house's commitment to ESG issues such as their voting and engagement practices - and whether they have set a net zero target as a firm.

So while the funds we select are passive, our fund due diligence is anything but. In a rigorous process incorporating both quantitative and qualitative evaluation, we aim to select funds that closely track market indices at a competitive cost, with limited counterparty risk and the potential to provide market returns over the long term.

Our passive due diligence runs half yearly, reporting to the end of December and June.

Peter Dalgliesh
Chief Investment Officer

Our quantitative/qualitative process

The first stage of our process is identifying our fund universe. This has grown over time and that growth looks set to continue. As with our active fund selection, we require at least a 3 year track record - ideally a 5 year track record for a full data set.

We evaluate passive funds in 14 asset classes and can run ad hoc analysis for more granular asset classes, such as funds tracking the FTSE 100 index, if required.

The asset classes match our strategic asset allocation (except global funds) and include the following:

- IA UK Gilts
- IA UK Index Linked Gilts
- IA Sterling Corporate Bond
- IA Global Bonds
- IA UK Equity Income
- IA UK All Companies
- IA North America
- IA Europe Excluding UK
- IA Japan
- IA Asia Pacific Excluding Japan
- IA Global Emerging Markets
- IA Global
- IA Property

We combine quantitative and qualitative data to produce a score for each fund within each sector, and then rank them.

In each case, the fund that is ranked top is preferred. However, it is not always what we ultimately invest in.

Say, for example, a fund that we don't currently hold ranks top of an asset class. We will look through the underlying detail of its final score to identify whether it would truly benefit clients to make a fund switch. We also look for consistency of scoring - a fund will have to be top ranked for at least two consecutive 6 monthly rounds of due diligence before we contemplate a change. This helps avoid increased turnover and limits the cost of trading – a key aspect in the appeal of passive investing.

The underlying factors we consider are:

- Cost
- Tracking error and tracking difference versus a fund's own benchmark
- ESG factors
- Tracking error and tracking difference versus PIM's internal benchmark
- Fund size
- Replication type
- Derivative use
- Stock lending policies

Each fund is scored independently for every factor we look at and only ranked within their sector based on the cumulative final score.

Grouping, measurement and reporting

While the individual funds are measured against their own benchmark, for the purpose of our rankings, we group the funds in their respective sectors.

For example, the iShares Japan Equity Tracker, Fidelity Index Japan and Vanguard Japan Stock Index funds are all grouped in the Japan sector and each one is ranked versus its respective benchmark before being ranked as a group.

Once all of the data has been collected and analysis is run for our half yearly passive due diligence, a report is written which highlights the top three ranked funds (where available) in each sector and explains why the top fund has scored well relative to its peers.

Investment vehicles

While Exchange Traded Funds (ETFs) are a popular way to invest passively, PIM uses only passive OEICs or Unit Trusts (open ended funds). There are 4 key reasons for this:

1. We can access OEICs/ unit trusts in the passive space at such a low cost, there is often no cost benefit to using ETFs.
2. To trade in ETFs would incur additional costs for clients..
3. As we have a single daily dealing point, much of the benefit of an ETF structure is eliminated.
4. Not all ETFs are compatible with all tax wrappers, a business process requirement of Parmenion.

We continuously review this, and if we determine that expanding our universe to include ETFs would benefit clients, it is something we would consider.

Process

We constantly gather and analyse passive fund provider data to deliver our due diligence in a fair, consistent, and repeatable manner. Enhancing our process is continual, as our business grows, as the industry changes, and as we identify enhancements to improve outcomes for underlying investors. The introduction of ESG as an officially scored factor in our process is evidence of this.

Working with passive fund providers

We work closely with passive fund providers to make the comparison between funds in each asset class as comprehensive and fair as possible.

For example, some providers price their funds at midday, while the available index data uses end of day prices. This timing difference means the tracking error of these passive funds can appear falsely high. To avoid this, we ask providers to re-calculate the fund net asset values using the end of day prices of the underlying investments, so they align with the index pricing point. While this seems quite a minor detail, it makes a meaningful difference to our final scoring and evaluation of funds.

Overall holding cost

Passive costs have come down considerably over recent years, as competition amongst fund providers within each asset class has increased. Whilst the headline ongoing charges figure (OCF) is the most important factor, it is also critical to look past this and factor in other potential costs of trading.

Overall holding cost is calculated assuming a 3-year holding period. Some elements of cost are explicit, such as the bid/offer spread on dual-priced funds or pre-determined dilution levies. Others, such as the amount by which the price of a single-priced fund is swung for significant trades, are harder to see. The overall holding cost we use includes both the OCF and potential dealing spreads. We also include the estimated additional expenses payable in each fund, for example custody and administration costs.

Within the cost factor, we score based on OCF of the fund versus the fund we own today (ideally a potential fund switch would not increase the cost of the solution) and then 3 year holding costs are compared to the average of all funds within the sector.

Given the importance of costs, it is weighted more heavily within our process.

Tracking error & performance

Tracking error and tracking difference are calculated using 5 years' worth of 1 and 3 year monthly rolling data (48 discrete 1 year periods and 24 discrete 3 year periods). By taking multiple periods within the 5-year data set we can identify which funds have consistently delivered superior tracking versus their benchmark within the sector.

One way to understand the difference between tracking error and tracking difference is to think of tracking difference as the destination, and tracking error as the journey. While two funds may return the same performance, one may deviate from the benchmark considerably more than the other along the way. Again, by analysing multiple periods we get a better idea of which funds are consistently superior.

In the same way that volatility measures the variability of absolute performance, tracking error measures the variability of performance difference. We know it is possible for one fund to smoothly, but progressively, lose ground against its index, while another might have marginally higher tracking error but a better overall performance. This is why it is important to analyse both.

When considering tracking error, we measure each fund relative to its own benchmark. Then we run exactly the same process again to measure the fund's benchmark versus the internal benchmark we use within our 20-year risk framework and client reporting.

The fund's tracking error and difference versus its own benchmark is more important, so this is double scored. However, the tracking error and difference to our own benchmark is also important as index returns can vary significantly within some asset classes because of the underlying make-up of the different indices. This is a single scored metric.

Given the importance of this analysis, we calculate all tracking error and tracking difference ourselves. Relying on data providers can lead to spurious results if, for example, they don't use the correct benchmark. Also, they can't get around the midday versus end of day pricing issue. This is why we've developed strong relationships with fund providers - to ensure as far as possible we are analysing and comparing funds fairly and accurately.

ESG factors

Parmenion have a rich heritage in ethical investing, and best practice from fund houses is of utmost importance to us. This is not only relevant to purer 'ethical' solutions. We incorporate ESG as an integral part of our passive due diligence process. We measure this at fund house level rather than individual fund, so funds receive a score based on the practices of the fund house.

We gain a detailed understanding via a questionnaire that has been constructed by our team with input from our expert Ethical Oversight Committee. This ensures we fully understand the ESG practices of each fund house on issues ranging from possible exclusions, stewardship, voting policies, UN PRI status, team diversity and others. Each individual metric is scored to produce an overall ESG score which is consistent across all funds from that particular provider.

While our passive solution should not be considered an ethical solution per se, it is still a factor that is important. The funds we invest in are tracking standard indices and should provide an index like return. They are therefore not actively screened. The reason for including ESG as a scored factor is to ensure the fund providers are using their size and power as significant shareholders in individual companies for the better.

Replication methods

Passive funds use four replication methods to track their index:

Full replication

Full replication means holding every stock at the same weighting as they are held in the index. The fund must, by definition, return the same as the index, less associated costs.

Derivatives

Derivatives over an index can be held instead of buying the stocks directly. Using derivatives introduces counterparty risks and costs that are not always apparent.

Stratified sampling

Stratified sampling means the index is divided into sectors or groups with a representative sample of stocks chosen from each to mirror the performance of the index. The fund's return will be similar to that of the index, provided the sampling is done well, with slightly lower associated costs.

Optimisation

Optimisation means using models that are based on historical data to track the index. The fund manager's decisions have a larger impact on fund returns, so these may deviate from that of the index.

We provide a score for method of replication, where funds with near full replication are favoured above those that use sampling. Both of those methods are preferred to those using optimisation or derivatives. In asset classes where full replication is not possible, we have a preferred option and a fund will not be marked down for following that method. Within fixed income asset classes for example where there are thousands of possible bonds to purchase and multiple bonds from single providers, it is more prudent and cost efficient to use a stratified sampling technique.

We do however recognise that many providers will use derivatives for efficient portfolio management (EPM). Here, derivatives are not a core part of the investment strategy but are used to, for example, minimise transaction costs, currency risk, or facilitate more timely investment switches. We don't penalise managers for derivatives exposure for EPM as they are acting in the underlying investor's best interests.

Rather than take a fund managers' standard line on this, we do ask what each fund's exposure is to derivatives and make our own minds up as to whether it feels high for EPM and the fund could possibly be marked down. These are all details that require dialogue with the fund management groups.

Stock lending policy

Passive funds are ideal “stock lenders” because of their long-term holdings in companies. Stock lending creates an income for the fund because a fee is paid by the borrower (usually an active fund seeking to sell the stock short). The fee is usually shared between the passive fund and the fund management company.

In return for borrowing stock, the borrower will provide collateral to the stock lender. The risk for the passive fund is that the borrower will default on the return of the stock and the collateral will not cover the costs of replacing it, or that there is a period of out of market exposure between the fund receiving the collateral and re-purchasing the stock in the market.

Each fund management company will have procedures in place for stock lending which include examining the credit worthiness of the borrower, the monitoring of the value and volatility of the collateral versus the stock lent and the percentage of the fund that may be lent.

To minimise risk, we consider a fund’s stock lending policy. In general, our preference is for funds with no, or a strictly controlled, stock lending. Where stock lending is permitted, we look for all or, at the very least, the majority of proceeds to be invested back into the fund. This ensures that where risk is taken on through stock lending, investors can be rewarded for taking that additional risk.

Fund size

In the passive universe, our preference is for funds of a larger size. We are risk-centric in our approach, so liquidity is front of mind, but a larger passive fund has other advantages:

- It is easier to fully replicate the index
- It is more likely to have two-way cash flows which can be netted off to reduce overall transaction costs
- It may be able to negotiate more competitive transaction costs
- Often scale can be used to reduce the fund OCF to the benefit of clients
- Better foresight and implementation of upcoming index changes

When scoring fund size, we look at the fund’s size compared to our current investment in the particular fund we use currently within that asset class. We then have boundaries of possibly percentage ownership if we were to switch to a new fund. The lower the possible percentage ownership the better.

Ranking & Weighting

Cost is key for passives and small differences between providers can have a big impact on long-term returns. Because of this, an OCF comparison attracts the most weight within our rankings.

After this, we look to double-weight an additional set of criteria including:

- Overall cost to own, assuming spread costs are split over a 3-year holding periodTracking error versus a fund's own index
- Tracking error versus a fund's own index
- Tracking difference versus a fund's own index
- Fund house ESG factors

By loading our analysis to these elements, we prioritise and equally consider risk and relative performance. This is in keeping with our risk-centric investment philosophy, and with investor requirements.

Replication methodology, stock lending policy, fund size and tracking error/difference versus our own risk framework are single weighted beneath this, as more subjective considerations than hard metrics.

Each fund is scored on each individual factor on its own merit and obtains a score for each based on limits set internally. As an example, a fund will receive top marks for 1 Year tracking error if it is on average less than 25bps from the benchmark for each of the 48 rolling one-year periods measured. The score will decrease as the average tracking error increases through different boundaries.

We then simply tally up the scores for each fund for each factor to create a total score. The sector is then ranked based on those total scores. By only ranking at the final stage each fund is scored independently based on our set limits for each factor.

This comprehensive, robust and repeatable process is designed to ensure that clients are invested in the best possible passive fund for each sector at all times.

Your expert investment management team

Harry Garrett,
Head of Investment

As chair of PIM's monthly committee meeting, Harry has oversight of all solutions and ensures the continual delivery to mandate. His other responsibilities include active and passive fund analysis across all asset classes and inputting to the long-term strategic asset allocation framework. Harry is a member of the tactical asset allocation committee.

Mark Foster,
Investment Manager

Mark covers both active and passive fund analysis and is a member of the Fund Research Committee. Mark started his career in financial advice before moving into a senior investment role for a pension fund within the LGPS, where he gained broad experience working across investment strategy, asset allocation and manager monitoring.

Get in touch

If you'd like to chat to us about passive investing, or our wider proposition, please get in touch.

Phone:

03300 945 900

Email:

mail@parmenion.co.uk

Registered Office: Aurora, Counterslip, Bristol, BS1 6BX.
Website: www.parmenion.co.uk

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