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PAM Insight Roundtable Discussion: Innovative approaches to thematic investing: navigating the way ahead

23/10/2014 by: Tristan Blythe, Group Editor

On Wednesday 22 October PAM Insight (publishers of thewealthnet) co-hosted a roundtable discussion with MSCI entitled Innovative approaches to thematic investing: navigating the way ahead. Participants were Mouhammed Choukeir, chief investment officer at Kleinwort Benson; Didier Duret, chief investment officer of ABN Amro Private Banking; Stephen Jones, chief investment officer of Holbein Partners; Guy Monson, managing partner and chief investment officer of Sarasin & Partners; James Sellon, managing partner of Maseco Private Wealth; Eric Verleyen, chief investment officer of SGPB Hambros; as well as Altaf Kassam, head of equity applied research at MSCI; Baer Petit, managing director and global head of index at MSCI; and Roger Urwin, advisory director at MSCI.

There are a number of themes that can help boost returns for a thematic investor, and have the potential to make "disruptive changes" to the investment world, according to participants at a roundtable co-hosted by PAM Insight, publishers of *thewealthnet*, and MSCI.

Roger Urwin, advisory director at MSCI, described thematic investing as "one of the disruptive changes" to the investment world. "The investment model we have used, which has been heavily based on asset allocation and alpha, is definitely set to change with many investors," he said.

Four themes were selected for the discussion, all of which Mr Urwin said he believes also present investment opportunities.

Rising position of China in open capital markets

The first of the four themes looked at China and the potential that the opening of its capital markets, and in particular the A-Share, presents for investors. A-Shares are usually only available to domestic-based Chinese investors, with international investors only able to access via the regulated Qualified Foreign Institutional Investor (QFII) system.

This system has led to a number of uncertainties for investors, such as over Capital Gains Tax (CGT). It is currently not clear whether China will charge CGT on gains made on the A-Shares market, said Altaf Kassam, head of equity applied research at MSCI. Other issues include limited capital mobility, all of which "does not lend itself to a fully functioning capital market."

Finally, the quota given by the Chinese authorities is not aligned to those that actually want to invest.

Current Chinese indices have large sector concentrations, Mr Kassam added. He said this was characteristic of capital markets starting to open up, as financial sectors and state owned industries tend to come to market first. The growth area that investors want access to is, he argued, in areas such as healthcare and consumer sectors.

Guy Monson, managing partner and chief investment officer of Sarasin & Partners, questioned whether Shanghai Connect, a programme linking the Chinese and Hong Kong stock markets, would impact on this theme.

Mr Kassam said the current programme only gives access to the Shanghai market, which is not the fastest growing market within China. "It will have an effect and is a welcome addition," he said. "But, I do not think it will change the overall picture. There is still a limited number of extra stocks being added."

Baer Petit, managing director and global head of index at MSCI, said it will be the first chance to gain access to A-Shares without a quota granted by China.

Mouhammed Choukeir, chief investment officer at Kleinwort Benson, said the opening of the A-Shares market may lead some to the conclusion this will support the Chinese equity market, but is there empirical evidence from previous and similar examples to support that? Mr Petit agreed that it dangerous to make "cause and effect" assumptions with a market of the size of China. He said the mechanism being used in China is akin to that used in Taiwan. "While we are not making a case for performance," he said. "We are making more of a case that this is a large structural piece of the global equity opportunity set and so the bias is that it would be rash to overlook it."

James Sellon, managing partner of Maseco Private Wealth, said that given the concentration of financial sector stocks in A-Shares, as outlined by Mr Kassam, it was important to consider the correlation of these with global financial stocks.

Mr Kassam said that whilst financial stocks had not been considered in isolation, "the diversification argument was another case for Chinese A-Shares in general." He said that emerging and developed markets have grown until the two have become strongly correlated. For A-Shares there is still a diversification benefit, indeed a stronger one than for frontier markets, he added.

Portfolios can be underweight emerging markets when constructed on a bottom up basis, Mr Urwin said. However, when they allocate based on the theme they will tend to "think the growth is worthy of a bigger position."

"This is particularly visible with private clients," said Didier Duret, chief investment officer of ABN Amro Private Banking. "They do not want to deal with the complexity of stock selection in individual countries. They want to capture the perceived diversification element. I do not believe that the correlation has grown between emerging and developed markets, because within these categories there is huge dispersion."

In addition, Mr Duret said that investors from developed markets view emerging markets differently from those within the latter. Local investors within emerging markets will be bottom up-based and know the companies.

Regardless of whether a business is based in a developed or an emerging market is only part of the equation. A domicile of business does not dictate where it generates its revenues, which can mean an investor can have exposure to a risk it was not expecting. This was the second theme discussed.

Economic exposure – evolving view of country risk

Mr Kassam said that some clients of MSCI are considering whether looking at where a stock is domiciled is "most appropiate." It enables investors to see which markets their investments actually give them exposure to.

Mr Duret agreed that the approach of considering economic exposure "makes sense for clients." He said: "They are fed up with the macro-risk and the country risk, when looking at Europe for example. They are more interested in businesses and industries. Where revenues originate is one dimension of this."

Eric Verleyen, chief investment officer of SGPB Hambros, said that this was something that wealth managers had largely adjusted to already. "We have been talking about this for a number of years, especially with the European crisis and the exposure stocks gave to troubled European economies," he said. He described it as less of a theme and more of a bias in the selection process.

Stephen Jones, chief investment officer of Holbein Partners, said this could be a complex issue as firms may hold debt in different markets and hedge exposure in different ways. Just considering revenue is one way of simplifying the problem of economic exposure. He added that the MSCI Europe index could mislead investors because most would need to consider the smaller MSCI Europe ex UK index to understand whether they wanted exposure to Europe via the index or not, as the UK firms would have much more global exposure than many European counterparts.

Mr Sellon also added that the hedging of foreign exchange exposure of firms is another area that complicates solving the problem of economic exposure.

Mr Monson argued that determining where a firm generates revenue could be oversimplified. To get a true picture, issues such as supply chains, intellectual property etc. have to be considered. "Yet put this to a client and it appears as gospel," he said. "Where a firm is domiciled is gospel as you are listed on that particular exchange, it is not as clear with revenues." He believes that it is a struggle to get within ten percent either way of an accurate figure on regional revenue.

Mr Kassam agreed this was an issue and cited the example of Amazon in the US which divides its revenue into 'US' and 'rest of the world,' despite its global reach. He said that MSCI has an estimation process for cases such as this.

Gaining access to certain markets was not down to economic exposure, Mr Choukeir said. Choices should be made on whether a firm is well run and is good value. If you want access to a particular market, invest directly there. Gaining access to markets through economic exposure from stocks based elsewhere “is not a pure way of doing it,” he said.

Mr Sellon said that making top down decisions on which markets to gain access to, i.e. America over Europe, could get skewed by the economic exposures though.

Economic, social & governance – beyond morality

Economic, social & governance (ESG) is another theme which can overlay the investment process.

This theme looks at risk that the ESG approach of a firm can present an investor with. These can be economic risks or long term perception risks surrounding a firm, Mr Kassam said. These issues can be at a sectorial level or for a specific stock. For example, energy companies own more reserves than can be safely burned, so this could be said to be a sectorial risk. Alternatively, it could be said to be an issue for an individual stock as it will affect firms in coal more than gas.

However, ESG should not be viewed as just a moral approach. Whilst it can play its part in ‘ethical investing’ it is not just this. It can be overlaid on any investment approach, regardless of individual investors’ values.

“Ethical and sustainable investing are different,” said Mr Sellon. “Investors can get confused between the two. It could be said that sustainable issues are common issues whereas ethical issues are personal values and beliefs. If you are an investment manager adopting a fund-based approach an ESG overlay is easier as it is binary but an ethical approach is more challenging.”

Mr Petit used gambling as an example. Investing casinos may be excluded on a moral or ethical basis by some investors. However, if using just an ESG approach, the reasons to exclude it would be if there were signs that a government was going to ban gambling or that there was a threat to the gambling sector – not because gambling is a ‘bad’ thing.

Mr Choukeir said that it can be difficult to know where to draw the line between the two. He cited the defence sector. A company may be involved in this and producing weapons, there may be evidence to suggest an ESG factor, perhaps which countries it is dealing with. A fund rating system, such as the one MSCI does provide, is needed but is of course open to a degree of interpretation. This is particularly the case when considering the governance element of ESG.

“Some investors see an ESG beta, tilting portfolios towards investing with desirable ESG features,” Mr Urwin said. “Studies show that positive ESG can have a positive impact on returns, which leads some investors to view it as a factor.”

Factor investing – fact or fad

ESG may be interpreted by some as a factor but it is not the most common element of factor investing, the final theme covered by the discussion.

The six key factors highlighted were: low size, value, momentum, quality, yield and low volatility.

Mr Kassam described factor investing, also known as ‘smart beta’, as a third way of investing between active and passive.

Mr Duret said that factors can be taken into account when making strategic asset allocation decisions, but it is not applicable when making tactical asset allocation decisions. This led him to suggest it is more of a structural element than a traditional ‘theme’.

There is another governance issue around factor investing though. If an active manager underperforms then an investor can lay the blame with them. However, if a factor underperforms compared with expectations it is harder to find somebody to blame. This has led to a slow take up of the approach, Mr Urwin said. However he sensed this is changing and could be a “big disruptive change to the industry. Investors are starting to consider whether this is lower cost and with more control than active managers,” he explained.
Mr Sellon said that in his opinion it moves from “somebody to blame” to “nobody to blame” argument. “It is not an individual fund manager underperforming,” he said. “If you take a factor in a diversified manner, you are not buying underperformance but buying a factor that is academically proven.”

Even active managers benefit from factors, Mr Choukeir added. Very often the outperformance of successful active managers is influenced by their factor bias. He cited the well-known example of Warren Buffet and his value bias – which is a factor overlay. Of course, this is combined with his ability to make successful investment decisions within that factor.

Mr Monson said there was a case that stocks could move from one factor to another, such as BMW, which was a value stock in the 1990s but might be regarded as a growth stock in the 2000s. This embeds increases in costs and turnover within a portfolio, but more accurately reflects style changes across indices. Mr Kassam said that the performance gained will cover the increased costs, if charged at a reasonable rate.