

IFDS BROWN SHIPLEY STERLING BOND FUND

ACTIVE OR PASSIVE?

Introduction

- The aim of the **IFDS Brown Shipley Sterling Bond Fund** is to offer investors a “Risk Conscious Route to Income”. The fund seeks to achieve this aim by generating a highly competitive level of income, whilst seeking to preserve capital over the medium term. In tandem, the fund aims to deliver a low volatile experience for unit holders.
- Specifically, the fund is mandated to be amongst the top decile of income generators within the IMA £ Corporate Bond sector, whilst preserving capital over the course of a complete interest rate cycle.

Should you have any questions or comments about the report or any other fund related matter, please do not hesitate to contact one of the team:



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- The income and redemption yields on the fund are not guaranteed and may change over time, due to future changes in the average maturity date of the bonds held by the fund or changes in current or perceived future interest rates.
- If the redemption yield is lower than the income yield, the investor is buying income at the expense of capital. As with all bond funds, there is a risk of default on either the income payment or capital payment or both by the underlying investments of the fund.
- The value of investments and the income from them are not guaranteed and therefore investors may not get back the full amount invested. Past performance is no guarantee of future performance. Currency fluctuations may cause the value of underlying investments to go up or down. The investment management charge on the fund is levied against the capital property, which may constrain capital growth.
- A simplified prospectus is available from our website and a company prospectus can be obtained by calling the IFDS Brown Shipley helpline 0870 043 4830. For security purposes, telephone calls may be monitored or recorded.

Corporate Bond Investing – Active vs. Passive?

The debate between active and passive investment management has been raging for many a year now. Whilst each has their proponents and respective merits, to date the argument has centred largely on that of equity market investing. We pose the question then...in the world of corporate bond investment, which is better – active or passive?

Analytical data fails to provide a conclusion. Over the past 5 years, the return on the “average” UK corporate bond fund is practically identical to the return on the most widely used corporate bond index in the UK.

Data to year ending February	2005	2006	2007	2008	2009	Cumulative
IMA Average £ Corporate Bond Fund	7.15%	7.74%	0.72%	-3.23%	-10.40%	0.81%
iBoxx £ Corporate Bond Index	7.82%	8.35%	1.11%	-3.79%	-11.16%	0.96%

Source: Lipper Hindsight, Markit Data

Percentage growth return, mid to mid in UK sterling with gross income reinvested

Whilst inconclusive, perhaps this is not surprising. As the debate between the two camps has continued, further analysis of the funds within the IMA £ Corporate Bond sector shows that many of the so called “active” funds are very index aware themselves and so display a high degree of correlation with the index itself.

To correct for this problem, we looked for those funds displaying a low (<90%) correlation with the iBoxx £ Corporate Bond Index. Of the 88 funds within the sector, just 14 displayed this characteristic, of which 9 had a 5 year track record. Using these 9 funds, we were able to form an “active fund” composite, the average performance of which is shown below.

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Active or Passive?

Data to year ending February	2005	2006	2007	2008	2009	Cumulative
Active Funds Composite	6.68%	8.65%	-0.01%	-2.40%	2.31%	15.74%
iBoxx £ Corporate Bond Index	7.82%	8.35%	1.11%	-3.79%	-11.16%	0.96%

Source: Lipper Hindsight, Markit Data, Brown Shipley Calculations

Percentage growth return, mid to mid in UK sterling with gross income reinvested

Clearly, this shows that over the past five years, genuinely active funds have significantly outperformed the passive iBoxx index, with material outperformance being generated in the past 12 months – a period of extreme stress for the corporate bond markets.

The “Index Bums” Problem

We consider the passive style of corporate bond fund management to be questionable at best. The reason? - The “index bums” problem.

The “index bums” problem refers to the practice used by many corporate bond fund managers in using reference benchmarks as a starting point for their asset allocation.

In fear of underperforming a particular benchmark or peer group comparison, many fund managers resort to replicating or “tilting” their portfolio away from the benchmark with a view to replicating or near replicating its performance.

Given the inherent differences in the construction of bond indices together with the different risks faced by bond and equity investors, this method of portfolio construction is nothing short of dangerous. Here’s why...

Unlike an equity shareholder, the purchaser of a corporate bond, whilst exposed to downside surprises, never experiences a positive surprise. The best possible outcome for the corporate bond investor is the prompt payment of coupon income together with the full and timely repayment of capital upon maturity of the issue. Whilst representing the best possible outcome, it also represents the expected outcome upon purchase of the bond. There are no upside surprises.

The flip-side of this, of course, is that corporate bondholders are subject to negative events. The deferral or non-payment of a coupon, the non-payment of capital upon maturity or fractional recovery of capital in the event of administration all represent real risks to the bondholder for which there is no positive surprises with which to set them off against.

The result of this dynamic is that the corporate bond fund manager must principally take the role of risk manager. This requires, as a pre-requisite, **diversification**.

Many investors confuse diversification with quantity of holdings. Holding a large quantity of positions, particularly when the positions themselves are highly correlated does not provide the investor with diversity – instead, it often adds to the monitoring costs of running the portfolio whilst providing the fund manager with a false sense of security.

The key risks to the corporate bond fund manager are:

- Default Risk
- Episodic Risk
- Systemic Risk

Each of which are arguably increased when adopting the index tracking mentality in a corporate bond portfolio.

Default Risk

Corporate bonds provide a higher yield than government bonds due to the possibility of default. In extremis, the government of the day can resort to printing money in order to repay its debts. Such luxury is not afforded to the corporate issuer.

Whilst avoiding defaults requires careful credit analysis together with some luck in the avoidance of unforeseen events, it should be readily apparent that the risk of default is clearly higher for the most heavily indebted of company. It seems perverse then, that for investors following the index tracking route to corporate bond investment, that they should allocate the most capital to the most heavily indebted organisations. Prior to their exclusion from the indices on account of being downgraded to “junk” status, both Ford and General Motors (on account of their highly leveraged balance sheets) represented some of the highest weightings in the iBoxx indices, and so for index based investors, represented some of their biggest risk exposures.

Though Ford and GM are no longer members of the index, their demotion themselves would have led to losses for index investors as they were forced to sell these positions upon the downgrade to junk status in order to maintain the index replication. With many investors all over the world seeking to perform the same trade at the same time, and for the same reasons, this results in the crystallising of the loss at the most inopportune moment for the investor. **Index tracking does not work.**

Episodic Risk

An episodic, or “event” risk represents the risk associated with an unforeseen event. Whether in the form of a change of legislation, a geo-political event, a change in the weather or simply the take-over of the issuing company, these episodic risks come along an all too frequent basis, and so create risks for bondholders.

As an index tracker, these risks come along more often than for the active investor who has the discretion to avoid situations he/she does not deem appropriate. Since the index based investor, by definition, holds all of the bonds in the index then the greater exposure to individual names clearly increases the risk of witnessing these events for which, unlike equity shareholders, there is no upside. **Index tracking does not work.**

Systemic Risk

Without doubt, systemic risk should represent the biggest source of concern for index based corporate bond investors. A systemic risk is one which has its origins within a particular company, country or

sector of the market, but which quickly spreads to contaminate its peers, neighbours, customers or suppliers. The recent banking crisis is a perfect example of such risks.

It is surely a concern then that for index trackers, who opt not to apply any discretion to their investments, the root cause of many such systemic risks is the overuse of debt financing itself which once above a sustainable level, pushes the perpetrator into a “death spiral” from which there is often no return.

Consider the weighting of the Financials (69.0%), and Banks (46.7%) in particular, within the iBoxx index as at end February 2009 for conclusive proof of the above if it were needed. With almost half of their capital allocated to Banks at the onset of the meltdown within the sector, we would hope that this experience has proved, beyond all reasonable doubt - **index tracking does not work.**

**“A Risk Conscious Route
to Income”**

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