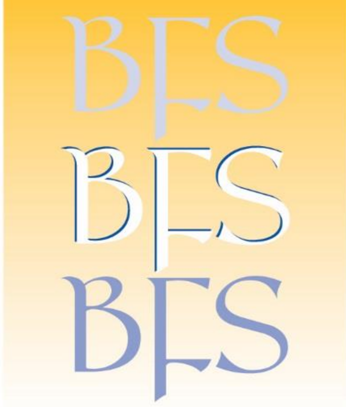

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Bridge Financial Services Investment Philosophy and Beliefs

1. Diversification.

Diversification can significantly improve a portfolio's risk/reward profile. Genuine commitment to diversification requires a willingness to allocate to asset classes/funds which may be out of favour or look relatively unattractive. Effective diversification requires an appreciation of asset class characteristics and inter-relationships. [The simultaneous collapse of the bank-laden ISEQ and property should forever serve as a reminder of ineffective diversification}. Diversification among assets with low correlations to one another, further reduces risk.

2. There is a strong case for preferring Passive or Systematic management.

In aggregate active management under-performs passive by the amount of the cost difference. The selection of successful active manager's ex ante is problematic, largely for the reasons outlined in (3) below.

As Stated by the well renowned economist William Sharpe:

If 'active' and 'passive' management styles are defined in sensible ways; it must be the case that:

(1) Before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and

(2) After costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar

Of course many active managers will deliver added value: the problem arises in selecting them. The greatest difficulty is posed by the powerful behavioural bias towards past and particularly recent performance which does not serve investors and advisors well.

3. For active funds, past performance is of little use in predicting future performance.

There is little or no evidence that strong investment performance has persistency over the medium to longer term. (There is some evidence that very poor performance persists). The selection of an active fund should be based on a broad assessment of factors, which should not be dominated by past performance. In so far as scale and resources are salient factors in any assessment, they are of very limited value: beyond a certain scale and resourcing which most mainstream providers meet, no correlation between greater scale and better performance has been established.

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Patrick Mackin trading as Bridge Financial Services is regulated by the Central Bank of Ireland (Ref No: 5097)

4. Absolute Return (AR) funds have a role in portfolios.

AR funds depend on active management, so that, in aggregate, AR funds should be a zero-sum game before costs. The level of correlation exhibited by AR funds with equities indicates a significant 'long' bias – meaning that AR funds in aggregate are picking up the return from their net positions in equities. Notwithstanding our general scepticism towards active funds, well-managed AR funds can have a place in investment recommendations, especially as components within a well-balanced portfolio. In particular, at a time when conventional bonds and cash appear particularly unattractive, AR may have a significant role as part of recommendations at lower risk levels.

5. Investment costs matter – a great deal.

The only certainty about future returns is the impact costs will have. The true burden of costs needs to be understood. In a low-return environment costs are likely to consume a very significant proportion of gross investment performance. Reducing costs to as low a level as feasible is a critical element of good client service. A euro saved in costs is the same as a euro earned due to performance but will have a greater effect due to consistency.

6. Rebalancing is a central element of portfolio management.

Over time market movements will bring the asset and fund weightings of a portfolio away from their target levels. There is considerable evidence that periodic rebalancing back to target enhances returns, in that it enforces a discipline of 'buying low and selling high'. Rebalancing also helps to ensure continuing suitability by keeping the risk level of the portfolio closer to where it was originally set. We recommend reviewing portfolios and rebalancing on at least a yearly basis.

The benefits that diversification provides goes hand in hand with rebalancing. Without rebalancing the total return will simply be the weighted average of the long term returns, providing no diversification benefit. Rebalancing benefits rise as volatility rises, so the greatest benefits come during periods (like 2008/2009) when there are wild movements in portfolios. Diversification does not assure a profit or protect against a loss, but it limits the damage inflicted by large downside events.

7. Market timing is unlikely to add value.

'Market timing' is the process of making very active short-term changes to portfolio asset allocation. The empirical evidence suggests that success is elusive, and demands considerable skill and resources. We do not believe that we should advise our clients to attempt to time short-term market moves.

8. Gearing should be avoided.

Gearing is a method of investment that involves borrowing for investment in order to boost returns. We do not see a case for using funds with gearing on any 'retail' product shelf – the potential for customer outcomes to disappoint is too great.

9. Small cap and value are factors which are associated with superior long-term equity returns.

There is very convincing empirical evidence that (i) smaller-cap stocks and (ii) 'value' stocks tend to outperform broader markets over the longer term, and that both return premiums are persistent. In this regard, there is a substantial cross-over between companies with above-average dividend yields and those which are regarded as 'value'. The return premium to value and smaller-cap can be explained as compensation for higher risk (especially in the case of smaller-cap) and a persistent anomaly in investor behaviours (especially in the case of value).

10. Where structured products are used they should not form part of the core client portfolio.

Their likely correlation with other portfolio components is uncertain/asymmetric. The actual risk/reward trade-off is often hard to assess. Uncertainty around the term: some structures terminate at the provider's option or 'kick-out' on specific outcomes. While the latter may be favourable to the investor, a portfolio intended for use for a number of years may need to be reconstructed unless a ready-made replacement is available.

11. Property should be approached with caution.

We believe that property can have a place in investment recommendations for clients: however, it should be always regarded as a high-risk element because of its illiquidity and potential for large drawdowns (as witnessed in 2007-2010). Even where clients have a strong risk tolerance and capacity to bear risk the allocation to property should be modest. Investing in two different property funds, offers very limited diversification. The property market tends to rise and fall as a whole, and global economic trends can hit most property markets at once. The same iron rule applies to property as for investments generally: where an asset class can deliver high returns, it can also deliver heavy losses.

12. Equity allocations: geographic exposure should be very broad and well balanced.

The starting point for the equity allocation of any portfolio should be a global fund, as the most diversified equity investment. Unhedged versions of global equity funds are preferred given:

- the costs which may arise
- the interaction between currency movements and corporate profits through international competitiveness, which tends to balance out over time
- the effect of currency on the translation of overseas earnings

While some 'skews' towards, for example, emerging markets and/or the Eurozone may be added, excessive tinkering should be avoided.

13. Equity allocations: sector-specific allocations should be avoided.

There are times when investors and investment advisors are possessed of great enthusiasm towards particular industry sectors; but there is no evidence to suggest that anyone has the ability to forecast superior long-term returns from one sector to another. The vogue for technology stocks at the turn of the millennium was a good illustration of this phenomenon at work. Likewise, the persistent popularity of sectors such as renewable energy is unlikely to be rewarded by superior returns.

14. Ethical/Socially Responsible Investments (SRI) should be accommodated if the customer wishes, but there is little basis for claiming superior prospective returns.

The evidence that SRI produces better returns is inconclusive: however, there is no convincing evidence of any loss of return - SRI funds stand analysis with other funds operating in the same investment sphere without SRI restrictions.

15. Inflation-linked bonds have a place in portfolios.

Inflation can be very destructive to long term savers. Most of the world's central banks want to see a modest level of inflation – the ECB has an objective of generating inflation of close to, but below 2%. Inflation-linked bonds offer the purest form of protection against inflation and have a place on portfolios - especially those of clients with a constraint on risk appetite/capacity.

16. Valuations matter

We believe that asset allocation is fundamental and our preference for asset classes is based on the long-term drivers of return and our understanding of risk characteristics and correlation. We also understand that the valuation of the assets at the time of purchase has a huge bearing on future returns e.g. investors who bought global equities in August 2000 got back to where they started in December 2013. Similarly the realistic expectation of the return from bonds (other than inflation-linked) is the yield to redemption at the time of purchase.

When investing in a portfolio of assets, consideration must be given to the long term valuation of any asset and this, along with consideration of risk should determine the specific asset mix chosen.