For Professional Investors and Advisers Only

RWC Equity Income

Q1 2015 Investor Letter | January 2015

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Portfolio Managers

Nick Purves, John Teahan and Ian Lance

Nick Purves and Ian Lance were previously responsible for income-based strategies at Schroders, co-managing approximately £5bn within the income fund range since 2007. Nick and Ian joined RWC in August 2010 to establish the Equity Income franchise and were joined by John Teahan in September 2010. Since joining RWC the Team has developed low-volatility equity income funds with a focus on capital preservation. The team has over 61 years' investment experience between them and currently manage USD 4.3 billion in equity income mandates.

Economics in One Lesson

"Why did no one see it coming?"[1]

Despite their failure to see the financial crisis of 2008 coming or to agree on the best way to resolve it, economists' confidence in their own ability does not appear to have been shaken. There does, however, seem to have been a marked shift in the economic narrative post the crisis with the rise to prominence of those spouting a Keynesian interventionist doctrine. With supreme irony the Financial Times (FT), which hitherto many would have assumed to have been the mouthpiece of free market capitalism, now make almost daily pleas for government intervention. This constant squealing for central bank financed support reached its peak when regular FT columnist Wolfgang Munchau called for 'a payment of €10,000 per citizen which would translate into €3tn'. Mr Munchau goes on to confidently assert that 'A helicopter drop would work but sadly, I fear, it would be too unconventional for the continental European mind.'[2] So powerful have these voices become that they have moved beyond shaping the academic debate to directly influencing government policy as witnessed when Paul Krugman recently advised Japanese Prime Minister Shinzo Abe to cancel his planned increase in consumption tax[3] but continue printing money to fund government deficit spending.

So it is against this background that I recently read what I felt was the best book on economics I have ever read; it was short, clear, contained no mathematical formula and put the alternative argument to the Keynesian claptrap that has become the staple diet of the mainstream media. The book looks at the three most common reasons that economic policy fails.

1. Whilst policy should be designed to benefit the widest possible group of people, the reality is that special interest groups become overly influential and ensure that new policy tends to favour them at the expense of others. Historically this might have been farmers or unions, for instance.

2. Politicians only worry about the short term effects of policy and hence favour policies which will be immediately beneficial even if they are harmful in the long term and fail to implement good long term policy if it will be unpopular in the short term. Ed Milliband's demonic ranting against the energy companies is clearly designed to grab votes in the short term but has already led to billions of pounds worth of investment being cancelled thus increasing the likelihood that in the longer run the UK has insufficient power generation capacity to meet demand.

3. Most economists and politicians fall for the concept known as Bastiat's broken window fallacy[4] which was an attempt to illustrate opportunity cost; the idea was that if a young lout throws a brick through a shop keepers window, and the latter pays £250 for it to be repaired, then the glazier becomes £250 wealthier and he in turn could choose to buy a suit, which makes the tailor wealthier etc. Some economists would argue that the original broken window has caused a positive multiplier through the economy and that following this to its logical conclusion, an economy could be made wealthier by encouraging the lout to go and smash lots of windows. Bastiat points out that this is bunkum because it ignores the opportunity cost; having spent £250 on a new window, the shop keeper has to cancel some other spending that he had planned and so there is no net benefit to the economy.

If these three points seemed familiar, you may be surprised to know that the book, Economics in One Lesson, was written in 1946 and the author was Henry Hazlitt who, from 1934 to 1946, was the principal editorial writer on finance and economics for The New York Times, writing both a signed weekly column along with most of the unsigned editorials on economics. According to Hazlitt, the greatest influence on his writing in economics was the work of Ludwig von Mises, and he is credited with introducing the ideas of the Austrian School of economics to the English-speaking layman. *Economics in One Lesson* (1946) has been called Hazlitt's "most enduring contribution," is considered a classic in conservative, free market and libertarian circles. Ayn Rand called it a "*magnificent job of theoretical exposition,*" while Congressman Ron Paul ranks it with the works of Frédéric Bastiat and F. A. Hayek. Hayek himself praised the work, as did fellow Nobel Prize laureate Milton Friedman, who said that Hazlitt's description of the price system, for example, was "*a true classic: timeless, correct, painlessly instructive.*"

So to what extent are Hazlitt's ideas relevant to today's economic policy? His first view that '*special interest groups get in the way of good economic policy*' is something we have commented on repeatedly here, here and here in our discussions of 'crony capitalism'. This can take many forms; last week, Ireland became the first EU country allowed to export beef to the US for 17 years suggesting the farming lobby remains strong in America. However, it is the financial services lobby that has become the most powerful in the last few years as demonstrated by the 2008 bail out of Wall Street and subsequent watering down of regulations aimed at preventing a repeat of the financial crisis. As Illinois Senator

[1] Queen Elizabeth II asking why no economists were able to see the 2008 financial crisis coming during a visit to the London School of Economics.
[2] Financial Times, extracted 11th January 2015
[3] How a Limo Ride With Paul Krugman Changed the Course of Abenomics, Bloomberg, extracted 21st November 2014
[4] Claude Frédéric Bastiat was a French classical liberal theorist, political economist, whose ideas have gone on to provide a foundational basis for libertarian and the Austrian schools of thought.

Durbin admitted in 2009, "*The banks -- hard to believe in a time when we're facing a banking crisis that many of the banks created -- are still the most powerful lobby on Capitol Hill. And they frankly own the place.*" Just before Christmas, the US senate passed the continuing resolution omnibus spending bill (aka the CRomnibus) and a repeal of part of the Dodd-Frank financial reform act of 2010 known as the Lincoln Amendment, which again allows the largest financial institutions to take risky bets on exotic financial products with federally insured bank assets like consumer deposits. What is depressing beyond belief is the fact that even after the financial crisis, Washington is still owned by Wall Street; the bill appears to have been drafted by Citi[5] and strong armed through by JP Morgan boss Jamie Dimon.[6]

Hazlitt's second idea that politicians will not make sensible long term strategy if it is likely to be unpopular in the short term seems truer today than ever and can be observed from the 'can kicking' strategies in Europe to the deficit spending policies employed by most western governments for the last two decades. Since the end of a crisis caused by too much debt, most governments have simply taken on more debt as none of them can face the political uproar that would follow any attempt to live within their means.[7] As Jean Claude Junker once said, "*We all know what to do, we just don't know how to get re-elected after we've done it.*"

But it is Hazlitt's third idea that I think has most relevance; the broken window fallacy points out that simply taking from one sector of society and giving to another does not improve the economy and yet this is what most economic policy has done in the last few years. Central banks policy of zero interest policy clearly helps borrowers whilst hurting savers. Printing money merely serves to drive asset prices up which is great for the wealthiest 1% who own a disproportionately large amount of those assets but unhelpful for those who wish to save or for first time house buyers. The central theme of '*Economic's in One Lesson*' is the fallacy of '*robbing Peter to pay Paul*' strategies whereas commentators today such as the Financial Time's Martin Wolf advocate exactly these policies.[8] It is also obvious why they appeal to politicians who must be seen to be doing something but who presumably regard money printing as costless (in the short term) whilst also allowing them to defer the tough decisions.

The rising inequality in the western world suggests that quantitative easing is not even a zero sum game since the assets whose prices are driven skyward are owned by the wealthiest 1% who necessarily have a lower propensity to spend than the population at large. The policy may allow company CEOs to massage their Earnings per Share by using cheap debt to buy back their own stock and further inflate share prices but the downside is that many companies simultaneously cut back research and development, capital expenditure and hiring which hinders the recovery in the real economy.[9] In short it is a policy to benefit Wall Street more than Main Street.

Some now believe, however, that more than just not helping the economy, quantitative easing may actually be deflationary which is supremely ironic as Mario Draghi starts cranking up the printing presses in order to save Europe from deflation. The suggestion is that quantitative easing interferes with the market pricing mechanism and encourages malinvestment which ultimately becomes deflationary. This certainly seems to have been the case with the housing booms and busts in countries such as Spain and Ireland and we could now be facing a similar situation in the US energy sector. The technology of fracking has been around for decades, what allowed the sudden boom in investment was a higher oil price and a near zero cost of financing.

I'm no Austrian but the concept of malinvestment would seem to apply to shale oil and gas if it applies to anything. It was produced by money illusion, faulty monetary policy and it will end as all booms do – in bust[10]

The same can be said of China who embarked on massive investment programme post 2008 in order to keep the economy growing. The increase in steel capacity in the five years following 2008 was the same as total steel production in all of Europe and North America. Since there was no corresponding increase in demand, this excess capacity is now being dumped on to the world market and steel prices are collapsing.

The view that quantitative easing is ultimately deflationary has been expressed by Narayana Kocherlakota, the Minneapolis Fed chief, as far back as 2011 as well as by others including India's central bank chief, Raghuram Rajan and Claudio Borio, the BIS's chief economist. Masaaki Shirakawa, the former governor of the Bank of Japan, says wearily that the world might have learned something if it had studied QE in his country. The monetary base was doubled after 1997, yet deflation ground on.

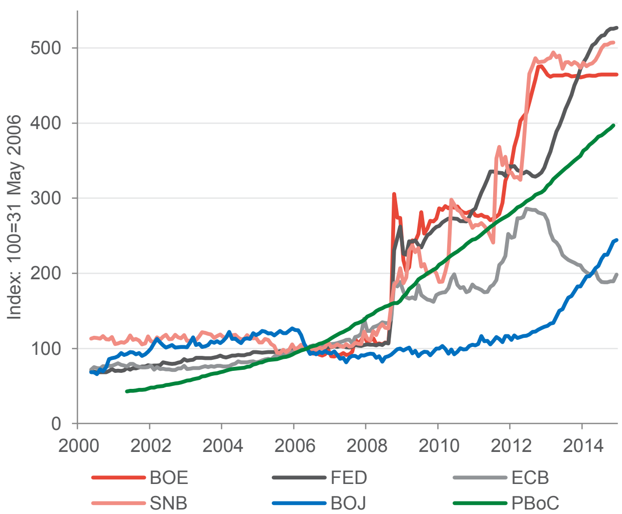
"*The central banks have been frustrated in their insane and misguided aim to increase inflation because QE and ZIRP actually foster the opposite of what central bankers expect. Central bankers and economists think that to get inflation they only need to print more money, not recognizing that the inflation that does result from money printing, asset inflation, leads eventually to consumer goods deflation. ZIRP and QE*

[5] Senator Elizabeth Warren has claimed that this part of the bill was written by Citi "This was a provision added by CitiGroup lobbyists," Warren told MSNBC host Rachel Maddow, December 2014
[6] The Hill reported that JPMorgan Chase CEO Jamie Dimon made calls to lawmakers on Thursday urging them to support the "cromnibus" spending bill, House Financial Services Committee ranking member Maxine Waters (D-Calif.) told reporters, December 2014
[7] Deleveraging, What Deleveraging, Luigi Buttiglione, Philip R. Lane, Lucrezia Reichlin, Vincent Reinhart, 29 September 2014
[8] Wipe out the rentiers with cheap money; cautious savers no longer serve a useful economic purpose Financial Times 6th May 2014
[9] For an excellent exposition of this see Andrew Smithers 'The Road to Recovery'
[10] Sigmund Holmes via David Stockman 'Contra Corner website 3rd December 2014

cause malinvestment and overinvestment that leads to excess productive capacity. That leads to overproduction and oversupply. Oversupply puts downward pressure on prices. That spurs a vicious cycle where the central banks print more money to try to create inflation. That puts more cash into the accounts of the leveraged speculating community and off we go again." Lee Adler, Wall Street Examiner[11]

Since the financial crisis, central banks have expanded their balance sheets by $10trillion as the chart below shows.

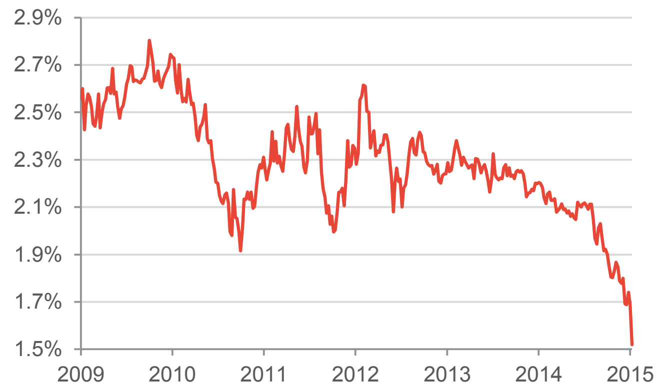
Chart 1: Comparison of Central Bank Balance Sheets



Source: Bloomberg, 29 January 1999 to 31 December 2014

Despite all this frantic money printing, signs of deflation are everywhere *(see charts on the following pages)* but the response of central bankers is always and everywhere to print more money (as the saying goes, to a man with a hammer, everything looks like a nail). This presents a potentially huge problem to world economic recovery. The Keynesian response to the financial crisis has become so universally accepted that it is now employed by nearly every major developed world government and central bank. Has anyone (other than Ron Paul, David Stockman and a few others) stopped to consider what would happen if it turns out this was the wrong response and Hazlitt and his fellow Austrians are right?

Chart 2: European 5-Year-Forward 5-Year-Inflation Swap Rate



Source: Bloomberg, 31 December 2008 to 12 January 2015

Chart 3: Brent Crude

Source: Bloomberg, 31 December 2007 to 12 January 2015

Chart 4: Baltic Dry Index

Source: Bloomberg, 31 December 2007 to 12 January 2015

[11] Wall Street Examiner, December 2014

Chart 5: Copper

Source: Bloomberg, 31 December 2007 to 12 January 2015

Chart 6: German 10 Year Yield

Source: Bloomberg, 31 December 2007 to 12 January 2015

Chart 7: French 10 Year Yield

Source: Bloomberg, 31 December 2007 to 12 January 2015

Chart 8: Italian 10 Year Yield

Source: Bloomberg, 31 December 2007 to 12 January 2015

Chart 9: Spanish 10 Year Yield

Source: Bloomberg, 31 December 2007 to 12 January 2015

Tally Ho!

Whilst the annual Boxing Day hunt now sees the hounds chasing a farmer laying a scent on a quad bike rather than a fox, it's nice to see that some other traditional blood sports have been maintained. I refer of course to the annual hounding of active fund managers for failing to 'beat the market'. As usual, fund managers had their festive fun interrupted by a stream of articles[1] suggesting that they were basically useless and that investors were wasting their time trying to find anyone who could beat the market.

Before we get in to this debate, I need to make a couple of points. Firstly, I get the point that the fund management industry collectively cannot outperform after fees. I also happen to agree that collectively the industry doesn't do a great job; it charges too much for indifferent returns and is still far too secretive. No wonder a PwC report published in October 2014, entitled '*How financial services lost its mojo - and how to regain it*' found that 12% of survey respondents trusted fund groups, compared with 27% for insurance providers, 28% for financial advisers, 32% for retail banks and 13% for investment banks. **However, that is not the same as saying that active fund management does not work as it manifestly can work.** There are many fund managers past and present who have outstanding long term track records; names such as John Templeton and Peter Lynch in the US, Anthony Bolton and, Neil Woodford in the UK come to mind. The returns on our longest standing fund, St James Place Equity Income Fund, have been 172% versus 91% for the FTSE All share total return which equates to 7.4% p.a. versus 4.7%p.a.[2] Even the doubters at the Financial Times would be forced to concede that fourteen years is a long enough period to have some statistical significance.

The implication of the criticism of active fund investing is that investors would be far better off investing in passive funds and judging by the $243bn net inflows to Vanguards funds in 2014, many have arrived at this conclusion themselves. Even Warren Buffett advised his wife to put her inheritance in low cost tracker funds![3] Coming to the defence of my industry, I would just highlight the following notes of caution to those ready to throw the towel in on active management and go completely passive.[4]

1. Is it absolute or relative performance that really matters to you?

   Investing legend, Sir John Templeton once said, '*For all long-term investors, there is only one objective: maximum total real return after taxes*'. For most fund investors, whether they be charities, family offices or pension funds, their liabilities are absolute £ or $ amounts.

   'Coco Chanel famously said when she lost her lawsuit to retain the rights to Chanel No. 5, as I recall, that she had only one desire in life, and that was to remain in her suite of rooms at the Ritz Hotel in Paris…….. She wanted her living standards maintained. I think Chanel wanted to keep her rooms at the Ritz regardless of inflation, deflation, the stock market, this or that'.[5]

   I think many investors would do better to start with the premise 'what return do I need' and work backwards rather than starting with some arbitrarily chosen list of quoted companies weighted by their size and then try to figure out how they will use them to get their required return.

   It is worth recalling that, equity returns are made up of starting yield, real income growth and change in valuation. According to authors of the Credit Suisse Global Investment Returns Handbook 2014, between 1900 and 2013, UK equities returned 5.3% real p.a. which was made up of 4.6% from dividend yield, 0.6% real growth in income and 0.1% change in valuation. But just holding equities in line with the market does not guarantee the owner 5.3% real return as the greatest determinant of future returns is starting valuation which is currently high by historical standards. Today if you just buy the index you are probably locking in a 2% real return at best which may not be sufficient for many people especially given the likely associated volatility. In a world in which equities are humming along at 10-15% a year, the index return is probably fine but in a lower growth world such as the one we appear to be facing, an active manager who can add alpha of 2-4% p.a. has the potential to double the annual expected return.

2. Do you know what you are buying?

   Think about what a cap weighted index is. It is a rag bag collection of investments determined by a group of actuaries. At various times, some indices become heavily distorted by certain industries and under exposed to others. You would not go to a restaurant for a meal where the only ingredients in the kitchen were kale, liver, snails and ice cream (although it hasn't held Heston Blumenthal back!) so why would you buy an index that was equally distorted. In 2012 the FTSE was festooned with overseas mining companies many of whom had appalling corporate governance (and in some cases, human rights) issues. How many investors stopped to consider what they were actually buying when they 'bought the index'.

[1] Shameful Secrets of 'active' fund managers, Financial Times, 21st November 2014
'Loser's Game' Financial Times, 21st December 2014
'Torrid Time for active fund managers' Financial Times, 16th November 2014
[2] Source: RWC / Bloomberg. Data is shown for the period 29/12/2000 to 31/12/2014 net of fees, as at 31/12/2014. Equity index used is FTSE All share (TR).
Note that Nick Purves has been responsible for the SJP Equity Income Fund since 29/12/2000 during that time he has been employed by both Schroders and RWC.
Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.
[3] 'Warren Buffett tells wife Go cheap and Passive', FinancialTimes.com, 7th March 2014
[4] See RWC Q3 2011 letter for Passive Investing – the unintended consequences
[5] From a talk given by Dr. Brock at the Portfolio Construction Forum, held in Sydney, Australia, from August 21-23, 2012

Table 1: Ownership of FTSE 100 Mining Companies

Company	Description	Biggest Shareholder	% Owned
Anglo American	Global Mining Company	Genesis AM	8.5%
Antofagasta	Chilean copper miner	Metalinvest	50.7%
BHP Billiton	Global Mining Company	Blackrock	4.9%
Eurasian Natural Resources	Natural resources miner	Kazakhyms Eurasia	26.0%
Evraz	Russian iron ore miner	Lanebrook	64.3%
Fresnillo	Mexican silver miner	Industrias Penoles	75.0%
Glencore	Mining and trading conglomerate	Qatar Holdings	9.0%
Kazakhyms	Copper mine in Kazakhstan	Novachuk Oleg Nikolaevi	7.8%
Polymetal	Russian gold miner	Powerboom Investments	19.9%
Rio Tinto	Global mining company	Shining Prospect	12.9%
Vedanta	Indian copper miner	Volcan Investments	69.8%

Source: Bloomberg, as at 13 January 2015

3. Indexes overweight expensive stocks and underweight cheap ones

   As indexes are weighted by size they tend to place a higher weight on expensive companies and a lower weight on cheaper companies, sometimes dramatically so. In March 2000, the index committee of the FTSE indices took nine companies out of the FTSE100 and replaced them with nine other which fundamentally changed the composition of the index. These changes and the subsequent returns are shown in table 2.

   What is extraordinary is that beating the market over a market cycle is theoretically easy to achieve. There are numerous strategies that have been tested over long periods of time and produce better results than the market. A value strategy, that is buying stocks that are lowly priced relative to their sales, earnings, cash flows, dividend yields or assets have been found to produce better returns than their relevant indices time and time again.[6] Small capitalisation stocks have also been shown to produce excess returns, albeit with higher risk,[7] although recent research by Vitali Kalesnik and Noah Beck has cast doubt on this.[8] Finally, Professors Dimson, Marsh and Staunton at London Business School[9] found that momentum also works.

Table 2: March 2000 changes to FTSE100

Company	P/E Ratio	Price change in following 3 months %	Additions	P/E Ratio	Price change in following 3 months %
Associated British Foods	12	+24	Cable & Wireless	104	-10
Allied Domecq	12	+29	Freeserve	n/a	-26
Hanson	11	+14	Thus	n/a	-55
Whitbread	9	+23	Baltimore	n/a	-57
Scottish & Newcastle	8	+41	Psion	n/a	-44
Powergen	7	+55	Nycomed	32	+4
Thames Water	7	+36	Celltech	n/a	-14
Imperial Tobacco	9	+30	Capital Group	155	+4
Wolseley	8	+1	EMAP	37	-26

Source: Simple but Not Easy by Richard Oldfield, 2007

So if it is so easy to beat an index, why don't more fund managers do it? Firstly, these theoretical back tests don't show the underlying portfolio required to achieve the results i.e. a value strategy would probably have been 80% weighted in banks in 2008 several of which would have gone bust. But the real answer lies in a quote in the FT article from Craig Lazzara of S&P in which he referenced a study from the same company. "Your chances of finding a fund manager who can stay ahead of the index five years in a row are about the same as tossing a coin and calling it correctly five times in a row"[10] (emphasis mine). So not only are investors, and this includes many professional advisors, obsessed with beating a cap weighted index, but they are also convinced that it should be done between 1st Jan and 31st December at which point the clock is reset and it has to be achieved in the following 365 days. Is this a realistic expectation? NONE of the strategies above which earn great long term returns work in every calendar year and NONE of the great investors of the last century has done this either. Why on earth do investors expect run of the mill active fund managers to do so?

Unfortunately, it is the focus on short term relative returns that can be so damaging and prevent the long term returns being realised. Some outstanding investors quite rightly refused to buy in to the TMT bubble in the nineties but then suffered the consequences; Julian Robertson shut his Tiger fund in February 2000 after $8bn of investor withdrawals. Others like well-known value manager Gary Brinson who was overseeing $360bn for UBS quit in March 2000 the same month that Tony Dye quit Phillips and Drew Fund Management. Highly respected fund manager and architect of the Enterprise Fund Jim Cox at Schroders decided to resign after being told he would have to explain to the firm's young tech analysts why he didn't hold their favourite stocks. Finally at the corporate level, highly respected value fund manager Sanford C

[6] What works in Investing, Tweedy Brown, 1992, gives a good summary of various empirical evidence supporting this. See also Brandes Research Institutes papers on value versus glamour
[7] The Cross Section of Expected Stock Returns, Fama and French, 1992
[8] Busting the Myth about Size, Kalesnik and Beck, Research Afffiliates, December 2014
[9] Credit Suisse Global Investment Returns Handbook, 2013
[10] Financial Times, 21 December 2014

Bernstein was acquired by growth fund manager Alliance Capital whilst value oriented fund manager GMO suffered $10bn of net client withdrawals between 1998 and 2000.[11]

What compounds the error is that the money that flows out of underperforming funds then flows in to the hot funds which have been performing. One of the most famous funds in the nineties was Janus Twenty, designed to invest in only 20-30 stocks selected for their growth potential. From January 1995 to December 1999, the fund's AUM mushroomed from $2.5 billion to $36.9 billion. Thanks to the internet boom, returns averaged 40% per year. Then in 2000, internet growth stocks crashed. Janus Twenty was hit harder than most funds with its concentrated growth positions, and its average return in 2000 was -35.1%. Money started to flood out of the fund which by 2003 was back down to $10bn.[11]

This process of money chasing hot funds around influences the way that managers who value their job security behave and ultimately ends up reducing industry returns. Taking a contrarian position and being early (which is also known as being wrong) is the surest way to lose assets and/or your job in a world fixated with short term relative performance and therefore fund managers adopt the rational response and either stick close to the index or just become short term momentum jockeys. One of the world's most outstanding investors, Seth Klarman, felt so incensed at how benchmark relative performance had negatively influenced the money management industry and the returns that investors experienced, he wrote the book 'At The Margin of Safety'.

'The truth is, I am pained by the disastrous investment results experienced by great numbers of unsophisticated or undisciplined investors...investors, particularly institutional investors, become enmeshed in a short-term relative-performance derby, whereby temporary price fluctuations become the dominant focus'

If the RWC offices suddenly caught fire and I could only save one book, it would probably be Margin of Safety. The book was written in 1992 by an investor so unconcerned by relative performance that he sometimes holds half his fund in cash and yet has compounded at 20% p.a. Yet here we are twenty two years later and fund managers are being castigated in the press for lagging behind the twelve month return of an equity bull market in its seventh year.[12]

I would argue that the key to reasonable long term returns are 1. Find a strategy that has been shown to work 2. Stick with it! The problem is that when faced with 1, many people confuse process and outcome. A sensible process is one that has some empirical evidence of success and that is implemented by a fund manager who has shown the ability to stick with it through good times and bad. This is, however, frequently confused with strategies that work well (good outcome) for a while, but don't tend to stand the test of time (poor process). Three years ago, any fund manager loaded up with mid-cap cyclicals and financials became an overnight hero following Mario Draghi's 'Do whatever it takes' speech which sent these sectors in to orbit. As often happens, the big asset management firms aggressively marketed these funds who saw their assets explode in the following 18 months. Unfortunately, as the world became more cautious about Draghi's ability to turn round the economic fortunes of Europe, the same sectors did badly and the funds exposed to them began to experience outflows. I would concede, therefore, that the industry must share some of the blame as it is skilled at making what is temporary good fortune look like a skilful process using glossy marketing literature.

'Ninety percent of what passes for brilliance, or incompetence, in investing is the ebb and flow of investment style (i.e., growth, value, foreign vs. domestic, etc.). Since opportunities by style regress, past performance tends to be negatively correlated with future relative performance. Therefore, managers are often harder to pick than stocks. Clients have to choose between fact (past performance) and the conflicting marketing claims of various managers. As sensible businessmen, clients usually feel they have to go with the past facts. They therefore rotate into previously strong styles, which regress [to the mean], dooming most active clients to failure.'
- Jeremy Grantham, August 2012

In summary, it would seem investors face three choices:

i. If you are going to use a cap weighted benchmark to measure an active manager, you have to be prepared to assess it over a market cycle (which is at least seven years not one year or one quarter).

ii. If you are going to buy a passive fund recognise that zero tracking error is not the same as zero risk – you could be paying horrible prices for horrible companies. *'Indexing is likely to end badly. Fundamental analysis and active management will make a comeback.'*[13]

iii. Use a benchmark that is more helpful than a cap weighted index. Paul Woolley, who is one of the founders of GMO and now a Senior Fellow at the London School of Economics, has a special interest in this area having funded the Paul Woolley Centre for the Study of Capital Market Dysfunctionality. He has put forward three recommendations to improve returns available to investors in active equity funds;[14] firstly, turnover should be drastically lowered i.e as other investors become very short term, you must become very long term. Secondly, you replace market cap weighted benchmarks with more stable ones 'global GDP plus local inflation makes a sound overall benchmark, while risk should be specified in relation to cash flows rather than prices'. Thirdly, asset owners should lengthen performance evaluation timescales and pay performance fees based on them. He concludes:

[11] Mutual Funds and Other 40-Act Funds, Andrew Ang, Columbia Business School, 8th March 2013
[12] See: RWC Q1 2011 letter on 'How relevant are short term returns?
[13] Mark Faber speaking at Societe Generale Investor Conference, 14th January 2015
[14] See: A speech by Dr Paul Wooley at The Princes Charities Event and the Long-term: Rethinking Portfolios for Prosperity, 27th June 2013

> *'A fund adopting these strategies will gain a private advantage in the form of higher medium- and long-run returns. As more funds follow suit, equity markets will become more stable, encouraging investment. If the market signals improve, there is a better chance of capital being allocated productively. This is a rare case of the private and public interests being in complete alignment'*

Maybe next Christmas, fund manager baiting will have gone the way of fox-hunting – we can live in hope!

About RWC

RWC is an independent investment firm founded in 2000, providing high-alpha asset management to institutions, professional investors and intermediaries.

The firm provides an intense focus on investment performance and extracting maximum 'alpha' (manager skill). Each of our select range of strategies is based around the proven skills of talented investment professionals.

The firm only launches strategies where it can secure top-performing managers to run them. The firm provides an environment in which talented managers, supported by dedicated analysts, can focus on delivering performance using their preferred process and philosophy.

This focus on performance sits within a culture of strong risk management. At all times, the firm's results are based on delivering returns within known and acceptable levels of risk. In each strategy, protecting clients' assets is as important as capturing return.

RWC is independently managed and controlled. The majority of the firm's equity is owned by the firm's portfolio managers, directors and other employees. Schroders owns a minority stake in the business. Most RWC staff have chosen to invest directly in equity and/or funds managed by the business.

RWC Asset Management LLP is a wholly-owned subsidiary of RWC Partners Limited and provides the majority of investment management services for the group. Both businesses are UK based and are regulated by the Financial Conduct Authority.

About the team

Nick Purves

Nick joined RWC in August 2010. He was previously senior portfolio manager at Schroders for over 16 years managing both Institutional Specialist Value Funds and the Schroder Income Fund and Income Maximiser Fund together with Ian Lance. During his time at Schroders, Nick was Citywire AAA, Nick and Ian's Income fund was Morningstar 5 star rated, AA rated by OBSR and won the Moneywise award in 2009 in the UK Equity Income and Equity Income and Growth sectors. Nick is a qualified Chartered Accountant.

Ian Lance

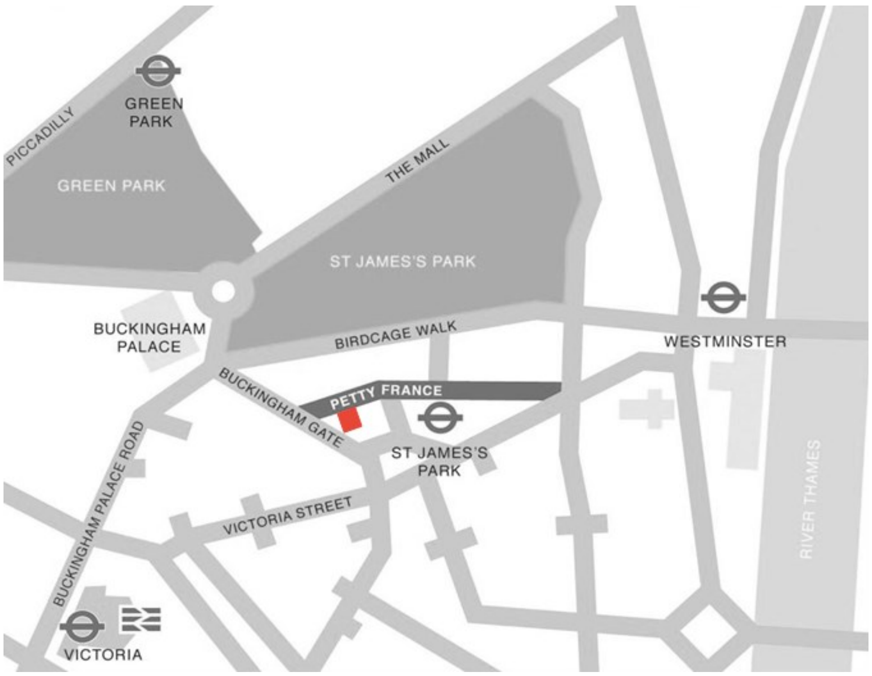
Ian joined RWC in August 2010. He was previously senior portfolio manager at Schroders managing both Institutional Specialist Value Funds and the Schroder Income Fund and Income Maximiser Fund together with Nick Purves. During his time at Schroders, Ian was Citywire AAA rated, Nick and Ian's Income fund was Morningstar 5 star rated, AA rated by OBSR and won the Moneywise award in 2009 in the UK Equity Income and Equity Income and Growth sectors. Previously Ian was the Head of European Equities and Director of Research at Citigroup Asset Management and Head of Global Research at Gartmore.

John Teahan

John joined RWC and the Equity Income Team in September 2010. He previously worked at Schroders, where he co-managed the Schroder Income Maximiser with Nick Purves and Ian Lance. John also co-managed the Schroder Global Dividend Maximiser, Schroder European Dividend Maximiser and Schroder UK Income Defensive funds, all three of which employed a covered call strategy. John also specialised in trading and managing derivative securities for a range of structured funds. Previously he worked as a performance and risk analyst for Bank of Ireland Asset Management UK. John is a CFA Charterholder.

Larry Furness

Larry joined RWC in August 2010 as a graduate recruit and currently works in the Equity Income Team. He graduated from the University of Nottingham in 2009 with an honours degree in Economics and during his tenure successfully completed two intern positions; the first at Permal Investment Management where he was involved in manager research for the firm as an Investment Analyst, and the Government Economic Service as an Assistant Economist. Larry is a CFA Level II candidate.



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Please contact us if you have any questions or want to discuss any of our strategies.

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