

## Don't be fooled by the decimal point

Equity investing is for the long term; at least ten years and preferably longer. That is far too long for many commentators and observers to wait before remarking and attempting to analyse performance and determine why a portfolio has under or outperformed a particular benchmark. Leaving aside the issue of how much risk a portfolio has embraced, or rejected, to achieve a specified return there is another factor that needs to be understood by anyone seeking to understand performance over time scales of a year or less.

Stock markets measure the capital value of the companies listed on them. It is not a very meaningful measure because it tells you nothing about profitability, or levels of debt or any other financial measure of the companies it contains. It also says little about historic returns because the difference in capital values over time does not capture the important element of dividends. (As an aside that is one reason structured products are an easy sell because they take the dividends, use them to buy derivatives, and hey presto the manager can claim to beat the capital only index and give you protection as well. In fact it is those dividends that generate half the returns from equity investing which investors forgo when they buy a structured product). Nonetheless, financial markets are familiar with capital indices and that is what a lot of commentary revolves around.

As a matter of convenience the value of the index is determined at the close of business and is reported in the news and the press the next day and is used as the basis for measuring returns over specified periods, be that days, weeks, months or years.

So indices are priced at 4:30 in the UK although there can be up to 10 minutes of price adjustment in the closing auction to ensure that outstanding trades are completed at a fair price. Final prices are therefore known by 4:40. To avoid these last minute fluctuations in prices, which can be exaggerated in thin markets, many funds calculate their Net Asset Values (NAVs) at midday when markets are more liquid. In other words, there is more trading at that time and the price discovery process has more data to work on.

So that means returns from funds over a defined period be that weeks, months or even years, will be determined at a different time, and probably price, from that of the relevant index. Those four and a half hours may not be much but in these days when capital values can be essentially unchanged over decades, an afternoon's trading can represent a large component of the return over the period, especially if markets are volatile. Even though the capital value of an index might be little changed over quite long periods there can still be substantial movement over shorter terms. When there are sharp falls the press commonly dubs them Black Monday, Wednesday or whatever day of the week it is. Oddly, the rebounds seem to attract much less attention.

As an example look at the historic one year returns in capital value for the FTSE 100 and 250 at the end of July 2016. They were up 5.5% and 1.3% respectively. Yet on the 24<sup>th</sup> June, the day after the Brexit vote, the FTSE 100 index rapidly fell almost 8% in the first few minutes of trading before gradually recovering over the rest of the day to close 1.97% down. Within that trading day though the index gained 1.8% just in the space of an hour or so from 2 pm to 3pm. While that level of volatility is unusual it is not uncommon for stock markets to move 1 or even 2 percent in an afternoon and if that happens at a period end it can have a big enough influence to overwhelm the effects of stock selection or relative weighting in a fund or portfolio. The effect can of course be magnified by differences at the other end of period, though these may sometimes work to cancel each other out.

If you see that a fund has under or out performed an index by a few percentage points over a year or less don't get too concerned. The chances are it is mainly due to an afternoon's trading more than stock selection. Over longer periods' the effects of dividends gradually increase and eventually dwarf the impact of such short-term volatility so these effects become less important. Small differences between funds and indices simply reflect noise rather than signal. So when you see fund performance figures for periods less than a year quoted to one, or even two, decimal places it really just demonstrates that fund managers, like economists with forecasts, have a sense of humour.