

UK Equity Funds 2011

Executive Summary

- Study of performance attribution for UK funds over calendar 2011, in terms of sector and Style influences.
- Large differences between industrial sector returns across the UK market. Most funds benefited from sector positioning, but intra-sector stock selection generally weak.
- A few key Style stood out, notably Dividend Yield, Book/Price, Forecast Growth & Beta.
- Within the UK Equity Income sector both allocation to Styles and intra-Style stock selection boosted returns, even after accounting for sector biases.
- UK All Companies funds results more mixed, with only positioning to Book/Price and Forecast Growth adding value.
- Combinations of Style factors proved powerful, with big return differentials between blends of yield and B/P.

Introduction

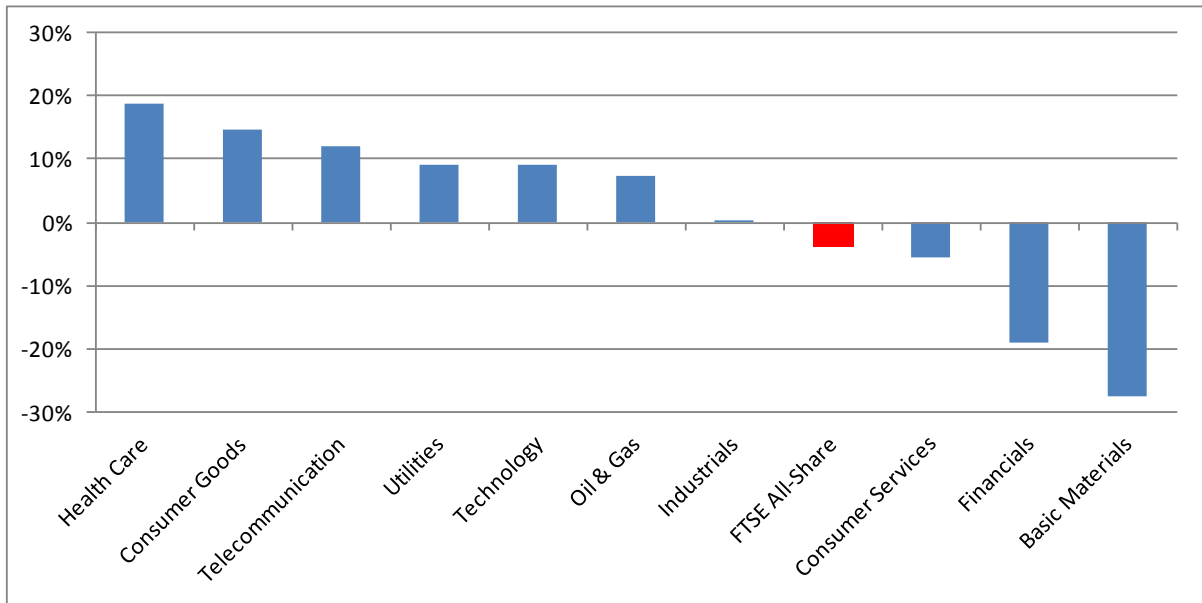
This study examines the sources of performance for UK focused mutual funds (UK All Companies and UK Equity Income IMA sectors) over calendar 2011. We investigate which themes were the primary drivers of fund returns, and how the best performing managers were positioned to benefit from them. Against a backdrop of economic uncertainty and increasing tensions over the Euro and the attendant sovereign debt crisis, 2011 witnessed major swings in sector and Style return patterns. We look at how managers navigated through these difficult waters.

Style Research has been collecting mutual fund holdings data for several years and has now built up a database covering in excess of 15,000 products worldwide. This is used extensively in our **Style Research Funds Analyzer** service, and we have employed this data in our fund performance research. In this investigation we separate out the fund returns due to sector positioning from that due to stock selection within sectors. And we also look at a similar decomposition using the Styles that were most interesting over the year.

Market Movements

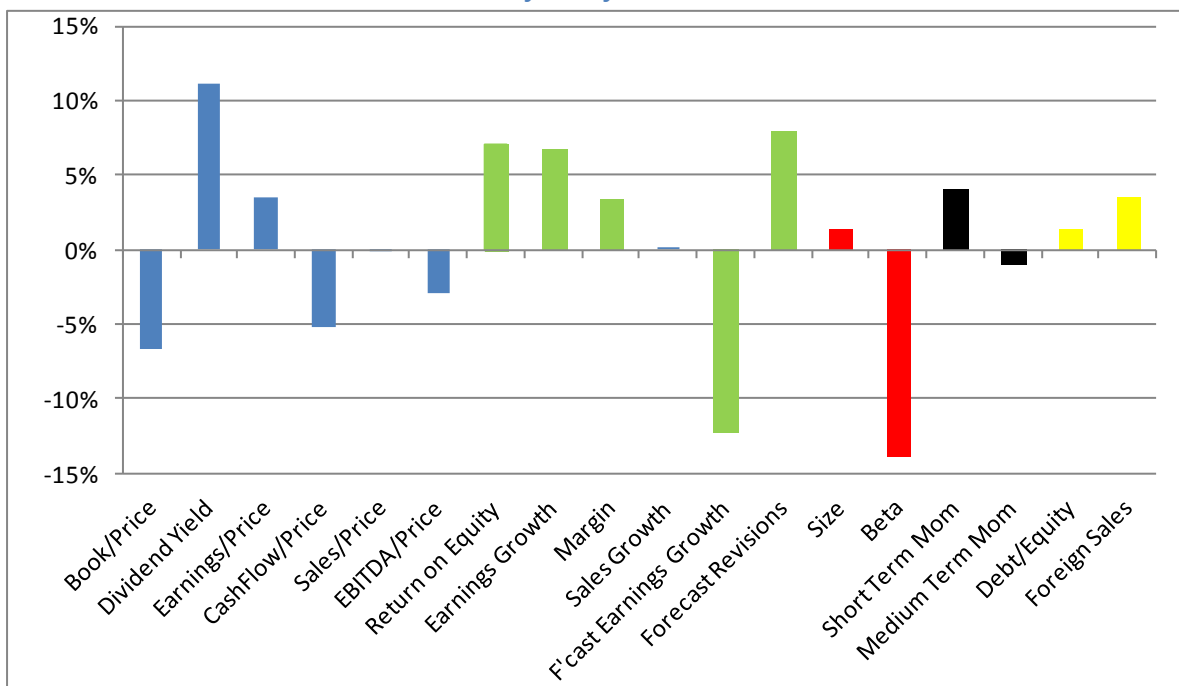
But before getting into the fund data, let's step back and take an overview of the market in general. The FTSE All Share index fell by around 3.5% over the year with a very large disparity between the best and worst performing sectors, as can be seen below.

FTSE Sector Performance over 2011



Being correctly positioned (at the right time!) in these sectors was a major determinant of performance. In particular, those funds avoiding Financials and Basic Industries would have had a great boost to performance over the year. And, at the industry level, where, for example, Tobacco outperformed Mining by nearly sixty percentage points, the potential rewards (and pitfalls) were even greater. Given this, we might be forgiven for thinking that getting sectors right was the only game in town last year. But the returns to Style were just as interesting. Below we show the returns of popular Style factors (relative to the UK market over calendar 2011).

Performance of Style Skyline Factors over 2011



There were some substantial rewards to Styles, such as the >10% from higher Dividend Yield stocks and the nearly 15% underperformance by those with higher Beta. And there were also some curiosities compared with historic Style patterns. For example, Value as represented by Book/Price (B/P) is normally highly correlated with the Dividend Yield factor (0.6 over the last 19 years) whereas last year their returns diverged and with a correlation of -0.4: 'expensive' high income stocks were the winners. A similar change in behaviour was seen on the Growth side of things: the normally correlated Forecast Earnings Growth and Forecast Earnings Revisions also had divergent returns, with the best performers amongst the upwardly revised low Growth expectation stocks.

Of course there is sometimes a linkage between Style performance and sector returns: a portfolio biased towards higher B/P stocks will be heavy in Financials, and so the negative B/P return could just be a by-product of the underperformance of Banks. But it turns out that these patterns were evident (though more moderate) even for sector neutral Style based portfolios. And as we shall see, there were some very potent returns when combining different Styles together.

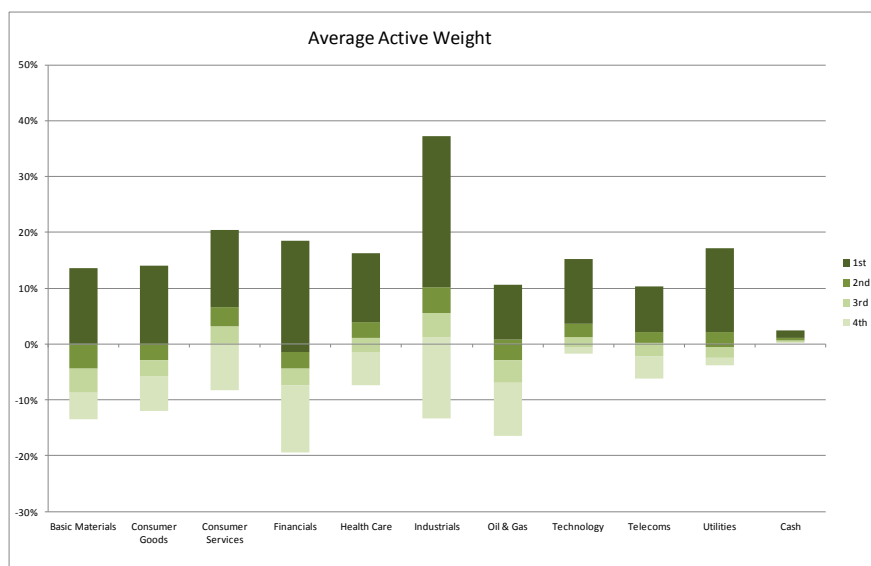
Fund Performance Features

Turning to the funds themselves, roughly a third of the UK funds in our sample outperformed the All Share last year. Given the performance of high Dividend Yield, it is no surprise that over half of the IMA classified UK Equity Income funds beat the index; but the success rate was lower in the UK All Companies sector, with only one in five managers outperforming. Our analysis focuses on performance numbers generated from funds for which we have monthly holdings, and we use the **Style Research Portfolio Analyzer** to compute attribution returns. Since these returns do not incorporate intra month trading and costs, they could be criticised for being artificial. They certainly outperform the official returns (by around 2% over the year on average, of which around 1.3% is estimated to be related to the annual management charge and the rest taken up by transaction costs etc). But our monthly returns have a strong (0.99) correlation with the official returns so we are confident that the results give reliable indications, and especially so in cross-sectional comparisons between funds.

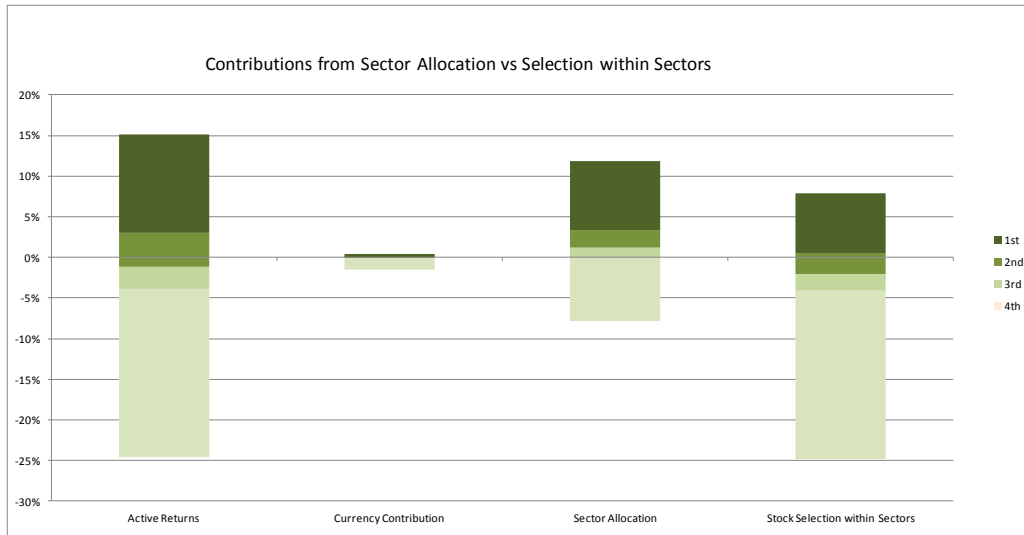
Industrial Sector Analysis

We start by considering industrial sector influences, divided into **sector allocation** and **intra-sector stock selection** contributions to returns. The former stems from active positions in sectors and is built up from each fund's active weight per sector and the sector's relative return versus the index. A fund with an overweight in an outperforming sector will get a positive contribution to allocation from its position in this sector. On the other hand, intra-sector stock selection compares a fund's returns with the benchmark's returns in that sector. A fund with better returns than the benchmark in a given sector will get a positive contribution from intra-sector stock selection.

Below, we show the average (over 2011) active weights by sector for our funds sample. To display the cross-sectional distribution across funds, we chart the ranges in four quartiles. For example, the average active weight in Industrials ranges from around 13% underweight to 37% overweight across our fund sample, and more than three-quarters of funds are overweight in this sector.

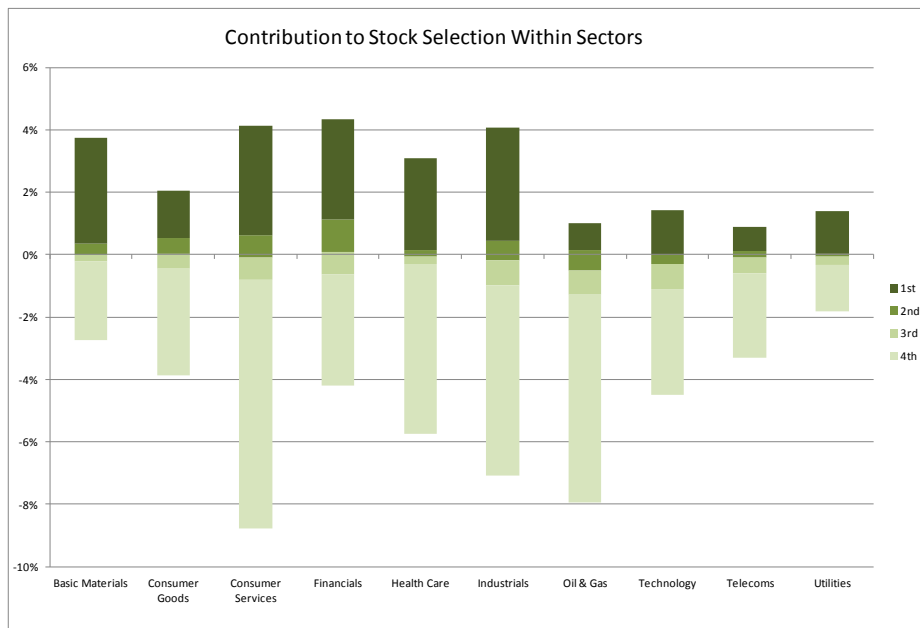


Conversely, most funds were underweight Financials, the median active weight being around -4%, and three-quarters of funds were light in Basic Materials. Given the negative returns of these sectors it should be no surprise that sector allocation was a positive contribution to returns in general and this is borne out by the following picture. Again we show the peer group divided into quartiles to display the overall range of active returns, alongside the contributions from sector allocation, and stock selection within sectors.



Whilst sector allocation was a positive for the bulk of funds, intra-sector stock selection was much weaker. Most funds struggled to select winning stocks within sectors, and this was the biggest drain on performance across this peer group. It appears that positive sector allocation was the primary driver of good returns, and once this is taken into account, in general funds lost value through stock-picking.

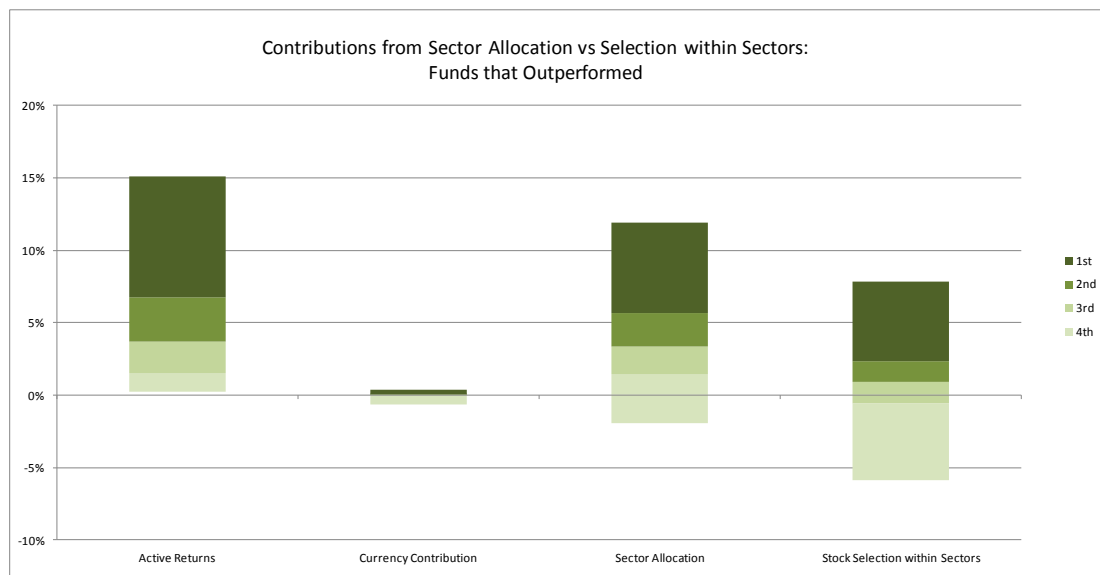
The poor stock selection was largely concentrated in a couple of sectors, as shown below:



The majority of funds struggled in Oil & Gas and in Technology, and these returns have swayed the overall stock selection picture. Though there were extremes of both good and bad stock-picking in other sectors, the median contributions were more neutral.

At this point it's worth remembering that our calculations overstate the actual returns, so these pictures flatter the fund managers. Around half of the funds outperformed the index based on our returns (vs. only 30% using the official numbers). If this difference were allocated to the stock selection chart (effectively the bars would all move down by an average of about 2%), then stock selection would have been poor across the board.

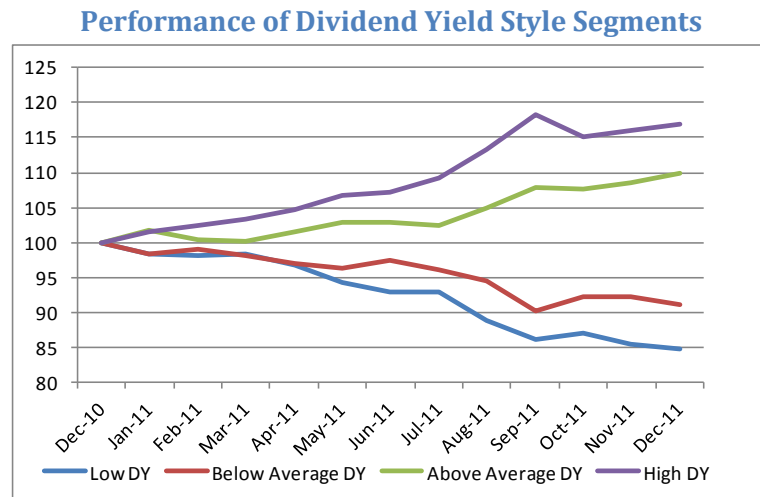
What about the best performers over the year? If we examine the same attribution but this time for only the funds that beat the index, once again sector allocation was a strong part of the performance, with virtually all funds benefiting from their sector positioning. However, in this cohort, stock selection was much stronger, with nearly three-quarters of managers adding value.



So we've seen that sector allocation has been a big part of the story behind last year's fund performance, accounting for a good deal of the performance delivered by UK funds. But Styles also have something interesting to say.

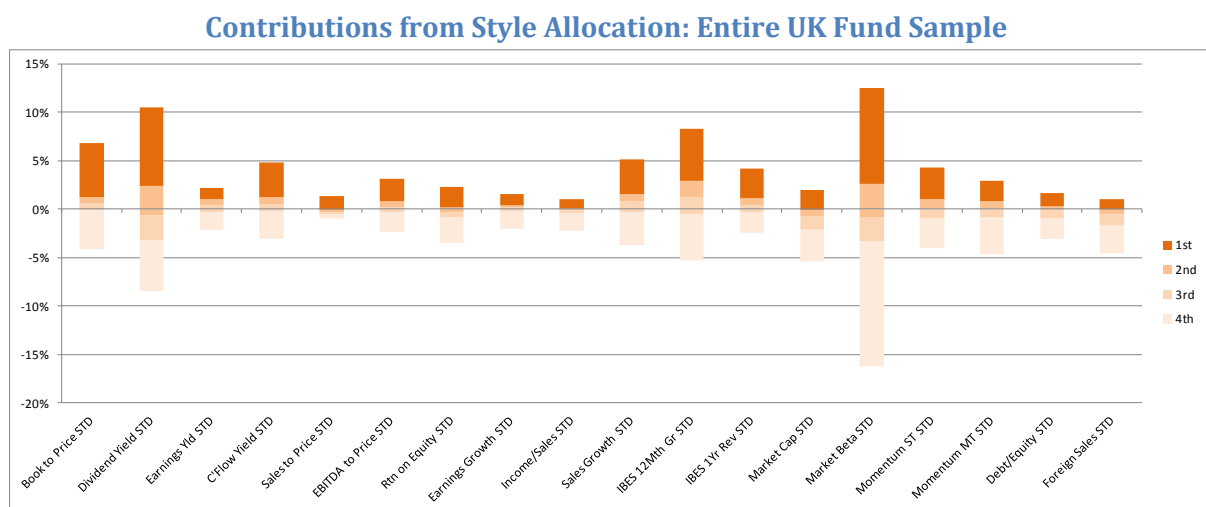
Style Analysis

In this section, rather than dividing up the market by sector, we split UK stocks into Style blocks. For each Style, we partition stocks into four groups, each of around 25% of the market. For example, here is the relative performance across the UK of the Dividend Yield factor Style segments.



The purple (High DY) line represents the 25% of the market with the highest Dividend Yield stocks, and that segment's performance is plotted relative to the market as a whole. Similarly, the blue (Low DY) line shows the relative performance of the 25% of the market with the lowest Dividend Yields. There was a 30 percentage point difference between the highest and lowest Dividend Yield stocks, so we should find allocation to these Style blocks to be important for funds. Likewise, stock selection within these groupings will reveal whether funds added value beyond their Style orientation.

We start with a broad range of Styles corresponding to the factors on the default Style Skyline, and examine the contribution from **Style allocation** for each one in turn. The following chart shows the range of allocation contributions across our fund sample over 2011.

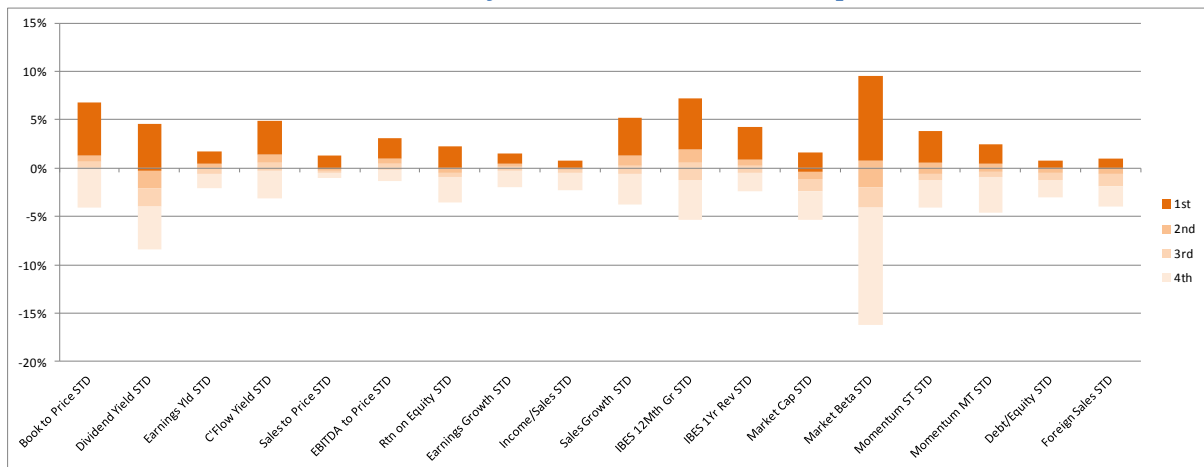


As before, we display the distributions of these contributions in a quartile chart. For Dividend Yield, for example, the Style allocation contributions range from around -8% to +11%. In other words,

within our sample there is one fund for which its positioning by Dividend Yield cost it 8%, and one fund where, by being biased towards higher Dividend Yield, the allocation contribution added 11%.

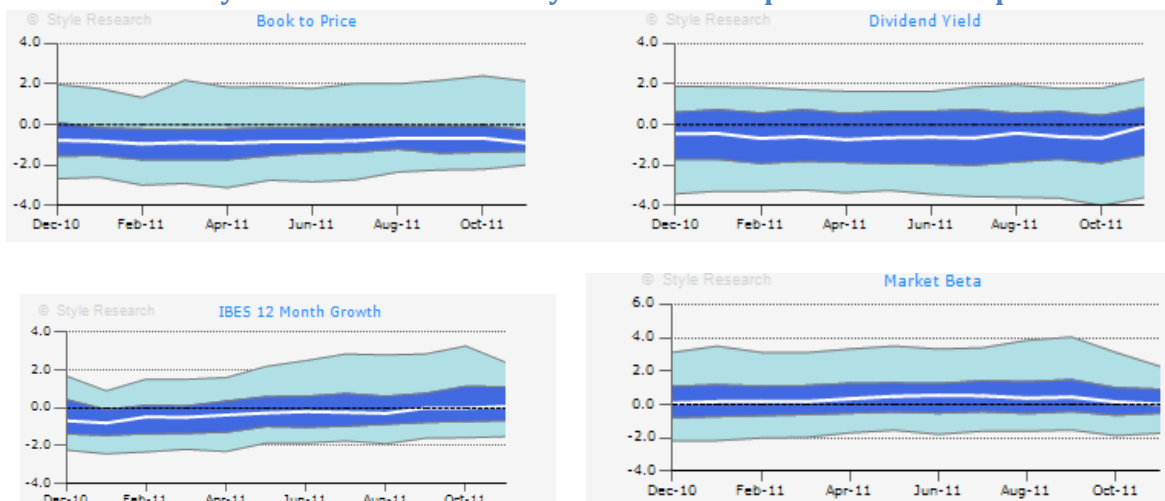
In addition to Dividend Yield, the stand out factors include B/P, Forecast Earnings Growth and Beta. Remember that this is based on our sample which extends across the UK Equity Income funds and the UK All Companies IMA sectors and so risks mixing up funds with different objectives. This can muddy the water when we are looking at Style factors, so narrowing things down to more focused peer groups is better. Here are the ranges of allocation contributions for the UK All Companies sector alone.

Contributions from Style Allocation: UK All Companies Funds



Though the same factors stand out, a clearer picture now emerges. In this peer group fully three-quarters of the funds have negative allocation contribution for Dividend Yield. As a group they are underweight high yield and this has detracted from their performance. This is also the case for Beta where these funds were biased towards higher Beta, which underperformed. On the other hand, the general bias towards more 'expensive' (and underperforming) low B/P stocks, added value. The following extract from the **Style Research Funds Analyzer** shows how the tilts for the UK All Companies sector confirm these biases for the DY, B/P, Forecast Growth & Beta factors. The white line represents the median tilt across funds, and the shaded blue lines mark the quartiles.

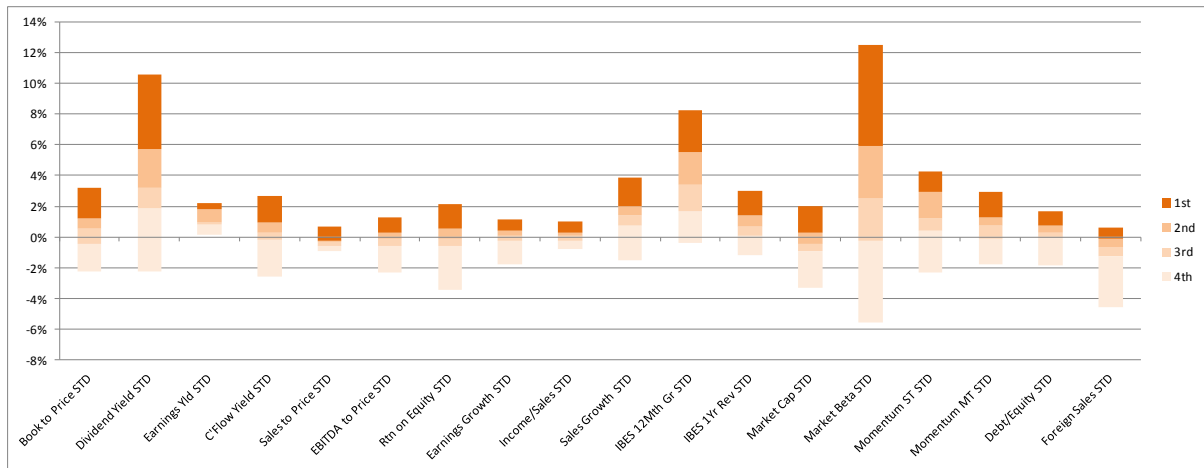
Style Research Funds Analyzer UK All Companies Peer Group



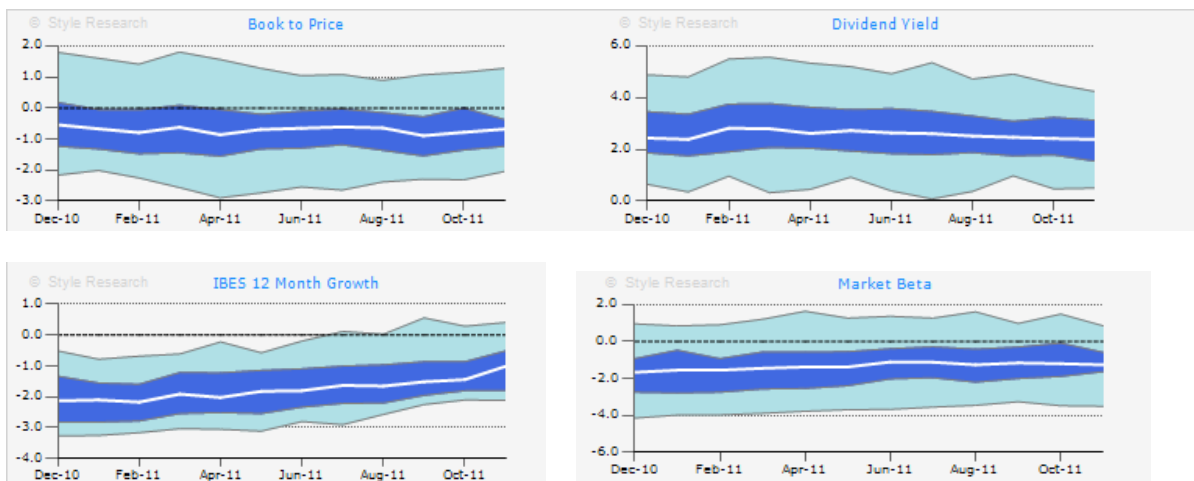
It is interesting that the median tilts to Dividend Yield and to Beta have more recently become more neutral.

By contrast, the UK Equity Income sector's Style allocation ranges are skewed the other way. Virtually all funds get a boost from their Dividend Yield positioning (remember this analysis is versus the FTSE All Share index), but it is also clear that positioning in Forecast Growth, and Beta have also benefited this set of funds.

Contributions from Style Allocation: UK Income Funds



The UK Income sector peer group Style tilts for these factors are shown below. Note that aside from the expected bias towards yield, these funds were ideally positioned for the other key factors too over the period, i.e. biased towards lower B/P, Forecast Growth and Beta.



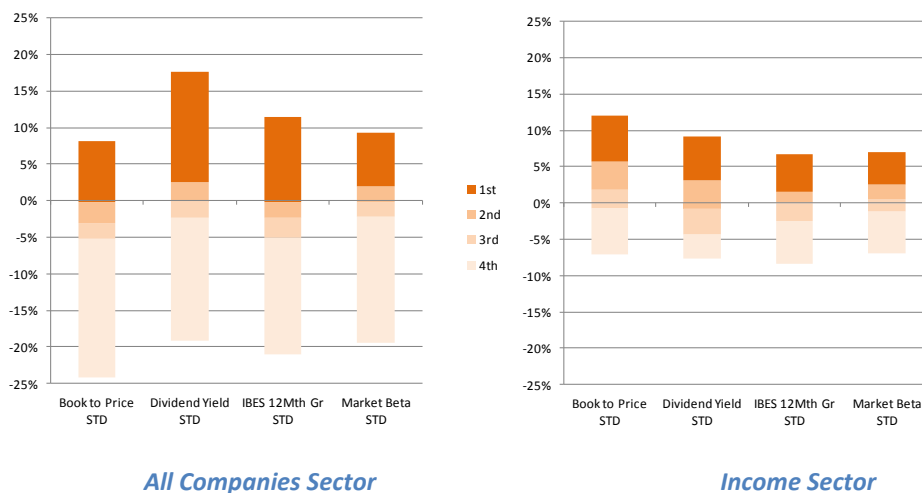
Incidentally, these tilts are broadly similar on a sector adjusted basis, and are not just the by-product of the sector positioning of the funds. The forthcoming upgrade to the **Style Research Funds Analyzer** extends these peer group charts to include sector and country-adjusted tilts.

Stock Selection within Styles

Narrowing down the focus onto these four Style factors, we now turn to whether funds added value from stock selection within the Style blocks, or **intra-Style selection**.

For convenience we show the two main peer groups side by side.

Contributions from Intra-Style Stock Selection



Again there is a dramatic contrast between the two groups. The bigger range of stock selection outcomes for the UK All Companies sector is a function of the greater number of funds in that grouping, but it is interesting to see that the majority of managers had poor stock selection within B/P bands. Recall that these managers were generally biased towards more 'expensive', low B/P stocks, which added value, but once this allocation is taken into account the funds performed relatively poorly.

The tables below drill down further to give an indication of the best and worst areas of intra-Style stock selection for the four factors under scrutiny. The median contribution to stock selection within each Style segment is reported in each cell.

Stock Selection Within Style Segments: median fund contribution

	High	Above Avg	Below Avg	Low		High	Above Avg	Below Avg	Low
Book to Price STD	-0.2%	-0.5%	0.0%	-1.3%	Book to Price STD	1.1%	0.9%	1.4%	0.3%
Dividend Yield STD	-0.7%	-0.2%	1.1%	-0.3%	Dividend Yield STD	-1.9%	1.0%	1.0%	-0.1%
IBES 12Mth Gr STD	0.0%	-1.2%	-0.4%	-0.2%	IBES 12Mth Gr STD	0.9%	-0.7%	0.1%	-0.6%
Market Beta STD	1.4%	0.2%	-0.9%	-0.6%	Market Beta STD	1.5%	0.7%	-1.2%	0.0%

All Companies Sector

Income Sector

The poor intra-B/P segment stock-picking was mainly focused in the lowest B/P stocks where the median manager dropped -1.3 vs. the return of this segment of the market. Similarly, weak stock selection in above average Forecast Growth stocks was the main cause of a poor showing for stock-picking within Forecast Growth segments.

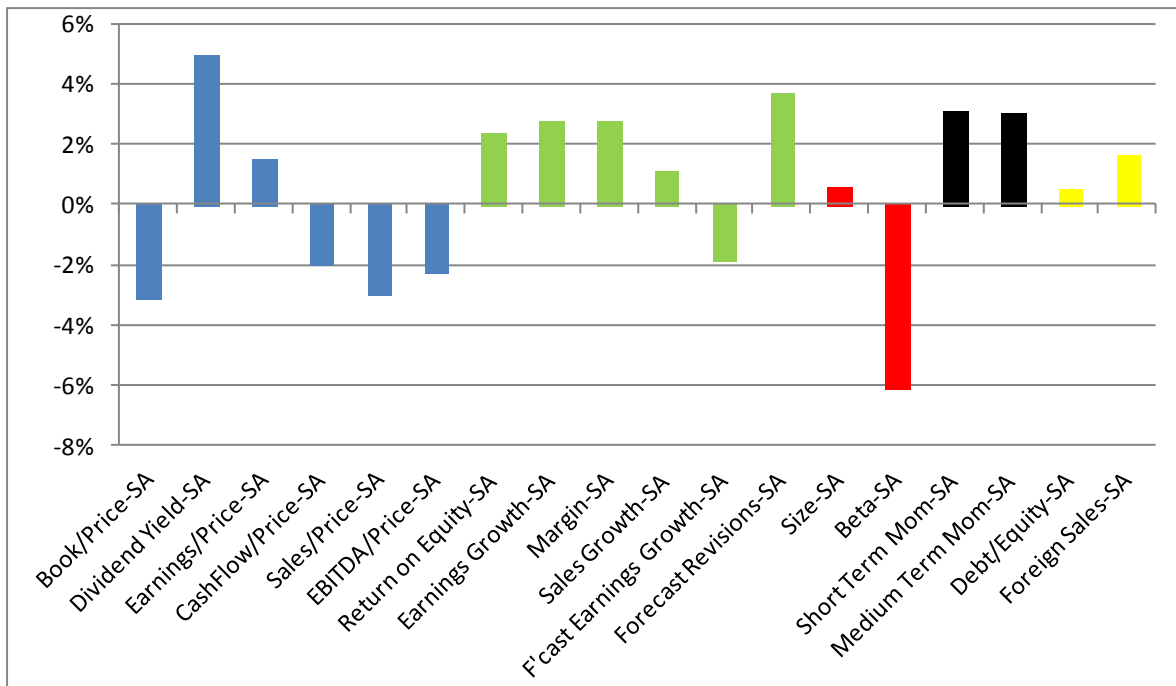
Within the UK Equity Income sector B/P segments, stock selection was generally good for most funds. Curiously, selection within Dividend Yield segments was more balanced, though the stock selection within the highest yield stocks was pretty weak. These funds by definition should be in higher yield, but once there, their stock selection was not good.

Sector Adjusted Styles

Splitting the market by Styles as above is a legitimate way of viewing the drivers of the market. Clearly, in a close to zero interest rate environment there was a search for yield, and regarding this bias as the primary decision, as opposed to one resulting from sector positioning, is very reasonable. Similarly, most managers focus on fundamentals such Value and Growth, or Defensive vs. Cyclical, so using proxies for these such as B/P, Forecast Earnings Growth and Beta could also be regarded amongst their main reasons when selecting certain stocks. Nevertheless, there is a strong linkage between certain Style divisions and sector characteristics. Being biased to low B/P is tantamount to being underweight in Financials and vice versa. So a check of whether the above results are robust when controlling for sectors is important.

The chart below shows the sector-adjusted Style returns for Style Skyline factors in the UK over 2011. Despite the sector neutrality, the Style patterns are very similar, though more muted, to the unadjusted returns we saw earlier. Strong performance from high yield, low B/P, low Beta etc *within* sectors is still evident.

Performance of Sector-Adjusted Style Skyline Factors over 2011



In the sector-adjusted Style analysis of funds we break down the market into four Style blocks, but now each sector one at a time. For example, Financials are divided into four segments by e.g. B/P, then Oil & Gas, then Utilities etc. This means that each Style group (e.g. high B/P) will now have the same sector composition as the overall market. The following charts summarize the contributions from allocation to, and selection within, the most interesting sector-adjusted Styles for the two peer groups.

Allocation: Sector Adjusted Styles



All Companies Sector

Income Sector

Allocation returns are now more moderate than before, and it is clear that most funds in the UK All Companies group were wrong-footed by Styles within sectors. On the other hand, UK Equity Income managers benefited from their yield bias even after taking into account their sector positions.

Stock Selection: Sector Adjusted Styles



All Companies Sector

Income Sector

Stock selection within sector-adjusted Style buckets was also generally weak in the UK All Companies funds. But most UK Equity Income funds showed good stock-picking results across all these factors.

With so many Styles, adjustments, contributions and peer groups flying around it's worth taking stock and summarizing the results so far. The tables below give broad indications of the success (or otherwise) of the peer groups across the most interesting Styles.

Unadjusted

	UK All Companies		UK Income	
	Allocation	Selection	Allocation	Selection
Book/Price	++	--	+	++
Dividend Yield	--	=	++	=
Forecast Growth	+	--	++	=
Beta	-	=	++	+

Adjusted

	UK All Companies		UK Income	
	Allocation	Selection	Allocation	Selection
Book/Price	-	--	+	++
Dividend Yield	--	-	++	+
Forecast Growth	-	--	=	++
Beta	--	-	=	++

Viewed this way, some of the patterns in the unadjusted results could be the ascribed to sector effects. For example, the '++' we awarded for allocation by B/P within the All Companies peer group was probably strongly linked to the sector positioning, as this disappears when we sector adjust. But many of the results hold firm and certainly put the UK Equity Income managers in a good light for both allocation and selection.

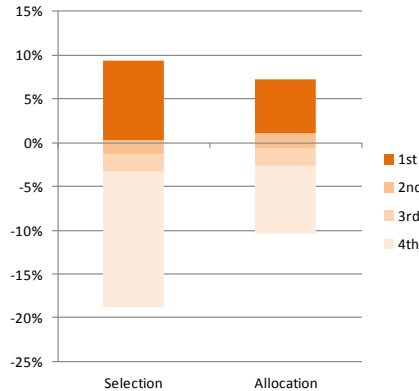
Two Factor Styles

To round things off, we go one step further and examine the impact of Style segments created from two factors simultaneously. Our motivation comes from the unusual behaviour of several Styles last year - notably the dislocation between B/P and Dividend Yield (DY). The following table summarizes the performance of a **Style Research Markets Analyzer** study that sorts UK stocks into four segments of B/P followed by a further split into four segments of DY. This gives rise to sixteen sections ranging from high B/P-high DY to low B/P-low/DY. Here is the market relative performance over the last year:

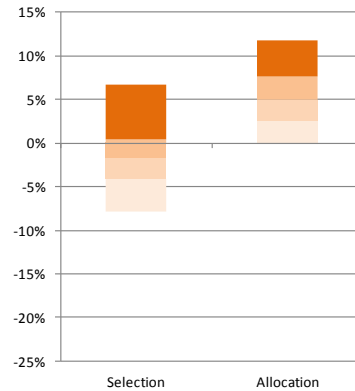
		B/P			
		High	Above Avg	Below Avg	Low
DY	High	13%	9%	13%	32%
	Above Avg	-2%	4%	16%	22%
	Below Avg	-10%	-19%	-1%	-6%
	Low	-28%	-23%	-1%	-8%

Amongst high DY stocks, the best performing were in the 'expensive' low B/P area, with a staggering +32% relative performance. At the opposite end of the grid, the low yield but 'cheap' stocks fell by -28% relative. Given these widely varying returns, the positioning of managers in these Styles is likely to have had an impact, and this is confirmed by the results below. We report the allocation and intra-group stock selection contributions using this four by four segmentation of the market.

Allocation and Intra-Style Stock Selection Contributions using BP by DY Segments



All Companies Sector



Income Sector

Across the UK All Companies sector the allocation returns are mixed, though the stock selection within Style segments is poor. However, there is a clear delineation of performance between allocation and selection within the UK Equity Income sector, where all managers outperform on allocation but most struggle with stock selection. Put another way, once you take into account the allocations (generally to high DY low B/P part of the market), stock selection was weak for these managers.

Now it is true that the above four by four breakdown could give rise to some big sector positions and it is certainly the case in this analysis. Here are the active sector positions of the high DY, low B/P segment at the beginning of the analysis period.



So are these effects purely (and fortuitously) down to the strong relative performance of sectors? We check this by constructing sector neutral Style segments that split each sector, one at a time, into Style blocks as above. This ensures that e.g. the high DY/low B/P segment has the same sector composition as the market as a whole. The relative returns over 2011 are shown below:

Sector Adjusted Two Factor Styles

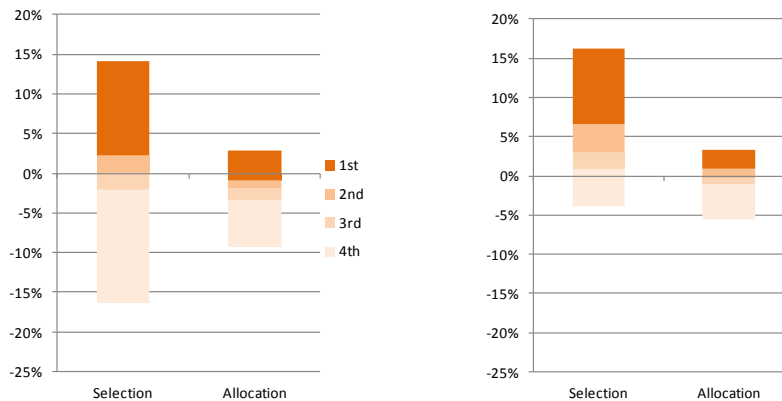
		B/P			
		High	Above Avg	Below Avg	Low
DY	High	1%	10%	4%	5%
	Above Avg	4%	1%	3%	10%
	Below Avg	-5%	-1%	3%	5%
	Low	-19%	-13%	-3%	-2%

Though the pattern of performance is not as clear or extreme as the unadjusted returns, it is still evident that, even within sectors, high B/P, low yield stocks were best avoided, and higher dividend stocks fared better.

Turning to the funds sample, there is again a contrast between the UK All Company and UK Equity Income peer groups.

Allocation and Intra-Style Stock Selection Contributions

sector adjusted BP by DY Segments



All Companies Sector

Income Sector

Whereas allocation to the sector-adjusted Style blocks was a negative for the majority of funds in the UK All Company group (managers had insufficient exposure to yield), it was more neutral for the UK Equity Income managers and they added value through stock selection.

Summary

We have seen various decompositions of fund performance: by sector, by Style(s) and by combinations of Style with and without adjustment for sector influences. Unsurprisingly, different slices of the data revealed different insights.

The sector decomposition emphasized the importance of the industry positioning of funds, which was a key determinant of performance last year. Avoiding Financials and Basic Industries was a large part of this. Once this was taken into account, stock selection was predominantly weak for most managers.

From a Style perspective, four main factors stood out: Dividend Yield, B/P, Forecast Growth and Beta. The UK Equity Income peer group, which included some of the most successful managers, generally benefited from its bias to higher yield and lower B/P, Growth and Beta stocks, though funds further enhanced returns within some segments by stock selection. The picture was more mixed for the UK All Companies group, with only the preference for lower B/P stocks adding value. These results survived using sector-adjusted Styles.

We also saw the 'turbo-charged' performance difference between different combinations of B/P & DY. Allocation to the right combination of factors proved to be very important over 2011.

Further studies will look at funds invested in different markets, with the added dimension of country asset allocation. And the forthcoming 'enterprise' version of the ***Style Research Portfolio Analyzer*** (where, incidentally, the bulk of the above results were generated) will add flexibility and speed to the calculations across thousands of funds.

Finally, it is all very well looking back and seeing retrospectively what has worked or not for managers over some past period. This is a useful exercise in and of itself, to learn where funds' strengths and weaknesses lie. (Note that we have deliberately focused on peer group results in this study as opposed to singling out individual managers - though of course our analyses are based on per fund analysis). But it is also an interesting question as to whether the performance of any of these Styles could have been anticipated, so that fund positioning (and of course fund selection and blending) could be set to benefit from these patterns ahead of time.

This will be the subject of a subsequent research paper, which will focus on this question, considering whether measures including those related to valuation, dispersion, past performance and macro influences can lead to reasonable forecasts of Style patterns. But, for now, the crystal ball is staying firmly under wraps.