

THE  
**JARGON BUSTER**  
**SERIES**

Demystifying  
the Asset Management  
Industry

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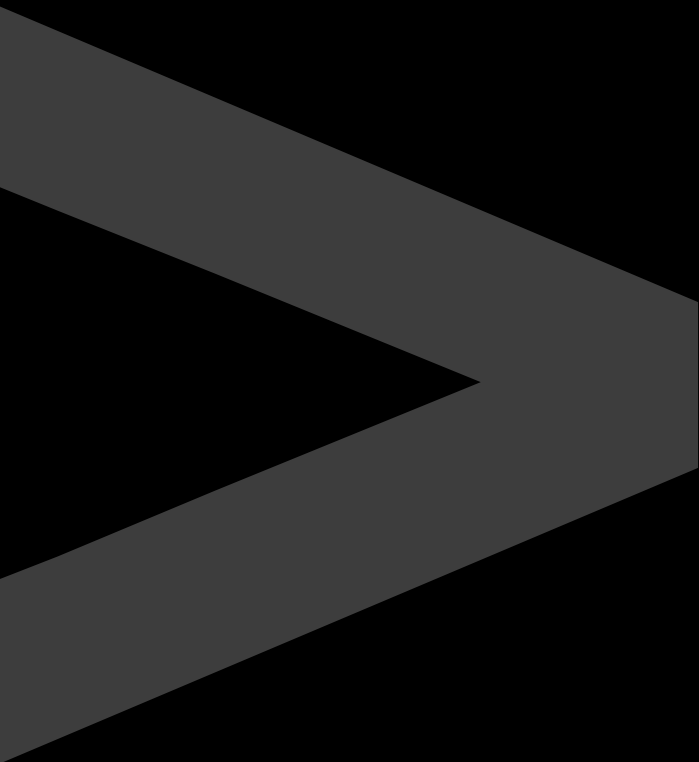
The Jargon Buster Booklet is not intended to make the reader a financial expert or an investment guru, but as a free resource to help demystify the asset management industry.



**WHERE THERE IS  
MYSTERY  
THERE IS  
MARGIN**

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# FOREWORD

## - UNDERSTANDING VALUE

### HOW DO WE TRULY UNDERSTAND THE VALUE THAT THE END INVESTOR IS RECEIVING?

Value means different things to different people. Performance is often central to customer satisfaction, so it's crucial to understand all the drivers of investment returns.

In the first half of this booklet we provide a refresher on economic fundamentals, such as monetary and fiscal policy, inflation, exchange rates and how the market's future interpretation of these factors affect the various asset classes.

The asset management industry is becoming more industrialised and investors now have more options as to how they access asset classes and investment solutions. Therefore, we also explore the pros and cons of active and passive management, as well the evolution of the asset management industry.

We also explore sustainable investing, what is ESG and what does it mean in terms of investing.

In the second half we outline the drivers and measures which allow investors to fully understand the risks and costs associated with the performance they have received.

Finally, we focus our attention on fees, examining and explaining the different types and the impact they can have on performance.



Ultimately, understanding performance is crucial to understanding the value the end investor is receiving.

**- MATTHEW LAMB**

CEO, PACIFIC ASSET MANAGEMENT

## WHILST READING LOOK OUT FOR:



### CONNECTED CONTENT

Follow the location icon  
to pages with connected  
content



### TECHNICAL CORNERS

Sections of the book with  
a little more detail



### DID YOU KNOW & INTERESTING FACTS

The speech icon for  
bite size facts

# THE JARGON BUSTER

## WHAT'S INSIDE?

### 1. ECONOMIC FUNDAMENTALS

The macroeconomy

Governments' objectives for the economy

How do governments achieve their objectives?

Monetary policy

Exchange rates

### 2. ASSET CLASSES IN DETAIL

Equities

Fixed Income

Alternatives

Diversifying Assets

Cash

### 3. ACCESS ALLOCATION

Active and passive

Factor investing

Direct

### 4. SUSTAINABLE INVESTING

What is sustainable investing?

What is ESG?

Key issues for ESG investing

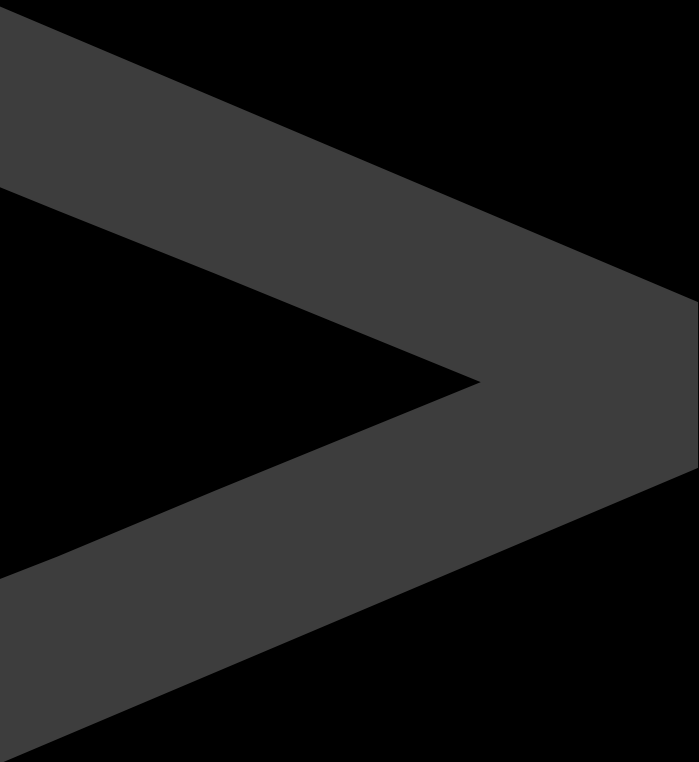
Why is ESG so important?

### 5. UNDERSTANDING RETURNS AND PERFORMANCE

Performance measures explained.

Alpha, beta, sharpe ratio, volatility

### 6. FEES IN FOCUS





# 1.

## **ECONOMIC FUNDAMENTALS**

In this chapter we provide a refresher on economic fundamentals, monetary and fiscal policy, inflation, exchange rates and more.

THE MACROECONOMY  
GOVERNMENT  
OBJECTIVES AND HOW  
THEY ACHIEVE THEM  
EXCHANGE RATES

# THE MACROECONOMY

## - OVERVIEW

The macroeconomy refers to a country's economy as a whole. Macroeconomics studies factors such as gross domestic product (GDP), unemployment and inflation to help governments determine the aggregate effect of certain policies on an economy.

### What are governments primary objectives for the economy?

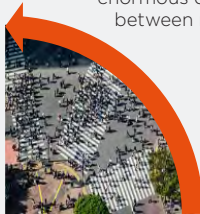
#### 1. Inflation

Governments will usually strive for a low and stable rate of inflation, typically around 2%..



#### 4. Equitable Distribution

Equitable distribution of income. Create a fair society, without enormous divisions between rich and poor.



#### 2. Unemployment

To achieve the natural rate of unemployment. The relationship between unemployment and inflation is closely linked.



#### 3. Economic Growth

Sustainable economic growth. Consistent growth is preferred to a volatile boom and bust cycle.

# HOW IS THE STATE OF THE MACROECONOMY MEASURED?

## ANSWER: GDP

Gross Domestic Product (GDP) is one of the measures of the total economic output of a country.

National statistics offices publish GDP figures, usually quarterly.

GDP indicates whether the economy is growing or contracting.



### DID YOU KNOW?

Microeconomics looks at the behaviour of individual economic units such as companies, industries, or households.

## THE GDP EQUATION

$$\text{GDP} = C + I + G + (X - M)$$

All the above equation states is that GDP is the combination of:

- all consumer expenditure (C)
- all investment by firms (I)
- all spending by governments (G)
- and the difference between exports (X) and Imports (M)

So in simpler terms GDP =

**CONSUMER SPENDING** + **INVESTMENT BY FIRMS** + **GOVERNMENT SPENDING** + **NET EXPORTS**



# INFLATION

## - A DESIRED INFLATION RATE OF 2%

Inflation is the term that refers to an environment of generally rising prices of goods and services within a particular economy. Rising prices impact the cost of living, the cost of doing business, borrowing money and mortgages. In general, the purchasing power of the consumer decreases. The measure of inflation over time is referred to as the inflation rate.

### WHAT CAUSES INFLATION?

#### COST PUSH

Increases in costs of production. For example, a depreciation in sterling causes avocados, which are bought in Peruvian Sol, to be relatively more expensive as an import. This increased cost to Tesco will be partially passed on to British consumers in the form of higher prices.

#### DEMAND PULL

Increases in consumer demand stimulates short term scarcity of products. In simple terms, if avocados become the next new superfood, demand rockets and supply runs low. The price of avocados will increase as people are now willing to pay more.

### DEFLATION AND STAGFLATION

Deflation is the general decline in prices of goods and services. It is caused by an increase in the supply of goods and services and an increased demand for cash savings by consumers and corporates. Whilst periods of deflation may be positive as the purchasing power of a currency increases, long periods of deflation are considered detrimental to an economy as consumers and businesses continue to hoard cash and reduce demand, with an expectation to benefit from continued falling prices.

Stagflation is the increase in the price of goods and services in an economy with falling GDP.



#### THREE INTERESTING FACTS

Historians cite runaway inflation as a major cause of ancient Rome's fall.

A dollar in 1950 had the same buying power as \$10.23 in 2017.

The Zimbabwean dollar bank note holds the record for the greatest number of zeros shown (100,000,000,000,000).

## **A GOLDBLOCKS ECONOMY**

### **NOT TOO HOT BUT NOT TOO COLD**

A Goldilocks economy is when growth isn't too hot, causing inflation, nor too cold, leading to a recession.

It is a healthy economy that has an ideal GDP growth rate of between 2-3%. It also has moderately rising prices, as measured by the inflation rate.

The first use of this phrase is credited to David Shulman of Salomon Brothers who wrote "The Goldilocks Economy: Keeping the Bears at Bay" in March 1992.

### **REASONS WHY A DESIRED RATE OF 2% INFLATION AND NOT 0%?**



Central banks around the world have tended to target a figure of 2%, as being the ideal inflation rate. Central bankers are more confident in their ability to bring higher inflation under control, whilst deflationary cycles have proved harder to reverse.

### **CPI VS RPI?**

Both RPI (Retail Price Index) and CPI (Consumer Price Index) are measures of inflation. They track the change in the cost of a representative basket of goods and services over time. There are two differences in the way they are calculated: the items in each of the baskets and the calculation methodology. For example, RPI includes the costs of housing e.g. mortgage payments, rents, and council tax while CPI does not, instead including items such as tuition fees and university accommodation. RPI is calculated using an arithmetic mean while CPI uses a geometric mean.

Interestingly, governments will often link benefit payments to CPI e.g. certain state benefits and public sector pensions whilst payments they receive, such as taxes, are linked to RPI. Remember RPI tends to run slightly higher than CPI.

# UNEMPLOYMENT

## - A MEASURE OF HEALTH

Unemployment is a phenomenon that occurs when a person who is actively searching for employment is unable to find work and is often used as a measure of the health of an economy. The most frequent calculation of unemployment is the unemployment rate, which is the number of unemployed people divided by the number of people in the labour force.

There are many different reasons for individuals being unemployed. For example some jobs are **seasonal** such as ski instructors, some people may be between jobs, or more seriously there may be **structural** unemployment, this occurs when unprofitable sectors discontinue employing workers.



### FACTS REMINDER

Two types of unemployment

1. Seasonal
2. Structural

## CONSEQUENCES OF UNEMPLOYMENT?

# 1

### BURDEN ON BUDGET

Not only does high unemployment result in lower tax revenues but also higher unemployment benefits.

# 2

### HYSTERESIS

If people are made redundant they may become demotivated and lose on-the-job training, which makes them less employable. After a period of unemployment its harder for them to find work and firms may be reluctant to take on workers who have been unemployed for a certain period.

# 3

### SOCIAL COSTS

Drug and alcohol abuse and related crimes are much more prevalent in neighbourhoods, cities, and countries with high rates of unemployment.

# RELATIONSHIP BETWEEN THE LEVEL OF UNEMPLOYMENT AND THE RATE OF INFLATION



## - THE PHILLIPS CURVE

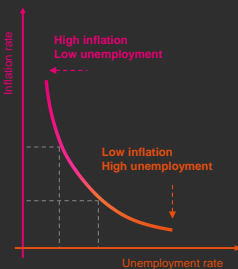
The Phillips Curve is an economic concept showing the relationship between unemployment and inflation in an economy. Developed by Alban William Phillips, it has become an essential tool to analyse macroeconomic policy.

Phillips analysed annual wage inflation and unemployment rates in the UK for the period 1860 – 1957, and then plotted them on a scatter diagram.

The findings suggested that decreasing unemployment results in an increase in inflation, and vice versa.

**Below is an example of the mechanism.**

- 1** A decrease in interest rates incentivises firms to invest and as a consequence hire more workers.
- 2** This increased demand for shop assistants, managers, legal advisors etc. leads to increases in employment.
- 3** Firms then need to compete for the limited amount of workers by increasing wages.
- 4** Wage costs for firms thus increase.
- 5** Firms pass on these increased costs in the form of higher prices to maintain margins.
- 6** An economy wide aggregation of this process increases the average price level - inflation.



Over the years, economists have discovered that the Phillips curve appears to shift. These shifts are typically attributed to changes in inflation expectations.

# HOW DOES THE GOVERNMENT ATTEMPT TO ACHIEVE ITS OBJECTIVES?

## - PRIMARILY THROUGH MONETARY AND FISCAL POLICIES

### GOVERNMENT OBJECTIVES REMINDER:

1. Low inflation
2. Unemployment
3. Economic growth
4. Equitable distribution

### THREE APPROACHES

1.

#### Conventional monetary policy

The process by which central banks control the supply of money in an economy, often by targeting an inflation rate or interest rate.

2.

#### Unconventional monetary policy

Another form of monetary policy that is used when conventional policies are insufficient.

3.

#### Fiscal policy

The government use of taxation and spending.

### INTERESTING FACTS

*As at March 2022*

#### Countries with the highest interest rates:

1. Argentina: 37.64%
2. Venezuela: 36.00%
3. Zimbabwe: 26.00%



#### DID YOU KNOW?

In the UK Interest rates are set by the Bank of England's Monetary Policy Committee (MPC). The MPC sets an interest rate it believes will enable the inflation target to be met.

The MPC is made up of nine members – the Governor, three Deputy Governors for Monetary Policy, Financial Stability and Markets & Banking, the Bank's Chief Economist and four external members appointed directly by the Chancellor.

The MPC currently meets eight times a year to set the interest rate.



## 1. CONVENTIONAL

**In conventional monetary policy, central banks use interest rates to control the supply of money.**

The government sets interest rates to achieve the desired unemployment/inflation rate. Changing the interest rate affects the cost of borrowing/saving.

**Increasing interest rates** induces investors and consumers to hold off spending as the cost of borrowing has increased. Consequently, with less money circulating in the economy there will be a fall in the rate of inflation.

**Reducing interest rates** makes it cheaper to borrow. This tends to encourage spending and investment and increase the money circulating in the economy. This is usually followed by a rise in the inflation rate.

## 2. UNCONVENTIONAL

**Unconventional policy consists mainly of Quantitative Easing (QE) whereby the central bank creates new electronic money.**

Money is created in order to buy financial assets e.g. government bonds to stimulate the economy.

The purchasing of large amounts of government bonds increases the money supply and reduces the costs of borrowing for companies and consumers. This should encourage private-sector spending, which in turn creates higher asset prices and helps return inflation to its target.

**Risks?**

- Unpredictability
- Excessive inflation, hard to grasp the magnitude of the liquidity injection
- Inequality, greater benefits to those who own assets

## 3. FISCAL

**Fiscal policy is the means by which a government adjusts its spending levels and tax rates to influence the economy. A fiscal policy is implemented through economic stimulus or austerity measures.**

**Economic stimulus**

Series of attempts by government to boost the economy by lowering tax rates or increasing government spending.

**Austerity**

Government measures implemented by increasing tax rates or decreasing government spending in attempt to reduce budget deficits.

**Milton Friedman**, the renowned monetary economist introduced 'Generation accounting' which in simple terms means that if a government runs a budget deficit, future generation will have to pay the price of that.



# EXCHANGE RATES

## - THE VALUE OF ONE CURRENCY IN RELATION TO ANOTHER CURRENCY

**The simple definition for exchange rates is:**

The rate at which the currency of a country can be exchanged for another country's currency.

A depreciation of one's own currency would cause other currencies to become relatively more expensive.



### INTERESTING FACTS

#### **GBP TO USD**

All time high of 2.86  
in Dec 1957

All time low of 1.05  
in Feb 1985

### ASSET MANAGEMENT PERSPECTIVE

Fluctuating exchange rates can have a significant impact on the performance of an investment portfolio, because of this, it is extremely important that when constructing portfolios asset managers are fully aware of the exposure they have to one currency vs. another.

This will enable them to reduce or increase exposure levels as they see fit, this can be achieved through diversifying their currency exposure and currency hedging.



### CONNECTED CONTENT

Find out more about currency hedging on the next page

# FACTORS AFFECTING THE EXCHANGE RATE BETWEEN TWO COUNTRIES

Numerous factors determine exchange rates. The following are some of the principal determinants of the exchange rate between two currencies.

## INFLATION DIFFERENTIAL

A country with lower inflation rate exhibits a rising currency value, as its purchasing power increases relative to other currencies. Consequently, countries with high inflation typically experience depreciation in their currency.

## PUBLIC DEBT

A country's debt rating is also a factor which has influence over its currency exchange rate. Fear of a debt default can result in the selling of bonds denominated in that currency by investors, resulting in a fall in the value of the exchange rate.

## BALANCE OF TRADE

A deficit in the current account shows that a country is spending more than it is earning on foreign trade. In other words, the country requires more foreign currency than it receives and hence this lowers its exchange rate.

## SPECULATION

Political events or changes in commodity prices may cause a currency to fall in value. Sentiments in the financial markets can heavily influence foreign exchange rates.

## INTEREST RATES DIFFERENTIAL

Higher interest rates attract foreign capital and cause the exchange rate to rise. The impact is however mitigated by the correlation that exists between the interest rates, inflation and exchange rates.

## CURRENCY HEDGING

Currency hedging is the act of entering into a financial contract in order to protect against unexpected, expected or anticipated changes in currency exchange rates. Hedging can be compared to an insurance policy that limits the impact of foreign exchange risk. However, there is no free lunch because currency hedging can be expensive.





# 2.

## **ASSET CLASSES IN DETAIL**

In chapter two we examine the major assets classes, looking at key characteristics, drivers, benefits and risks.

EQUITIES  
FIXED INCOME  
ALTERNATIVES  
DIVERSIFYING ASSETS  
CASH

# EQUITIES

## - HIGHER RETURNS BUT WITH HIGHER RISK

Equities are shares in a company that are traded on the stock market. As a part owner of a firm, a shareholder shares in the profits generated in that company. Equities can be profitable to the investor through increases in the value of the equity and through dividends.

Out of all the asset classes, equities have some of the greatest potential for returns, however, they also bear the highest risk, since their values typically fluctuate significantly.

### TWO EXAMPLES OF APPROACHES TO STOCK INVESTING:

#### GROWTH

Growth investors seek companies that offer strong earnings growth.

**Key characteristics:**

- Often priced higher in the short term for higher growth in the long term.
- High earnings growth records.
- Typically more volatile than broader market.

#### VALUE

Value investors seek stocks that appear to be undervalued by the marketplace.

**Key characteristics:**

- A belief that markets over react to bad news.
- Priced lower than the broader market but also to similar companies in the industry.
- Potential for value trap: companies that are cheap for a reason.

### “ FAMOUS QUOTES ”

Investing should be more like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas.

- Paul Samuelson

“Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”  
That’s what value investing is all about.

- Warren Buffett

# MARKET CAPITALISATION

Market capitalisation or “Mkt Cap” as it often appears on factsheets, is the total value of all outstanding shares of a publicly-traded company. It is a way of determining the rough value of a company. Small, Mid, Large and Mega caps are generally understood by their names, however, the definitions differ from country to country.

**Below is a table of current approximate US definitions.**

Mega Cap	\$200bn+
Large Cap	\$10-200bn
Mid Cap	\$2-10bn
Small Cap	\$300m-\$2bn
Micro Cap	<\$300m

## Mkt Cap Calculation

**Shares outstanding** X **Price per share**

Market capitalisation is not the same as market value, which can generally only be assigned when the company is actually sold.

## DRIVERS OF EQUITY MARKETS

### MACROECONOMY

The macroeconomic environment is one of the main drivers of equity markets.

### VALUATIONS

Are used by financial market participants to determine the price they are willing to pay for a stock.

### COMPANY FUNDAMENTALS

Essentially, investors form opinions about a company's prospects based on future returns implied by the stock price.

### MARKET EXPECTATIONS

The economics of a business, such as the balance sheet, income statement, overall management and cash flow. These fundamentals help determine the company's health and its growth prospects.

**Equity prices are forward looking so news is often priced in**

It is important to remember that equity markets, like all markets tend to be forward looking, they price in expectation. They are deemed to be efficient, so news, good or bad is often already priced in.

# FIXED INCOME

## - A KEY COMPONENT FOR RISK AVERSE PORTFOLIOS

A fixed income security is an investment that provides a return generally in fixed periodic payments and the eventual return of the original investment (principal) at maturity. Fixed income investments are typically low risk/low reward strategies and thus are a key component in risk averse portfolios.

Fixed income issuers can be governments, agencies, corporates, banking and other lending institutions.

### KEY FIXED INCOME CONSIDERATIONS

#### 1 INTEREST RATES

There is a negative correlation between interest rates and a bond's price. As interest rates rise bond prices fall.

#### 2 FINANCIAL HEALTH OF THE ISSUER

The financial health of the company or government entity issuing a bond affects the price investors are willing to pay for the bond.

#### 3 CURRENCY

Bonds can be priced in hard currency (typically US Dollars) or their local currency. This is a key consideration when investing in emerging market debt.

#### 4 LIQUIDITY

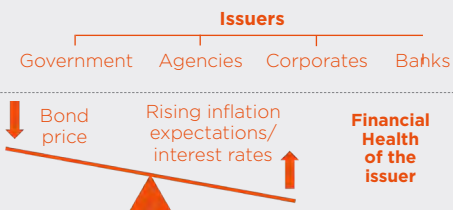
How easy is it to buy and sell a bond. Many specialist credit instruments can look very appealing right up to the point that you need to sell them. Mortgage Back Securities in 2008 financial crisis is a great example of how important understanding the liquidity of an instrument is.



#### KEY FACT REMINDER

Typically  
low risk/low  
reward

Drivers  
of bond  
prices





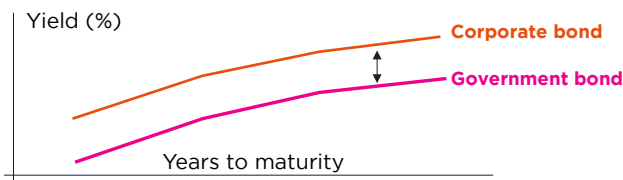
## BEFORE WE START YIELD:

The income return on an investment, such as the interest or dividends.



## CREDIT SPREADS

Credit spreads are the common way market participants compare the value of one bond to another. A credit spread refers to the difference between the yield of a corporate bond and a government bond of the same maturity and reflects the additional yield an investor can earn for taking that additional level of credit risk.



## DURATION

Duration is a measure of the sensitivity of a bond's price to changes in interest rates. Duration incorporates a bond's yield, coupon and maturity and is expressed as a number of years.

### Duration Example

A security with a duration of five years means the bond is expected to decrease in value by 5% if interest rates rise 1%. On the other hand, the security is expected to rise in value by 5% if interest rates fall 1%.

Interest rates  
rise 1%



Bond decrease  
in value  
by 5%



Interest rates  
fall 1%

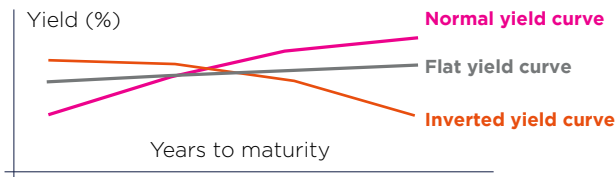


Bond increase  
in value  
by 5%



## INVERTED YIELD CURVE

An inverted yield curve can be used as a leading indicator of recession. When yields on short-term bonds are higher than those of long-term bonds, it suggests that investors expect interest rates to decline in the future, usually in conjunction with a slowing economy and lower inflation.



# ALTERNATIVES

## - WIDE RANGING AND UNCORRELATED

An alternative asset is a relatively new type of asset class within traditional investment portfolios ie equities, fixed income or cash.

The term alternatives encompasses a wide range of assets including precious metals, art, wine, antiques, coins, or even stamps. It also includes financial assets such as real estate, commodities and private equity.

## EXAMPLES OF ALTERNATIVES:

**REAL ESTATE**

**INFRASTRUCTURE**

**COMMODITIES**

**PRIVATE EQUITY**

Alternative assets are uncorrelated to traditional asset classes and have diversification benefits. Due to their nature, they do not tend to move in the direction of the stock market and may, therefore, be suitable to diversify portfolios.

### Positive characteristics

- Low correlation to traditional assets
- Diversification benefits

### Negative characteristics

- Less liquid than traditional investments
- Longer investment horizon

## THE END OF THE CLASSIC 60-40 PORTFOLIO

Historically when building a portfolio, the classic 60-40 approach (60% equities and 40% bonds) was often the starting point, which made perfect sense when the traditional characteristics of both equities and bonds were dependable.

However, in the last few decades a series of bear markets and factors such as unprecedented monetary policies, increased risks in bond funds and high equity valuations have seen the popularity of the 60-40 portfolio decrease.

Its now generally accepted that a more diversified portfolio is required, using a number of other asset classes to just equities and bonds.

# DIVERSIFYING ASSETS

## - AN ADDITIONAL LAYER OF DIVERSIFICATION

Diversifying assets comprise a variety of asset classes, such as equities and bonds. However, they have been chosen with a specific goal of being uncorrelated with other assets, while at the same time providing profits over time.



## NON-DIRECTIONAL BENEFITS

The main reason to hold a variety of asset classes is to make a portfolio more stable. This idea only holds true if the assets you select are uncorrelated. In other words, asset class returns that are independent of each other, thereby reducing a portfolio's overall risk.

Instead of building portfolios based purely on a mix of traditional asset classes which are directional, diversifying assets are used to bring a non-directional feature and an additional layer of diversification.

### ABSOLUTE RETURN

An absolute return fund seeks to generate a positive return for investors, so essentially to make money in any underlying market condition. The key difference to a normal long-only equity or bond fund is that absolute return funds should be less dependent upon the direction of the underlying markets. An absolute return fund would be therefore considered as a diversifying asset.



TECHNICAL  
CORNER

# CASH

## - 'SAFE' BUT WITH LITTLE REWARD

In general, cash is the safest asset of all – but the one that provides the lowest returns.

### Three reasons to hold cash in a portfolio:

#### 1. Liquidity and opportunity

Allows for opportunistic investment when asset class valuations decline to attractive levels.

#### 2. Reduced portfolio volatility

Holding cash in a portfolio may reduce returns as markets rally, but its stable value can serve as an anchor within a portfolio to limit losses during declines.

#### 3. Protection against crisis

Cash is the safest asset of all and has been proven to be a valuable asset class in times of economic uncertainties.

## WHY BEING INVESTED IS KEY

**In a world where interest rates are lower than inflation, it is essential to be invested.**

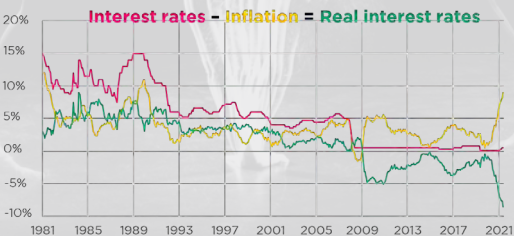
Savers around the developed world are all too aware that interest rates are close to their lowest level in history.

However, the real challenge is not the level of interest rates but what remains for savers after adjusting for inflation, the real interest rate.

Before the financial crisis, interest rates were higher than inflation and so you could leave your money in the bank, go for a round of golf and by the time you played the 18th hole, you were slightly richer in real terms.

Since 2009, every month you leave your money in the bank, you get poorer once you have adjusted for inflation.

UK Bank of England interest rates  
and UK inflation 1981-2021



**THERE IS A CLEAR MESSAGE FOR  
SAVERS: INVEST TO MAINTAIN AND  
GROW YOUR SAVINGS IN REAL TERMS.  
- THE MONEY ILLUSION**



In economics, the money illusion refers to the misconception that cash has a fixed value in terms of its purchasing power. But as we have just read, in times of low interest rates and comparably higher inflation, the purchasing power of money in the bank will be eroded.

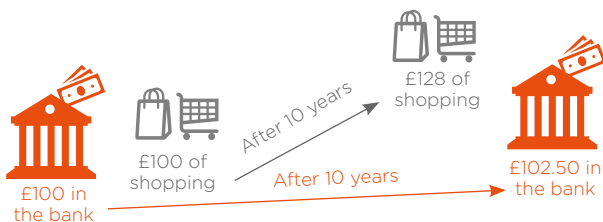
**THE MONEY ILLUSION IN PRACTICE:**

Assuming real interest rates are approximately -2.25%, the following would be true:

£100 in the bank today would purchase £100 of shopping

If that £100 is deposited into the bank today, assuming a fixed interest rate of 0.25%, in 10 years' time it would be worth £102.50

However, due to inflation, the shopping would cost £128, assuming a constant inflation rate of 2.50%



In other words, the real interest rate is what an investor, saver or lender receives, or expects to receive, after allowing for inflation.

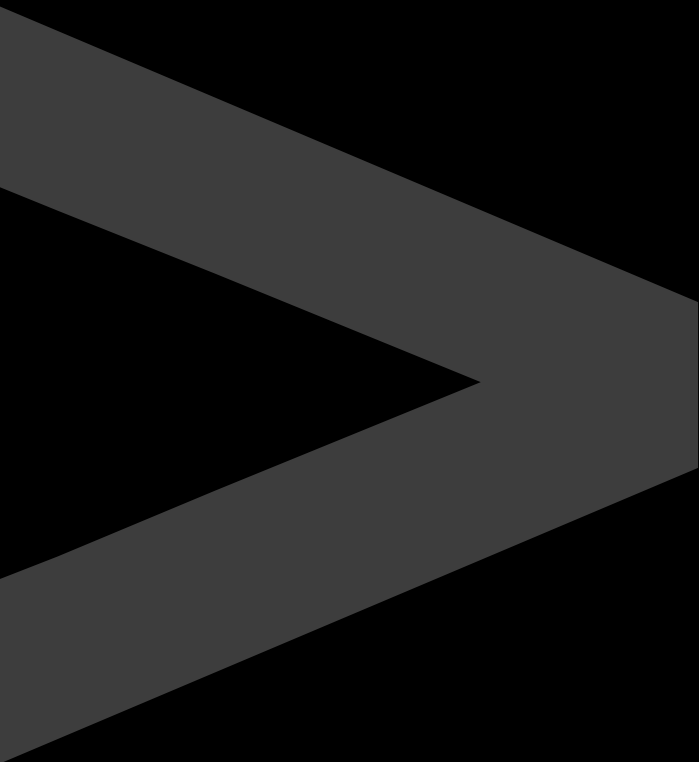


**MONEY ILLUSION EXAMPLE**

**Less for your money**

**2016: Toblerone reduces bar sizes**

In 2016 instead of putting up prices, the maker of the Toblerone Bar reduced the size of bars and chocolate, a great example of the same face value cash amount buying you less.



# 3.

## **ACCESS ALLOCATION**

Investors now have more options on how they access asset classes and investment solutions. In this chapter we explore the different options including active, passive, factor investing and direct.

ACTIVE

PASSIVE

FACTOR INVESTING

DIRECT

# ACTIVE MANAGEMENT

## - SKILLS AND MARKET INSIGHTS

Active management, also known as active investing refers to paying an investment specialist or team to actively hand-pick investments with the goal of beating the market and minimising losses.

Active managers rely on their own skills and experience to make investment decisions. They will utilise analytical research techniques such as bottom-up and top-down research to buy, sell and hold securities.

Active managers can be individuals (single manager), co-managers or a team of investment specialists.



### Key benefits

- Active funds aim to beat the benchmark and offer a potential to make a higher return than the average.
- The in-depth research carried out by managers gives the active funds an edge to potentially outperform the benchmark.
- Active managers can minimise potential losses by avoiding certain securities, sectors or regions.

### Key disadvantages

- Professional market research is expensive which often means higher fees.
- Style bias may limit performance when that specific approach is out of favour with the market.
- While successful share selection offers prospects of out-performance, there are no guarantees on picking a winner.



### THREE INVESTMENT TERMS

#### Top-Down

Considers the macroeconomy first, looking at the overall economic picture

#### Bottom-Up

First considers the microeconomic factors, such as the company's overall health

#### Non Directional

A fund that aims to generate a stable return regardless of market performance, also known as Absolute Return



# EXPLOITING INEFFICIENT MARKETS

Inefficient markets are often better accessed via active managers e.g. emerging markets or smaller companies.

The lower coverage of investment banking research, geography, local cultural and language barriers and unorthodox business models are all ways for active managers to take advantage.

Furthermore, the cost of tracking less liquid markets is higher than for more efficient markets, therefore the cost differential between active and passive management is less pronounced.



## WHAT IS A MUTUAL FUND?



TECHNICAL  
CORNER

A Mutual Fund is an investment vehicle consisting of a pool of funds collected from investors in order to invest in securities such as stocks, bonds, cash or funds. You can think of a mutual fund as a company that brings together a large group of people and invests their money on their behalf. Mutual funds are managed by an investment manager, who invests the fund's asset in order to produce capital gains and income. Every mutual fund is structured and maintained to match pre-defined investment objectives. Mutual funds can be active, passive or a blend of the two approaches.

# PASSIVE MANAGEMENT

## - INVESTING IN AN INDEX FUND WITH BROAD MARKET EXPOSURE

Passive Management, also known as passive investing is the opposite of active management. Passive funds track an index or market rather than trying to beat it.

Investors can allocate to this approach through exchange-traded funds (ETFs), unit trusts or open-ended investment companies (OEICs). These funds may hold all the assets in a given index, or a representative sample.



### Key benefits

- Typically provide a broad diversification and spread of risk, as passive funds hold all or a representative sample in their corresponding benchmarks.
- Lower fees and operating expenses than actively managed funds, as they track a benchmark rather than looking for winners.
- Offer an easy way to invest in a chosen market as there is no need for in-depth market research.

### Key disadvantages

- A total market risk exposure as passive funds track the entire market.
- Lack of flexibility as managers are typically prohibited from using defensive measures such as exclusion of certain securities, even if the manager thinks their share price is going to decline.
- Managers do not seek out performance but look to closely track a benchmark. They rarely beat the return, and are likely to return slightly less due to fees.



### EXCHANGE TRADE FUNDS VS TRACKER FUNDS

#### Exchange Traded Funds (ETFs)

ETFs aim to mimic the performance of a particular market. ETFs trade like a common stock on a stock exchange and their price can change throughout the day.

#### Tracker funds

Tracker funds are essentially the same as an ETF but can only be traded once a day.

# THE NEXT GENERATION OF PASSIVE INVESTING

## - FACTOR INVESTING

A modern technique that aims to systematically recreate traditional portfolios by using low cost, exchange traded instruments.

Instead of building portfolios based purely on a mix of asset classes, factor investing considers underlying factors that determine the risks associated with those asset classes.

Such factors might include the price trends of the equity market, the size of a company or a bond's sensitivity to interest rates.

This approach allows an investor to paint a much more comprehensive and accurate picture. Factor investing goes beyond a broad-brush understanding of asset classes to really dig into the 'DNA' of markets.

## FACTOR INVESTING STYLES

**There are various different factor styles, below are a few examples:**

**Liquidity:** A trading strategy that compensates an investor for taking the risk of investing in less liquid assets. This will typically be executed through buying illiquid assets.

**Momentum:** A trading strategy that relies on short-term movements in a security's price rather than fundamental value. In other words, momentum investing seeks to buy high and sell higher.

**Carry:** A trading strategy that involves borrowing at a low interest rate and investing in an asset that provides a higher yield.



## SAVING COSTS BY INVESTING DIRECTLY

### DIRECT INVESTING

Portfolio managers invest directly in the market instead of going through a fund. Direct investment permits access into all available markets globally and thus allows for greater flexibility in choosing the investments at a lower cost.



# 4.

## **SUSTAINABLE INVESTING**

Sustainable Investing is investing to make a difference and selecting investments that exhibit better characteristics for the environment of the world and its inhabitants.

In this chapter we try and distil what sustainable investing is into a few key principles that help people understand what they are investing in.

# WHAT IS SUSTAINABLE INVESTING?

## INVESTING TO MAKE A DIFFERENCE

Socially conscious investors are increasingly investing in companies which incorporate ESG criteria in their operation. But what does ESG mean for you as an investor? And what exactly does the acronym 'ESG' stand for?

Arguably, there is no bigger and more important change than transitioning global societies to a fairer, more diverse and sustainable future.

### SUSTAINABLE VS ESG

Sustainable investing is a catch-all term for investing in a way that accounts for being socially responsible and investing ethically while also seeking returns.

Environmental, Social, Governance (ESG) based investing is a form of socially responsible investing that emphasises not only a company's financial returns and performance, but also its impact on its employees, its stakeholders, and the environment.



#### DID YOU KNOW

##### Impact Investing

Impact investing is similar to ESG in that both types of investments offer a financial return and are in line with the investor's social conscience. However it may pay more attention to the products and services the company offers or the investments need to have a direct, measurable social and/or environmental positive effect.

# WHAT IS E, S, G?

## E

### ENVIRONMENTAL

Environmental issues such as climate change & pollution. Key issues for **Environment** investing include:

- Climate Change
- Pollution
- A company's utilisation of natural resources
- Carbon emissions
- Access to clean water

## S

### SOCIAL

Social issues around workplace practices & human capital. Key issues for **Social** investing include:

- Diversity and inclusion
- Human rights
- Supply chain sourcing

## G

### GOVERNANCE

Governance issues such as executive pay, accounting & business ethics. Key issues for **Governance** investing include:

- Executive pay
- Shareholder rights
- Board composition and diversity

## WHY NOW?

# ALL SECTORS OF THE ECONOMY MOVING TOWARDS SUSTAINABILITY

## 1

### GOVERNMENT



Governments have materially increased their commitments to Sustainability in 2020 and 2021



COP26 has focussed the mind back on the need for a move towards a more Sustainable World



EU's Green Deal forms key part of its £750bn stimulus package

## 2

### CORPORATE



Corporates can benefit in terms of profit and brand loyalty through Sustainability



90+% of CEO's believe Sustainability is important for the future of their industry



Many investors now asking hard questions of corporates

## 3

### CONSUMER



Consumers now care more about the sourcing of their goods



60+% of consumers now consider sustainability when looking to make purchases

## 4

### REGULATORY



Regulatory requirement to consider sustainability within client advice proposition



Asset managers have to disclose more about how they incorporate Sustainability into their propositions



# WHY IS ESG SO IMPORTANT?

## ESG CAN HELP PUSH FOR CHANGE

ESG gives investors the tools to build a future that reflects their principles. Companies and businesses are increasingly being held accountable for their actions and urged to do better. Now, more than ever, companies understand they have to actively improve their contribution to the environment and society.

ESG is valuable for developing investment portfolios that align with values, morals, and principles of investors and help influence change in the areas that matter the most. This also helps to mitigate investment risk as ESG investing can boost productivity and profitability of businesses.



## WHAT DOES SUSTAINABLE INVESTING MEAN TO PAM?

### A commitment to responsible investing

As a signatory to the UN PRI Principles for Responsible Investment, Pacific Asset Management has publicly stated our support for the better understanding of the investment implications of ESG factors.

As a business we are committed to constantly strive to be a more responsible firm both in how we operate and how we manage our clients' investments.



Sustainability meets Suitability

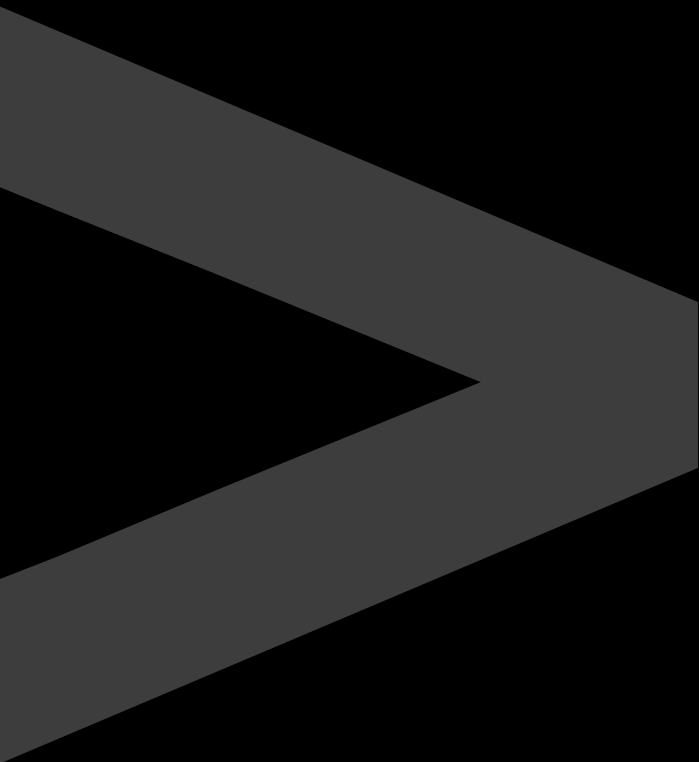
Sustainable Investing is becoming a standard investment approach.

Yet, to truly succeed, advisers, clients, corporations and employees must become enlightened to what ESG means to them. EnlightenESG's aim is to help people to understand what Sustainability in investing means to them. It is an open, accessible, and standardised suitability profiler that ensures a positive solution for all.

Scan to find out more:



To find out more visit: [www.enlightenesg.com](http://www.enlightenesg.com)  
or email: [hello@enlightenesg.com](mailto:hello@enlightenesg.com)



# 5.

## **UNDERSTANDING RETURNS AND PERFORMANCE**

In this chapter we explore the different measures that allow investors to fully understand the risks and costs associated with the performance they have received.

ALPHA

BETA

SHARPE RATIO

VOLATILITY

# MEASURING PERFORMANCE

## - CRUCIAL TO UNDERSTANDING RETURNS

Performance can be measured using numerous methods but understanding the various terms and what they mean can often be difficult. However, being able to understand those returns is crucial for investors to assess the risks and costs associated with the performance they receive.

## HOW IS FUND PERFORMANCE CALCULATED?

1

### FUND PERFORMANCE

A mutual fund's performance is expressed in terms of its total return, which is the sum of the change in a fund's net asset value (NAV), its dividends and its capital gains distributions over a given period of time.

2

### NET ASSET VALUE (NAV)

Net asset value (NAV) is the value per share of a mutual fund or an exchange-traded fund (ETF) on a specific date or time. The NAV per share is calculated once per day based on the closing market prices of the securities in the fund's portfolio.

## THE POWER OF COMPOUNDING

Compounding is the process in which both capital growth and interest are continually reinvested, constantly increasing the base on which accumulated assets can grow over time.

The example below shows four initial investments of £100,000. Surprisingly it's example 4, with just 4% return per year which gives the greatest final total return.

This not only shows the power that compounding can have but also why consistent positive returns are key.

Assuming an £100,000 initial investment

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Year 1	-15%	10%	5%	4%
Year 2	-10%	10%	-5%	4%
Year 3	10%	10%	10%	4%
Year 4	15%	10%	-10%	4%
Year 5	20%	-20%	20%	4%
Total	£116,127	£117,128	£118,503	£121,665

# KEY EXAMPLES OF PERFORMANCE MEASURES

Mutual funds and managed portfolios have been assigned certain measures by which investors can judge their performance.

**Below are some key examples:**

## Alpha

### Alpha: Is it worth paying for?

Alpha in simple terms equals what percentage of a return is down to manager skill.

It is the unexplained excess return an investment produces compared to its benchmark. It's the performance that cannot be explained by beta and other factors.

Consequently, alpha is worth paying for if the excess return justifies the cost.

#### POSITIVE

##### ALPHA

Manager has outperformed the benchmark

#### NEGATIVE

##### ALPHA

Manager has underperformed the benchmark

**Investors typically seek investments with high (positive) alpha.**

## Beta

### Beta: Is it just the market?

Beta is a measure of the volatility of a portfolio's returns in comparison to the market index.

Therefore, Beta represents the tendency of a security's returns to respond to swings in the market.

In simple terms, Beta gives investors an indication of how much a security will move when the broader market rises or falls.

#### BETA equal to 1

Security's price moves with the market

#### BETA less than 1

Security's price is less volatile than the market

#### BETA more than 1

Security's price is more volatile than the market

**Conservative investors will typically seek investments with low betas to reduce volatility in their portfolios.**

# FURTHER EXAMPLES OF PERFORMANCE MEASURES

## Standard deviation

### Measuring the predictability of an investment's return

Standard deviation or commonly referred to as volatility is a measure of a portfolio's risk. The volatility of an investment measures the variability of its individual returns over a certain period of time relative to its average return over the same period.

In simple terms, it is a measure of the predictability of an investment's return.

A higher volatility means a security's value can change dramatically over a short time period in either direction. A lower volatility means a security's value does not fluctuate dramatically, and only changes at a steady pace over a period of time.

## Sharpe ratio

### Comparing investments on a risk-adjusted basis

The sharpe ratio is a measure of a portfolio's return versus a risk-free return. It is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

The greater the sharpe ratio, the better the returns in comparison to the risk it has taken on. However, the figure obtained from calculations is merely a raw number, meaning that it should be used in comparison to other funds.

Sharpe ratio has become the industry standard to compare investments on a risk-adjusted basis.

## FURTHER USEFUL MEASURES OF PERFORMANCE

For years, investors, fund managers, and analysts have sought reliable measures of performance. The following are some of the commonly used ones.



### Annualised performance

Annualised performance is the yearly average percentage return on an investment.



### Yield

The income return on an investment, such as the interest or dividends.



### Independent ratings

Some companies such as Lipper and Morningstar have developed proprietary systems to rate mutual funds on a risk-adjusted performance basis.



### Cumulative performance

Cumulative performance is the total amount that an investment has made over time, expressed as a percent.



### Peer group comparison

Evaluating a fund's performance in relation to other similar type investments.

## SHARPE RATIO IN DETAIL

The sharpe ratio was developed by Dr. William Sharpe, professor at the Stanford Graduate School of Business and one of the recipients of the Nobel Prize for his contribution to the capital asset pricing model.

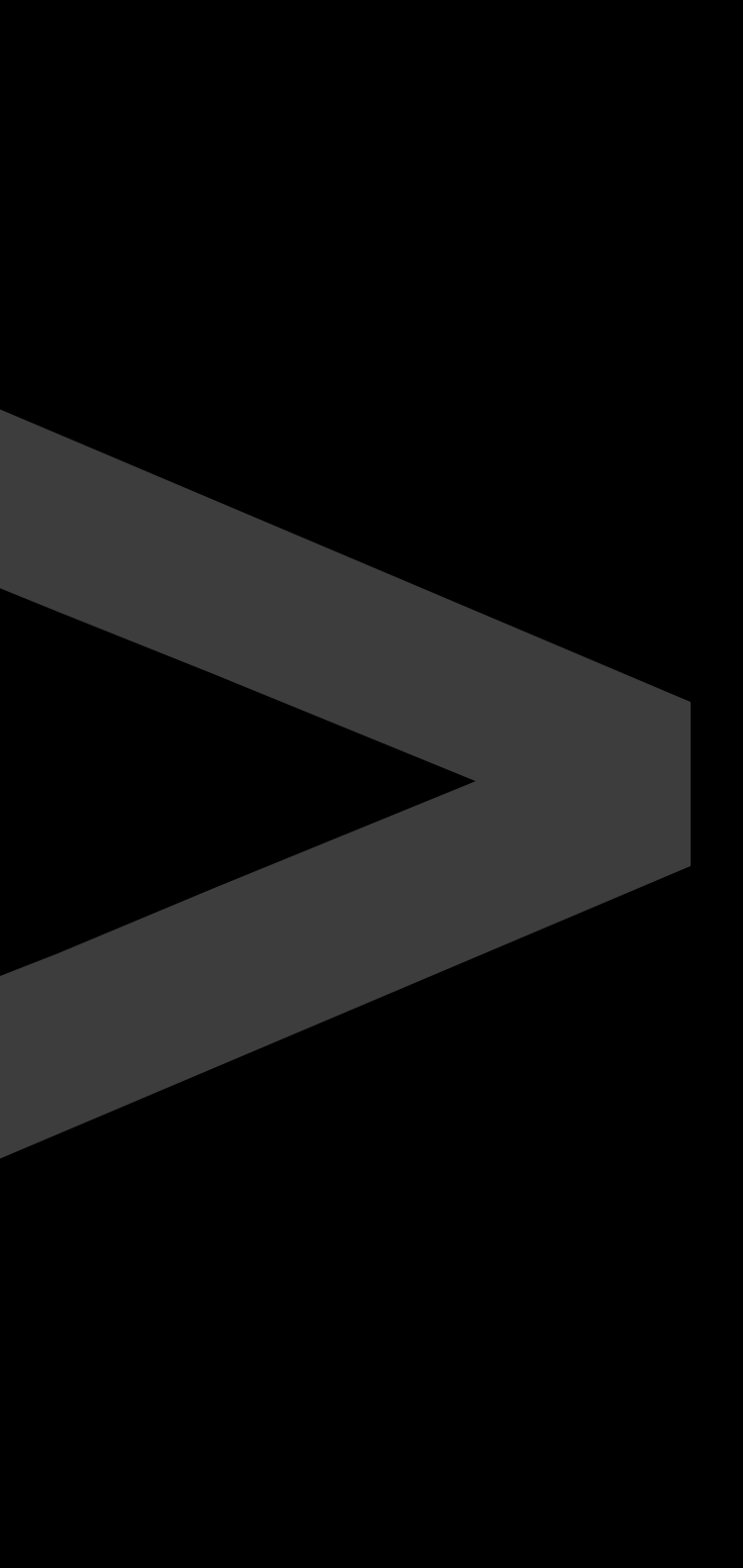


TECHNICAL CORNER

## SHARPE RATIO CALCULATION

$$\frac{\left( \begin{array}{c} \text{Expected} \\ \text{Portfolio} \\ \text{Return} \end{array} - \begin{array}{c} \text{Risk} \\ \text{Free} \\ \text{Rate} \end{array} \right)}{\text{Portfolio Standard Deviation}}$$







# 6.

## **FEES IN FOCUS**

In this chapter we turn our attention to fees, explaining the various terms used and how fees can greatly affect performance.

COMMON TERMS

AMC, TER, OCF?

WHY FEES ARE SO  
IMPORTANT

# FOCUS ON FEES

## - DEFINITIONS AND EXPLANATIONS

There are regular charges for holding a fund. These ongoing charges are used to cover the costs for running a fund. Some funds may also apply one-off charges or performance fees if the fund manager outperforms. All have to be typically disclosed to the clients before they invest.

There are also trading costs incurred for buying and selling assets. They are a necessary cost of investing and are paid separately out of the fund. The following is a list of key terms and definitions.



### NAVIGATING FEES: COMMON TERMS

#### **1. Initial charge: also know as entry charge or initial commission**

Charge that covers the cost of setting up a client's investment. This cost is typically taken out of the initial investment.

#### **2. Annual management charge: AMC**

Fund management companies charge annual fees for running client portfolios. They are generally applied as a percentage of total assets and are deducted directly from the fund.

#### **3. Additional fund charges**

Typically these include administration, custody, legal, regulatory and any underlying fund costs.

#### **4. Performance fee**

A payment made to a fund manager for generating positive returns, typically over a hurdle with a high water mark (see below). It is usually calculated as a percentage of the assets under management.

#### **5. Hurdle rate**

A compensation mechanism that sets a minimum rate of return to achieve before a fund manager gets paid a performance fee.

#### **6. High water mark**

This term is generally used in the context of fund management compensation when it is performance-based. A manager must get the fund above the high water mark before receiving a performance fee on the assets under management.

#### **7. Withdrawal fee: also known as exit charge**

A charge taken before the proceeds of the client's investments are paid.

# AMC, TER AND OCF

## WHAT IS THE DIFFERENCE AND WHAT DO THEY MEAN?

**AMC = Annual Management Charge**

**TER = Total Expense Ratio**

**OCF = Ongoing Charges Figure**

TER and OCF are very similar, but the OCF includes performance fees and one-off charges.

Comparison table

Fee	Annual management charge (AMC)	Additional fund expenses/charges	Performance fee and one-off charges
Annual management charge (AMC)	✓	✗	✗
Total expense ratio (TER)	✓	✓	✗
Ongoing charges figure (OCF)	✓	✓	✓



### NEXT UP

Why fees are so important

# WHY ARE FEES SO IMPORTANT?

## - THE INDUSTRIALISATION OF THE ASSET MANAGEMENT INDUSTRY

In recent years passive funds have shot up in popularity, with the majority of major providers offering low-cost products. This industrialisation of the asset management industry has brought clear benefits in terms of cost reduction.

However, active managers have been slow to react and have a long way to go in terms of fee reduction. It is imperative that the cost benefits of this trend are passed on to the end client.

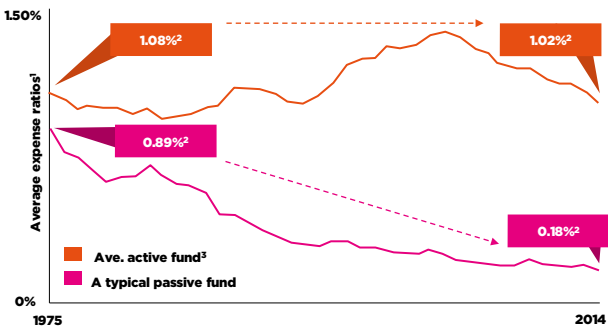


### Did you know?

According to data supplied to the Financial Times, the cost of retail investing in the UK remains above 2.5% annually, having only fallen by one tenth since the Retail Distribution Review (RDR) was introduced. The UK introduced RDR in 2013 imposing sweeping changes to the way financial advisers serve consumers.

As at 31 Aug 2016.

## THE COST OF ACTIVE AND PASSIVE FUNDS SINCE 1975



1. Represented as a percentage of net assets. 2. Sources: Vanguard and Lipper, a Thomson Reuters Company, as of 31 December 2014.
3. Institutional share class.

Investment fees are one of the most important differentiators when choosing between investments. Over the long-term, even small differences in fees can have a big impact on returns through the effects of compounding.

Whilst past performance of a fund is not necessarily an indication of future performance, fees are certain to be realised over time.

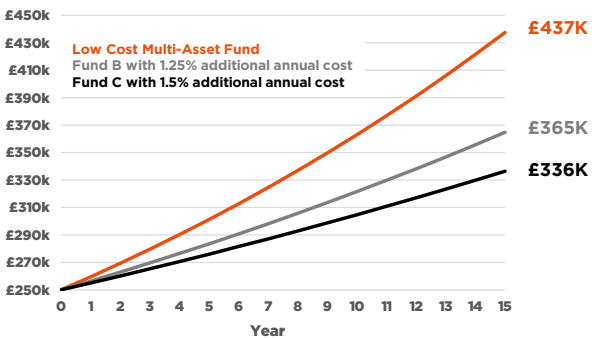
# THE IMPACT OF FEES

The hypothetical example below shows the true extent of even a small difference in fees on an identical fund.

- **Fund A charges a 1.2% management fee**
- **Fund B in grey charges 2.4%**
- **Fund C in black charges 3.0%**

On a £250,000 initial investment, assuming growth of 5% per year over 15 years, investing in Fund A, the low cost solution would generate:

- **£72,689 more than Fund B**
- **£100,955 more than Fund C**



**Did you know?**

Funds that are subject to the “UCITS” rules, which are set out under detailed EU legislation, include a requirement to give new investors a **Key Investor Information Document (KIID)**.

This document provides important information to investors.

A full-page background image showing a person in motion, skateboarding or running down a curved, light-colored surface. The person is wearing a dark t-shirt, black leggings with a red stripe, and dark sneakers. The background is a clear blue sky.

## ACKNOWLEDGEMENTS

The Jargon Buster has been written and produced by members of the Pacific Asset Management Team.

Special thanks to:

Simon Lowans	Adam Chebbi
Dylan Johnson	Freddie Streeter
Matthew Lamb	Will Bartleet
Emma Church	

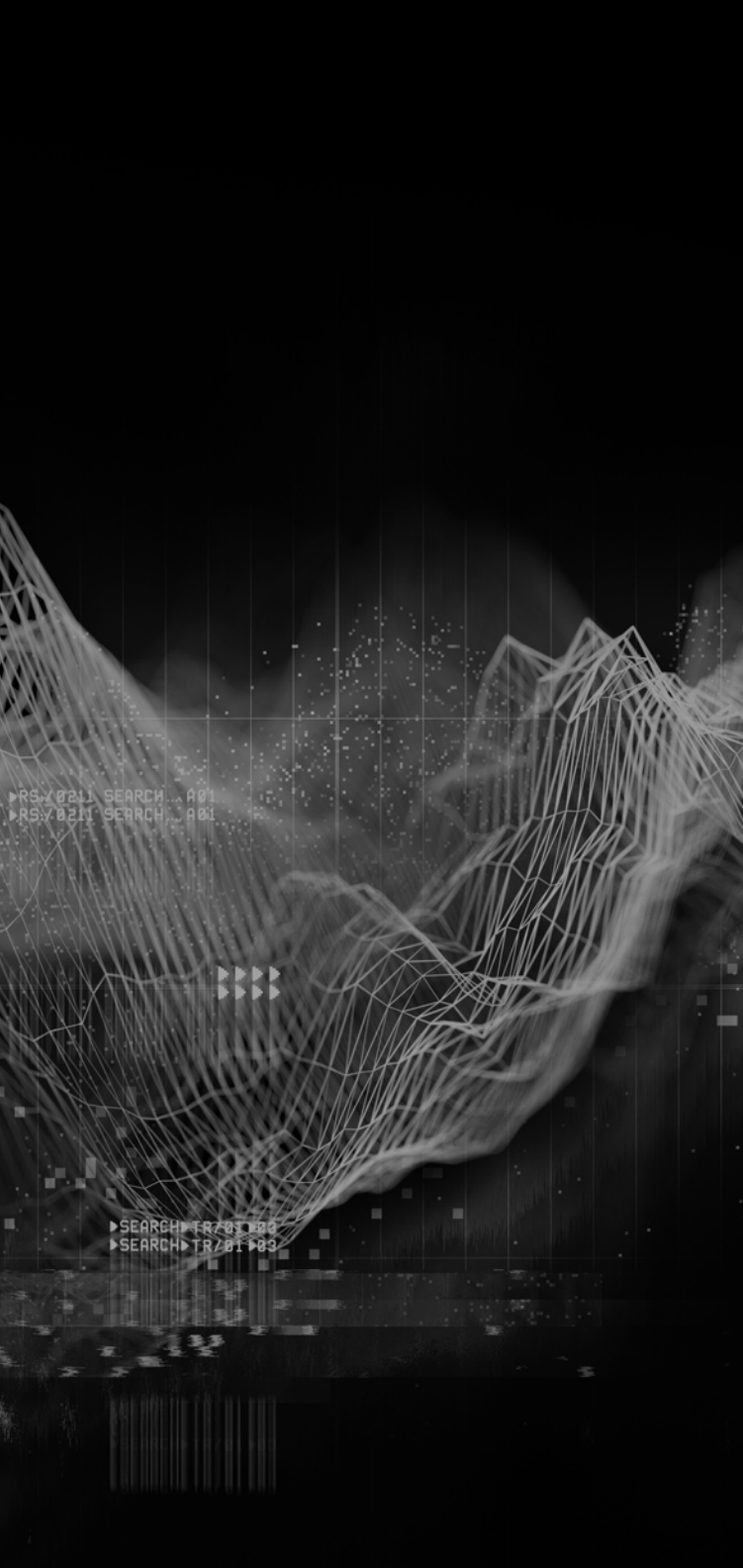
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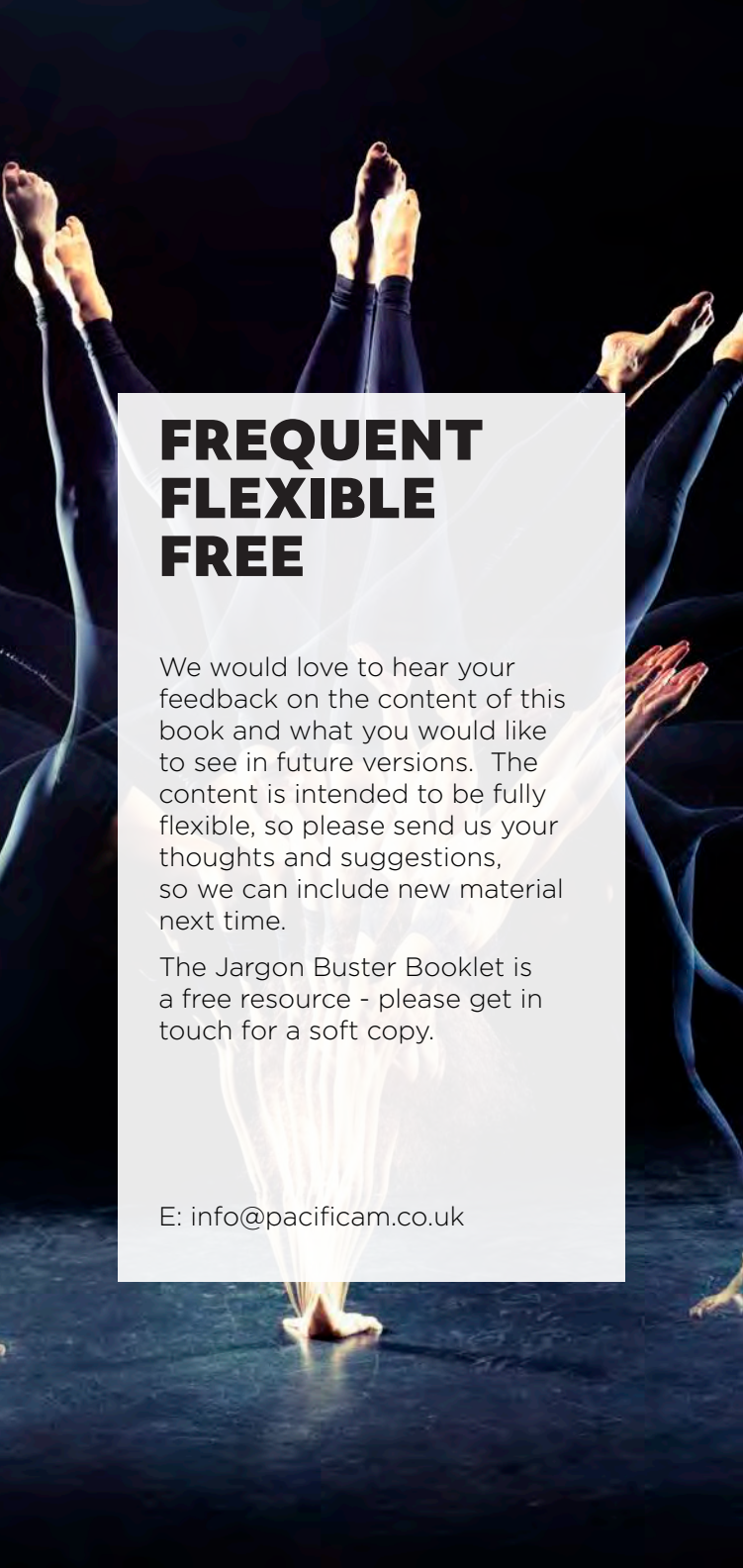


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