

# FE Crown Fund Ratings

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## Your questions answered

### What are FE Crown Fund Ratings?

FE Crown Fund Ratings are quantitative ratings ranging from one to five designed to help investors identify funds which have displayed superior performance in terms of stockpicking, consistency and risk control.

A single FE Crown Fund Rating reflects the lowest tier, and suggests the fund has failed to impress on the above terms, while a five FE Crown Fund Rating reflects the highest tier and identifies a fund which we think is of superior quality.

### What do Crown Fund Ratings aim to achieve?

The Ratings identify funds that have, over recent times, displayed superior performance in terms of:

- stockpicking
- consistency of outperformance against a credible benchmark
- achievement of results at a relatively low risk

This is not the same as simply identifying the best performers. Funds can also achieve good performance as a result of:

- making significant bets on market movements
- sudden bursts of performance, with other periods being indifferent or poor
- taking very high risks

Our view is that certain types of performance are more valuable than others. The drivers behind performance recognised by an FE Crown Fund Rating are those that we believe are intrinsically more valuable to investors in nature, because of their solidity.

FE Crown Fund Ratings are not individual fund recommendations, and should not be seen as specific advice, but a quantitative rating like this provides the starting point for refining and monitoring a list of funds that would be suitable for consideration. Because of the focus on alpha, Crowns are by definition aimed at the active investor. Tracker-type funds are rated, but, unless they are poor at tracking the index, their ratings will be of little value.

### Which funds qualify for FE Crown Fund Ratings?

FE Crown Fund Ratings apply to all the main FE universes including unit trusts and OEICs, investment trusts, life funds, pension funds and offshore funds.

### How often are FE Crown Fund Ratings updated?

Quarterly at the end of March, June, September and December.

### **How are FE Crown Fund Ratings calculated?**

We build up a score based on analysing a fund's performance over the last three years. The score is made up of three components – alpha, relative volatility, and consistently good performance. Previously we have used a fund's sector average as the basis of calculating these numbers. From October 2011, we have enhanced the Ratings to use more closely-targeted benchmarks where sectors are too diverse, improving the quality of the calculations and removing dependence on the nature and size of fund sectors.

### **Has the FE Crown Fund Rating system changed?**

Yes. Prior to October 2011 there were only three tiers, and the best funds were graded with a triple Crown Rating. This did not offer sufficient granularity, however, so we decided to increase the number of tiers into which the rating is split, from three to five– this is particularly important given that these ratings are designed to show poor as well as good funds, so a single Crown Fund Rating should only be given to the weakest funds.

### **How broad is each of the five tiers?**

Broadly speaking, the top scoring 10% of funds in each main asset class will get a five FE Crown Fund Rating, the next 15% four FE Crowns, and each of the remaining 25% tiers will get three, two, and one FE Crown respectively.

### **What happened to the old FE Crown rating system, where the highest possible rating was three FE Crowns?**

The essential aims of the FE Crown Fund Rating system, and the three tests upon which it is based, have not changed significantly. However, there are a number of major and minor differences introduced at the end of September 2011 which are worthy of note.

#### **Major changes**

- **More crowns**

We have moved from three to five FE Crowns. Because we cover the whole spectrum of funds in each universe, from best to worst, we believe that three FE Crowns did not give enough granularity to our measurements.

There are a number of three tier rating systems available but generally they are systems that only rate the top 20-40% of funds in a universe, and so each rating is in effect an accolade, not a measurement identifying poor funds as well as good ones, like ours.

- **Benchmark versus peer group**

We have moved to using targeted benchmarks, where sectors are too diverse, as the basis of the tests, rather than using the sector average.

We have long felt that many sectors are not homogenous enough to provide a single, adequate sector average benchmark, and as a result some funds (those in the IMA Specialist sector for example) were necessarily ignored, whilst others may not have had as accurate scores as we would have wished.

In many cases, the sector average has still proved to be the best fit. But there have also been many changes to benchmarks. An example of why this has been necessary is UK Mid Cap funds. Some time ago, they predominantly had top-crown weightings, reflecting a good run for mid-cap stocks. Mid-caps then went out of fashion, and they all lost their top rating. This obviously tells you little about how well the funds were run in relation to their focus, and so these funds now have benchmarks such as the FTSE 250, which will reveal much more.

### **Minor changes**

- **The alpha calculation**

The alpha calculation, as well as benefitting from better benchmarks, is now adjusted for volatility, more in line our FE Alpha Manager calculations. Alpha is sometimes spuriously enhanced by higher volatility, so this change is designed to remove that effect, as well as make different funds' alphas more comparable. The Alpha value is weighted according to the r squared correlation to its chosen benchmark, with the remainder coming from Sortino which measures risk adjusted returns without need of a benchmark.

### **Volatility and consistency calculations**

These calculations have been tweaked to give slightly more sensitivity.

### **Sensitivity to time**

Prior to end September 2011, our previous Crowns Fund Ratings gave slightly more weight to greater recent alpha and volatility history than to that three years ago. Although we have recently introduced a forward weighting to the new FE Risk Scores, to give a better feel for current risk trends, when it comes to rating a fund, we have decided to even-weight the history.

### **Sectors**

The final rescaling of scores, and the apportionment of Crowns, was previously done sector by sector. Some sectors are quite small which is likely to make the scoring unrepresentative, and some were too small to score at all – hence we previously excluded funds from ratings on the grounds of small sector.

With funds now being based on targeted benchmarks, and alpha being adjusted for risk, we no longer have to pigeonhole everything into sectors. Instead we are moving from 30 sectors to 11 sub-asset class groupings, into which funds are placed for final rescaling and Crown apportionment. This gives a broader base for the apportionment without risking direct comparison of very different funds.

### **What are the effects of these changes?**

Aside from dividing the range of scores into five segments from three, there will be two main effects:

#### **1. More funds can now be rated**

Funds that used to be in certain excluded sectors will now qualify. So we can now rate a number of important funds in the Specialist sector, for example.

## **2. Some funds that had a high rating will now have a low one, and vice versa**

Although there are not very many of these in relation to the whole universe, here are the main reasons this might happen, in descending order of likelihood:

- The benchmark has changed. Although a fund might look good in relation to its sector average, it might not do so against its better-fit benchmark. Always consider what benchmark is actually being used.
- Notwithstanding good alpha, the fund is relatively volatile or inconsistent. As mentioned, the volatility and consistency measurements have been sharpened and so higher volatility and lower consistency will tend to count more against a fund. Also since the alpha is now adjusted for volatility, funds that may have had their alpha flattered by the volatility will no longer do so.
- The good performance of the fund occurred more in the past. Because of the removal of forward weighting, good longer term performance counts as highly as that in the recent past.
- The fund is in a small sector, and some of the apportionment of Crowns may have changed in the smaller sectors, in particular, due to Crowns now being apportioned in bigger groups.

### **Why are FE's new Crown Fund Ratings more valuable to investors?**

- All our scoring is based on a benchmark. For the Alpha value we will weighting by r squared correlation, for the unexplained portion of the fund's performance we will be using the Sortino measure, which looks at risk adjusted returns without need of a benchmark. This prevents the situation where the benchmark does not adequately explain a substantial part of a fund's behaviour, leading to the ratios and scoring arising to be spurious. The mid-cap example given above is a case in point. The scoring needs to be robust.
  - In a period of considerable market uncertainty that looks set to persist, we believe it is important to put more emphasis on risk and consistency.
  - Additionally in a period of market volatility, it is appropriate to adjust to a more medium term weighting, rather than weight towards the present – an approach which looked more sensible when markets were consistently rising.
  - When FE Crowns were previously apportioned strictly by sector, there was no consideration, particularly in smaller sectors, to whether the funds in a given sector might be particularly good or particularly poor. By introducing a broader comparison, funds are no longer given top Crowns simply because they are at the top of their sector.

### **Other considerations:**

FE Crown Fund Ratings are however purely quantitative and backward looking, and, as such, cannot offer any certainty about the future.

In order to get a fully rounded view, an investor should also consider:

- Qualitative measurements and comments, which look at the quality of the processes by which a fund is managed.
- The strength and track record of the fund manager(s) involved in running the fund.
- The strength and approach of the asset management group behind the fund in the field in which that fund operates.