The importance of investing with a GENUINELY ACTIVE MANAGER

The relentless rise in the popularity of passive investing (where investors buy index funds that simply aim to mirror the performance of an underlying benchmark, less fees) has put the active fund management industry under a sometimes uncomfortable spotlight. If investors can enjoy market returns while paying lower fees, why should they trust their money to active managers who charge more, yet often struggle even to match the market? It's a question to which many active managers have struggled to deliver a convincing answer.

At Nutshell, we believe that active management can deliver market-beating returns, while potentially reducing volatility and cushioning an investor's capital during bear markets. But it's important to find a genuinely active manager. If your manager is simply going to hug the index, you might as well invest in a passive fund, which will charge you less for the privilege. So what makes a genuinely active manager?

An active manager should have the confidence in the rigour of their investment process to single out their best ideas, wherever in the world they may find them. They then need to have the freedom to allocate meaningful amounts of their portfolio to these high-conviction ideas. Diversification is important. Indeed, it is a key part of the investment process. Bad things happen to even the best companies and being overly dependent on any one investment is never sensible. But the number of stocks required to deliver true portfolio diversification, especially in the larger company space, is far lower than many investors assume.

Similarly, academic research shows that overall market returns over time have been driven by a tiny handful of highly successful companies. So while allocating tiny amounts of a fund's capital across scores of individual companies may feel like the 'low-risk' option, in reality, any active investor who hopes to outperform the wider market needs to use their skills to narrow down their search. The goal is to avoid the underperformers (which make up the majority of stocks), find the truly great companies, and then stick with those companies over time, allowing the miracle of compounding to do its work. The alternative, which is to run a portfolio which is an index tracker in all but name, is a recipe for persistent disappointment.

Why moats matter

At Nutshell we maintain a concentrated portfolio of around 30 stocks, selected from a universe of more than 10,000 globally-listed securities. How do we choose the companies that make it into our portfolio? Our main focus is to find those rare exceptional companies who enjoy a persistent comparative advantage over others in their sector. This is what is commonly referred to as a 'moat'. A moat can be anything from the ownership of key patents, to a strong brand, to a dominant market position in a sector that commands high switching costs.

Whatever the nature of the moat, its fundamental benefit is that it enables the company to enjoy excess returns, without fear of these being competed away in the medium-term. This is typically revealed in key financial metrics including earnings stability and high profit margins. Such dominant, high-quality companies also tend to have large market capitalisations. Examples of such companies include social media giant Facebook, whose dominance stems from the network effect – switching to a rival social network is unappealing if all of one's peers are using Facebook, and it's a similar story for photo and video-sharing app Instagram, which is also owned by Facebook. US tech giant Microsoft and China's Tencent dominate their spheres for similar reasons.

Nutshell's selection methodology uses in-house proprietary bottom-up screening models, based on fundamental factors, to narrow down the universe of stocks we choose from. However, ultimately the portfolio manager employs their discretion as to whether or not a stock is added to the portfolio. Since we are new and of modest size, we benefit from the resulting ability to be relatively nimble (particularly given the highly liquid nature of the stocks we invest in). We have been fully invested since September and the strategy has started to perform well versus other established peers in the global quality space.

We also integrate ESG factors (those relating to environmental, social and governance issues), using positive and negative ranking biases based on ESG performance. On top of that, we exclude certain sectors which we feel uncomfortable about such as companies operating in the tobacco or fossil fuel industries. Incorporating an ESG element into our process is the right thing to do from a moral perspective. But it's also worth noting that recent academic research suggests that ESG inclusion may also benefit performance. This makes some intuitive sense; an awareness of ESG impacts implies that a company's management has its eye on long-term performance and planning, rather than simply next quarter's earnings targets.

In short, at Nutshell, we still believe that genuinely active managers, who focus on hunting down truly great companies, can deliver market-beating returns for their investors. Find out more about active investment management at **nutshellam.com**.

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