



HOW THE FUND SELECTION MODEL WORKS

Introduction

Diversified investments form an important part of the investment policy of many asset managers. Investment funds and ETFs can assist with this. But how does one manage to select the best investment fund within a certain investment category? To this end Alpha Research has developed a data-based selection process designed to solve exactly this problem.

Selection process for the FSM

The quality of all investment funds is ranked in two (2) steps for each investment category using Morningstar's database, which features tens of thousands of investment funds and ETFs. 480 investment categories are currently distinguished. Using 12 measurable criteria and a quantitative method, each investment category is assessed in turn to determine which investment funds have the highest quality.

Investment categories

For each individual investment category, the FSM is applied in the same way. 480 investment categories are currently distinguished. Out of these 480 categories Alpha Research selected the following investment categories to be in the Fund Selection Report:

Equity:

- » Global Equity
- » Global Equity Small Cap
- » US Equity
- » European Equity
- » Global Emerging Markets
- » Global Frontier Markets
- » Asia Pacific ex Japan

Fixed income:

- » Euro Government Bonds
- » Global Bonds
- » European Corporates
- » Global High Yield
- » Euro High Yield
- » Global Emerging Markets Bonds
- » Global Emerging Markets Bonds Local Currency

Other:

- » Real Estate
- » Commodities



Two-step plan

The FSM is divided into two quantitative steps.

Step 1. Pre-selection (quantitative)

As part of the first step a pre-selection is necessary as there are large numbers of funds within certain investment categories, such as global equities. In this step, the wheat is separated from the chaff. In this process, selection is made on the basis of:

- » Fund track record. A fund is required to have existed for at least 3 year to ensure proper evaluation of the performance measures.
- » Fund size requirements: For the quarterly Fund Selection Update, a fund must have a minimum size of EUR 100 million. For the Insights published in the interim months, this threshold is lowered to EUR 10 million to allow for a broader exploration of niche funds.

Step 2. Peer group analysis (quantitative)

Once a peer group has been assembled, the most important step in the selection process must take place: the peer group analysis. The quality of an investment fund is measured on the basis of our 12 quantifiable criteria. These criteria are divided into four blocks. The weight allocated to the blocks is specified in the brackets as follows.

- | | |
|------------------------|-------|
| 1. Performance factors | (25%) |
| 2. Consistency factors | (25%) |
| 3. Cost factors | (25%) |
| 4. Risk factors | (25%) |

Ad 1. Performance factors

This block consists of an examination of the following performance factors, evaluated over a 3-year period:

- » Compound 3 year annualized return
- » Jensen's Alpha versus Benchmark
- » Calmar ratio (a relative measure of return against the average drawdown)

Ad 2. Consistency factors

This revolves around the consistency and reliability of the investment fund, with a focus on underlying factors, such as:



- » Fund manager start date – the longer a manager has managed a fund, the more consistent the fund
- » Morningstar Rating

Ad 3. Cost factors

Research shows that various types of costs have an enormous impact on the investment results. The higher the costs, the lower the score in this block. Cost types that are measured include:

- » Expense ratio – the fund’s standard fee
- » Annual Management Charge – the fund’s standard costs with possible additional costs

Ad 4. Risk factors

Risk cannot be captured in a single risk measurement. The FSM uses the following factors for this:

- » Beta - market sensitivity
- » Sharpe – risk adjusted returns
- » Covariance to Benchmark – the fund’s volatility
- » Annualized Volatility last 3 years

Sample calculation

In step 2, it was explained that the 12 criteria are subdivided into 4 blocks. Each block has its own weighting within the total score. Within the block itself, the various criteria, in turn, often have their own weighting.

Below, you will find an example for the investment category Global Equity. In this category, the T. Rowe Price Global Growth Stock Fund investment fund is scored as follows:

Global Equity Large Cap blend	Score	Weighting	Block score
Performance	9.78	25%	2.45
Consistency	9.59	25%	2.40
Costs	8.89	25%	2.22
Risk	8.21	25%	2.05
TOTAL SCORE			9.12



Frequently asked questions about the FSM

1. Which currency is the basis for assessment in the FSM?

If necessary, the share class with the longest history is calculated back to the euro. This way, all investment funds are assessed according to the same (euro) currency.

2. Are ETFs included in the Fund selection model?

Yes, ETFs form part of the database and are included in the selection process. The FSM therefore does not discriminate between investment funds and ETFs.

3. Who are Alpha Research?

Alpha Research provides financial markets research and consultancy services to the business market. Its clients include banks, asset managers and financial media, among others. Alpha Research relies on quantitative analysis methodologies and uses a model-based and structured research process. Alpha Research was founded in 2012. The founder formerly worked at AXA IM and Petercam and has led a committee within the Dutch CFA.

Should you have more specific questions, please contact Maria Thorvardardottir on mth@ecrresearch.com or +31 30 232 8000

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