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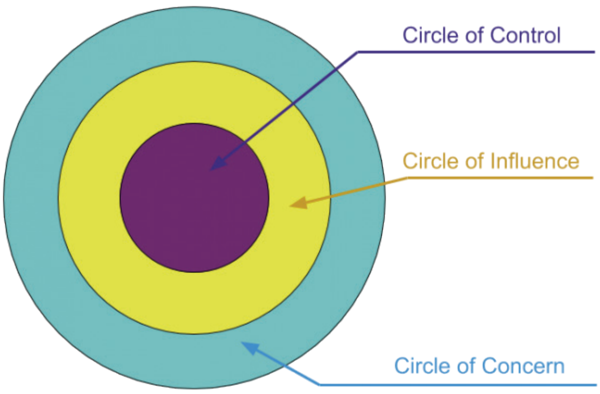
Frame Funds.

Circle of Control & Investment Strategy

What is the circle of control?



Source: https://www.thensomehow.com/circles-of-influence/

The concept behind the circle of influence and control is simple. What is within the 'circle of control' is what can be controlled by an individual, in this scenario, the investment manager. Within the 'circle of influence' is what influence the investment manager has over others and within 'circle of concern' are external factors that are outside of the investment managers control.

How can we relate this to an investment strategy?

There are relevant applications of the circle of control within the investment industry. One is applying the circle of control to a hedge fund/absolute return investment strategy versus a benchmark focused investment strategy.

A hedge fund applying an absolute return strategy has the ability to invest in multiple asset classes and strategies with no external predetermined composition of what they must invest in. The benchmark focused strategy, in this article, selects stocks mostly in-line with their predetermined benchmark; however, attempts to beat the benchmark by tweaking the weighting composition either by going over/underweight or attempting to be more active, among other things.

We first consider the factors which overlap between the absolute return strategy and benchmark strategy using the circle of influence and control, then we outline factors that are unique to each strategy.

What elements of each investment strategy overlap within each circle?

Circle of control
- Entry price
- Exit price (assuming no forced liquidation)
- Holding period
- Position sizing
- Stock selection

Circle of influence
- The funds reputation
- Security price (dependent on the size of the order)
- Broker relationships

Circle of concern
- Order shopping (orders may be leaked to other market participants)
- Company announcements
- Company strategy and personnel risk (for held investments)
- Financial risk management (e.g. liquidity risk, counterparty risk)
- Economic data releases
- News/social media
- Fiscal and monetary policy
- Generating Alpha
- Geopolitical risk
- Other market participant actions
- Black swan events

Within the circle of control for the overlap between strategies, both strategies have control over their execution, holding period and size. Their circle of influence depends on the fund's reputation in the market and how they can influence an asset price through accumulating or distributing stock on market. The largest number of factors are within the circle of concern.

What factors are unique to a benchmark focused investment strategy?

Circle of control
- Portfolio weights relative to the benchmark
- Decision to include non-benchmark stocks or exclude benchmark stocks within the portfolio
- Rate at which portfolio is turned over

Circle of Influence
- There are no notable factors within the circle of influence

Circle of Concern
- Tracking error
- Benchmark additions/subtractions
- Position sizing and weights
- Whether the stock is within the benchmark

- Whether the stock is outperforming/underperforming within the benchmark
- Reweighting of a benchmark stock upon positive/negative changes in fundamentals
- Risk profile of the benchmark

For the benchmark strategy, the main focus of control is the adjustment of portfolio weights to determine how much they wish to mimic the benchmark whilst attempting to outperform it. One of the first questions asked when considering a stock for investment is whether it is part of the benchmark, regardless of how logical an investment it may be. It may be considered a large risk to include a non-benchmark stock, due to the skewed negative payoff of including it and suffering if the stock underperforms (investors may punish the fund for including a stock outside of their universe) versus including it and having it outperform (which is what is expected of the manager). Investment decisions aren't based as much on investment strategy or macroeconomics, but rather, focused on the benchmark and company specifics.

We have failed to identify any reasonable unique factor that fits within the circle of influence for the benchmark investment strategy. The circle of concern for the benchmark investment strategy is directly focused on relative performance to the benchmark.

What factors are unique to a hedge fund investment strategy?

Circle of control
- Macroeconomic themes to invest in
- How to gain exposure to such themes (through investing in an underlying security, its derivatives, or both)
- Strategy idea generation and planning
- Strategy back testing and optimisation
- Strategy execution
- Risk reduction by executing specific strategies to gain exposure to a theme (e.g. long an outperforming gold miner, short an underperforming gold miner)
- What level of risk to take on to achieve a certain rate of return
- Systematic, discretionary or hybrid investment strategies

Circle of Influence
- Strategies may be replicated by others after execution which provide additional liquidity and momentum
- Influence economic policy through market movements (recent hedge fund buying in US treasuries has somewhat forced the US Federal Reserve to cut interest rates)
- Media exposure to current investments which generates retail investor interest

Circle of Concern
- Strategy effectiveness (whether a strategy is temporarily underperforming, or have the fundamentals changed, thus rendering the strategy ineffective)
- Strategy correlation
- Strategy decay
- Allocating capital to the right themes
- Whether current exposure is achieving optimal reward to risk
- How long the investment theme is going to play out

When considering the hedge fund strategy, the main point of difference is the relationship with control. The hedge fund strategy's focus is on the elements they can control, rather than the changes in the benchmark. One of the first questions a hedge fund manager will ask is, "what is the best way to gain exposure to a current economic theme", the subsequent questions are focused on the implementation of the strategy.

Within the circle of influence a hedge fund has the ability to discuss and promote their strategies to the broader market. This may assist the strategy to gain momentum as they are replicated and adopted by others.

A key risk for a hedge fund is that given the unlimited number of strategies to execute, they may have trouble sticking to a long-term profitable strategy when it is underperforming in the short-term, especially given the consideration of monthly performance reporting to investors.

In conclusion

Looking at the two investment styles through the circle of control setting allows us to highlight key similarities and differences between the two styles, mainly, the relationship with control.

The benchmark investment strategy is a *risk taker*. What we mean by this, is that the strategy takes the minimum predetermined risk of the benchmark. The starting level of risk for a benchmark investment strategy is the level of risk of the benchmark. Thus, tying an investment strategy to an equity index benchmark can have unintended consequences for the investor. A benchmarked investment strategy for an Australian equity manager is forced to expose the portfolio to large amounts of overnight risk, or movements in overseas equity markets. Recently, overnight risk from US, China, Middle Eastern and European markets have resulted in significant increases in volatility in Australian markets.

On the contrary, a hedge fund strategy is a *risk maker*. They determine exactly the amount of risk to take on to achieve a desired rate of return. By not being tied to an equity index benchmark, it allows the starting risk level to be zero (cash), then to increase from there. For example, they may ensure long positions are matched with short positions (pairs trading) or they may choose to limit overnight risk by ensuring all positions are hedged outside of regular trading hours.

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