

Thesis Product Update

September 2011

Product Update normally provides an insight into new Thesis products or services or our view of other providers' products already in the market. This month we take a slightly different approach as Giles Marriage introduces you to a new member of the Thesis investment team and just how 'she' might aid our own investment solutions...

Introducing TESS

TESS, standing for the Thesis Equity Stock Screen, was born out of a desire to develop a more rigorous and consistent equity selection process. Establishing an appropriate stock screen using the right ratios and then back testing the results has been a 'behind the scenes' project of our UK Equity Committee since 2009.

Based around the simple premise that "good companies produce good numbers", we sought to develop a decision analysis matrix that removed the opinionated and notoriously unreliable "noise" and recommendations from brokers and other market sources (often short-termist), thus leaving us with a more distilled picture of the real health of a company from which to formulate a decision. In other words, TESS is a quantitative process for filtering stocks, as opposed to applying a fundamental approach.

Number crunching

With so many different ratios to look at, the first stage of the project was simply to establish the best measures to analyse company financials with - the profit and loss account, the balance sheet and the cash flow statement. From an ideal list, we then had to establish which ratios were the most reliable and also readily available in data form, going back as far as feasibly possible. It was at this difficult stage we sought the help of Dr Vineet Agarwal of Cranfield University, one of Europe's leading business schools, who had experience in developing a similar process for a UK credit insurer.

The next decision was to segregate out the largest 250 non-financial stocks from the financials - the latter being quite different beasts to analyse from an accounting perspective (as events since 2008 can testify!). By analysing the non-financials data over eighteen years and finessing the list of ratios down we were able to establish a model of 50 stocks, using six variables that outperformed the market in 16 out of the 18 years (from 1991 to 2009). Company TESS scores are therefore calculated based on rankings on dividend yield, earnings growth, earnings to price, earnings to sales, and return on assets, together with historic return data.

What back testing proved

A three month lag is assumed between the balance sheet date and actual availability of accounting data and in the back-tested model the top scoring 50 stocks were bought and held for a year and then reviewed on an annual basis. Amazingly, £100 invested in December 1991 in the bottom 50 stocks each year would have grown to £203 by December 2009, in all stocks to £594 and in the top 50 to a staggering £2,037.

Pleasingly, in the two years that the best 50 underperformed the other 200 (in 1996 and 1999), the magnitude was relatively small. In addition, these results were not driven by outliers - on average, 61% of the best 50 stocks earned above median returns in the subsequent one year and results were also not biased towards smaller companies. While some sectors were under/over represented in the top 50 portfolio, over the 18 year period, on average, no sector accounted for over 10% of the portfolio.

An aid to identifying winners and losers

Our overall aim has always been to identify those companies that will prosper in both good and bad times and equally to identify and discard those that will languish. Avoiding the companies that will lose out in the current challenging environment is now just as important in terms of ensuring competitive investment returns for our clients.

This is not to say that TESS uses the best combination of ratios - there may still be another combination that has performed better in the past. However, there is also a need to balance simplicity against potential data mining issues when screening companies, and so our quest for the 'Holy Grail' of investment selection continues...



This Month's Product Update written by:

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Please feel free to contact your **Investment Manager** to discuss any aspects of this update.

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