

Defaqto Diamond Rating methodology for single solutions & MPS

February 2025



Introduction

Diamond Ratings are quantitative ratings to aid the selection process, providing an efficient method to help identify the most consistent investment solutions in terms of risk adjusted returns.

Defaqto appreciates that in a Consumer Duty regulatory landscape being able to explain concepts to clients in a way that they understand is key.

The Diamond ratings and associated methodology have been designed to remove unnecessary complexity from quantitative ratings.

What are risk adjusted returns?

Risk adjusted returns illustrate the investment return often in excess of a risk free rate e.g. short term money market rates, whilst taking into account the level of risk (volatility) to achieve that return.

Why use risk adjusted returns over simple returns?

Example:

'Fund A' compared to 'Fund B' is identical in terms of investment return over a given period. However, 'Fund A' has achieved the same return as 'Fund B' by experiencing less risk (volatility) when compared to 'Fund B'. This indicates that the manager of 'Fund A' has managed risk more efficiently than 'Fund B' over the given period, to deliver the same investment returns.

'Fund A' has a greater return for every unit of risk employed when compared to 'Fund B'. And therefore, a greater risk adjusted return when compared with 'Fund B'.

For this reason, we use risk adjusted returns so that each fund and its share classes can be compared on a like for like basis when taking into account the magnitude of risk vs return.

How Defaqto defines risk adjusted returns for Diamond Ratings?

The Diamond Ratings use a modified version of the widely used Sharpe ratio.

Sharpe ratio is usually calculated for funds as follows:

Sharpe Ratio = (Return - Risk Free Rate) / Standard Deviation

The higher the output of the Sharpe ratio calculation, the better the risk adjusted returns. However, the challenge with Sharpe ratio is that when performance turns negative, the output of the ratio inverts and outputs a higher value when volatility increases. Below is an illustration of this:

Fund 1: $(-5\% \text{ return} - 2\% \text{ risk free rate}) / 5\% \text{ volatility} = -1.4\%$

Fund 2: $(-5\% \text{ return} - 2\% \text{ risk free rate}) / 10\% \text{ volatility} = -0.7\%$

Both funds have experienced the same return but Fund 2 has a higher Sharpe ratio, which when ranking risk adjusted returns, would suggest better historical risk adjusted returns for Fund 2, which isn't the case in this example.

We therefore cater for this issue by modifying the Sharpe ratio so it doesn't invert. Using the below calculation, this allows the Sharpe Ratios of share classes or MPS portfolios with negative returns to be ranked against share classes or MPS portfolios with positive returns.

Modified Sharpe = Annualised Return / Annualised Standard Deviation \wedge (Annualised Return / Absolute Value of Annualised Return)

Rating criteria

The data points used as criteria for the ratings are as follows:

- Discrete 1 year Modified Sharpe - year 1
- Discrete 1 year Modified Sharpe - year 2
- Discrete 1 year Modified Sharpe - year 3
- Discrete 1 year Modified Sharpe - year 4
- Discrete 1 year Modified Sharpe - year 5

Peer groups

Defaqto understands that financial advisers actively use IA sectors, AIC sectors and Defaqto MPS Comparators when segmenting the fund, Investment Trust and Discretionary MPS universe, and that their clients are familiar with IA sectors. To help advisers explain the rating to their clients, we've adopted IA sectors, AIC sectors and Defaqto MPS Comparators as mutually exclusive peer groups when ranking like for like investment solutions.

- For Unit Trusts, OEICs and ETFs we've adopted IA Sectors
- For Investment Trusts we've adopted AIC sectors
- For Discretionary MPS, we've adopted Defaqto MPS Comparators

Defaqto then applies additional inclusion criteria, to define the Diamond Rating peer groups:

Unit Trusts, OEICs, ETFs & Investment Trusts:

- Must be registered for sale in the UK
- GBP share classes only
- Comparable sectors only – sectors where the returns of the constituents can't be compared on a like for like basis, aren't included
- Share classes must have 5 years or more performance history

Discretionary MPS:

- Must be registered for sale in the UK
- Platform custody
- Portfolios must be assigned to one of the following Defaqto MPS Comparator peer groups:
 - Defaqto MPS Comparator Defensive
 - Defaqto MPS Comparator Cautious
 - Defaqto MPS Comparator Balanced
 - Defaqto MPS Comparator Growth
 - Defaqto MPS Comparator Adventurous
- Portfolios must have 5 years or more performance history

Methodology

- Defaqto calculates Modified Sharpe ratios for each discrete performance observation period for all share classes or Discretionary MPS portfolios that meet the inclusion criteria.

- The Modified Sharpe figures are then ranked independently for each 5 discrete periods, within peer groups of like for like strategies (IA sectors, AIC sectors & Defaqto MPS Comparators). The higher the risk adjusted returns are relative to peers, the lower the rank. E.g. Rank 1 = highest Modified Sharpe
- The ranks are then totaled
- The 'total ranks' are then quintiled. As follows:
 - The lowest 20% of total ranks (best performing on a risk adjusted basis) are assigned a 5 rating
 - The next 20% are assigned a 4 rating
 - The next 20% are assigned a 3 rating
 - The next 20% are assigned a 2 rating
 - The highest 20% of total ranks (worst performing on a risk adjusted basis) are assigned a 1 rating

Update frequency

Unit Trusts, OEICs, ETFs & Investment Trusts:

The Diamond Ratings are updated twice a year in February and August, calculated using data as at 31st December and 30th June, respectively.