Equities without tears

Actively managed funds struggle to beat the market. ANTHONY GARNER *on the thinking investor's alternative: index-tracking ETFs*

Few private investors have the skills or resources to undertake direct investment in single stocks. Not too many professionals have those skills either. To diversify adequately against the specific risks associated with individual stock investment, you probably need at least 50 to 100 stocks in your portfolio. That way, a few swift Enron style collapses or Northern Rocks are not going to make you and your portfolio feel too queasy. Even if you have the resources to diversify across 100 different stocks, stock selection is a formidable task.

Managed funds are the obvious alternative. The good news is that an investor in a well chosen collective investment vehicle is unlikely to be taking too much stock-specific risk. The bad news is that it is as difficult to find a fund that will continue to outperform (or at least not underperform) its chosen benchmark as it is to choose a good stock. The health warning 'past performance is no guarantee of future returns' should be taken very seriously. Making the rash assumption that I have persuaded the private investor to choose funds rather than single stocks, I hope to convince him further that he is very probably wasting his time looking at actively managed funds.

An increasing number of investment professionals take the view that active fund management (stock picking and discretionary market timing) does not make sense theoretically and is not justified empirically. An impressive body of research, conducted over the past 50 years of active professional investment management, suggests that attempts to beat the market consistently are futile. The great majority of active fund managers actually underperform their given benchmarks. This underwhelming non-achievement is exacerbated by the high charges levied for such services – and I'm not talking of the hedge-fund boys (the new 21st century 'Masters of the Universe') and their '2 and 20' fee structure. I'm referring to the unit trust manager, friend to widows and orphans, whose quoted charges include bid/offer spreads of up to 6 per cent and annual management fees and expenses of up to 2 per cent.

An investor would, in all probability, be better advised to pick a range of index-tracking exchange traded funds (ETFs) covering a broad spectrum of world markets and to accept market returns.

Many will argue strenuously against this point of view and allude to the dramatic success of this or that manager or individual. But success comes and goes. However intelligent or skilful you may be, you still

need to be in the right place at the right time. And that is difficult to achieve, day in day out, over the months and years.

Take a look at the costs of buying and holding a highly liquid index-tracking ETF such as Power Shares QQQQ which tracks the NASDAQ 100 Index. The bid/offer spread is miniscule and it trades like an ordinary share on Nasdaq, so you will pay only a normal brokerage charge on your purchase (let us assume 0.3 per cent). The fund levies annual management fees and expenses of a mere 0.2 per cent.

ETFs tracking more exotic indices will have a larger bid/offer spread and a higher annual expense ratio. Nonetheless, the expense of owning and trading even the most exotic index-tracking ETF is dwarfed by the standard charges of the average UK unit trust.

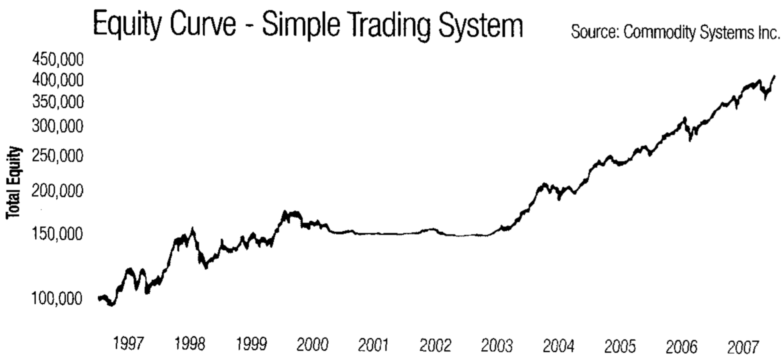
Losses, temporary or otherwise, are a fact of life in investing. A long-term equities investor must grit his teeth and sit through some gut-wrenching periods. The average investor will be beset by fears and doubts through these difficult times. Should I sell out? Is it too late to sell? Will the markets ever recover? Is it Armageddon?

The problem is illustrated by looking at the back-tested results of buying and holding a portfolio of index-tracking ETFs sponsored by Barclays Global Investors. ETFs are a relatively new product and hence data for back-testing is of short duration. Nonetheless, Barclays has a selection of 17 US listed country funds with a track record going back over ten years.

These are as follows, for those who would like to access prices on Bloomberg: Australia (EWA), Austria (EWO), Belgium (EWK), Canada (EWC), France (EWQ), Germany (EWG), Hong Kong (EWH), Italy (EWI), Japan (EWJ), Malaysia (EWM), Mexico (EWW), Netherlands (EWN), Singapore (EWS), Spain (EWP), Sweden (EWD), Switzerland (EWL), and the UK (EWU). For the sake of completeness I have added the US, in the form of the SPDR S&P 500 ETF (SPY).

My back-tests assumed starting capital of $100,000 invested equally between the 18 funds with annual re-balancing, to prevent any one stock becoming too large a part of the portfolio. The start date was January 1997 and the end date October 2007.

Holding these 18 funds for that period (assuming full tax free re-investment of dividends) would have achieved a compound annual growth rate of 14.70 per cent. This would have involved three very tough years after the portfolio value peaked at the beginning of 2000: at its worst, your account would have



Bullish on meat

Let food be your medicine, said Hippocrates. **John Stepek** fancies a good steak

Food price inflation is hitting the front pages. As consumers have winced at the rising cost of a loaf in their local supermarket, City speculators have piled into agricultural or 'soft' commodities, which have soared in price even as other asset classes have wilted. Demand for Westernised diets from the growing middle class in economies such as China and India, and the ill-advised craze for bio-fuels sweeping the US and the EU, have driven up grain prices in particular to record levels.

But while grain prices now look rather expensive for new investors to the sector, one foodstuff has been conspicuously absent from the boom - meat. The price of live cattle, for example, has fallen by about a fifth in the past year. That's at a time when wheat prices have near-doubled, according to the Dow Jones-AIG Commodity Index.

What's keeping the prices down? Corn is the most widely used livestock feed in the US; so higher corn prices mean the cost of keeping livestock rises too. Livestock farmers watch their corn-growing neighbours getting rich, while they lose all hope of ever making a profit from their animals. The solution for many farmers is to slaughter their livestock early. Some even decide to turn their farms over to grain production instead. But when lots of farmers kill their animals at once, you get a glut of meat hitting the market, sending prices lower, making it even less economical to be a cattle farmer.

But look a little further out, and those livestock farmers who can hold on should do rather well. More animals being killed now means fewer mature animals making it to market in the future - and that means less meat. Falling supply should result in higher prices, which means that the best way to play the grains boom now is to buy livestock. You can do so via the Livestock exchange-traded commodity (LSE: AIGL) from ETF Securities, which tracks the price of lean hogs and live cattle as measured by the DJ-AIG Livestock Sub-Index.

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been down 46.3 per cent from its high and not far from its inception level of six years earlier. Volatility would have been high at 21.6 per cent (annualised standard deviation of daily returns).

Even the simplest mechanical strategy can ease the agony of sitting through a loss of almost 50 per cent in your portfolio's value. I back-tested a few simple rules designed to enter positions at a statistically favourable moment and to exit during a market downturn. During a downturn, funds are kept in cash, earning interest. In my back tests, I used the same 18 ETF portfolio over the same test period and a smoothed 200 day moving average of the daily closing prices.

To prevent getting chopped in and out of the market too often, I added a band above the moving average, calculated as one standard deviation of the past 200 days' closing prices. The rules are simple: when the price closes above the standard deviation band on the upside, buy the relevant ETF at the next day's open. When the price closes below the moving average on the downside, sell the relevant ETF at the next day's open. Ongoing positions are rebalanced once a year to prevent any one position from getting out of kilter. On a new trade, the initial position size used was one-eighteenth of the total account value.

The compound annual growth rate came out very similar to buy and hold at 14.2 per cent. Volatility was far lower, however, at 13.5 per cent and during the crucial years 2000 to 2002 this system held on to its gains far better. Drawdown is dramatically reduced: at its worst point during the bear market, buy and hold suffered a maximum loss of 46.3 per cent of the portfolio's value, whereas this simple system capped the loss at 23 per cent, as positions were exited during the down turn and funds were left in interest-earning cash. In other words, this simple system provides a far less volatile alternative to buy and hold: it makes the often stomach-churning business of equity investing a great deal more comfortable to live with. Clearly the tax implications need consideration.

Sceptics will maintain that mechanical systems do not work and that you can not ignore the fundamentals. They are wrong. Sophisticated investors have profited handsomely over the years by following price trends on a purely mechanical basis and they will continue to do so. ●

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