AF4 2020/2021
Portfolio Construction
Part 1 Investment strategies

The full title of AF4 is Investment Planning. Advisers establish clients' current situation, identify their objectives and recommend a solution. The first two parts are fairly easy to assess in a written exam but what about the third?

One thing that can be said with certainty is that you will not be asked to construct a portfolio. What you can expect are questions that ask you to:

- Comment on the appropriateness of a client's investments
- Comment on the overall structure of a portfolio and recommend how it might be improved or recommend an alternative
- Explain different investment strategies that could be used by both investors and fund managers.

Most questions will be asked from the point of view of an individual and their adviser but some will be asked from the perspective of a fund manager or an investment company.

Case studies and questions will reflect the current market conditions.

This first part won't cover the process that advisers should follow to ensure they give appropriate advice. This is probably going to be tested but candidates' own experience should enable them to answer these. In addition, the first chapter of the AF4 study guide gives an excellent summary of the process. Instead this first part will focus on the main strategies and techniques that can be used in constructing a portfolio. The second part will look at the practicalities of how advisers and firms select appropriate assets in a portfolio.

The milestones for this part are to understand:

- How current market conditions affect investment decisions
- The dangers of DIY investing
- The benefits and drawbacks of long term holding compared to a short-term active trading strategy.
- The difference between a Growth and Value investing.
- The principles of Contrarian and Momentum strategy
- The benefits and drawbacks of using tracker funds compared to an active investment strategy.
- The principles of a core and satellite strategy.
- The principles of Environmental, Social and Governance investing

The current state of play

Covid has made life difficult for investors. Cash and Sovereign Bonds yield virtually nothing so in the search for yield investors have no choice other than to invest in equities or property. Shares across the world fell in reaction to the crisis but most major markets have regained all their previous losses. Whilst share prices tend to be leading indicators this recovery seems odd as most economists predict a recession and many companies have cut their dividend. The most likely reason for this bounce back is that governments are using Quantitative Easing on a regular basis to buy bonds and the released liquidity is forcing up asset prices.

How long can this continue? As might be expected ask two economists and you'll be given five different opinions! However, the following seem to be the most likely possibilities.

- QE continues, covid becomes less lethal or a vaccine is produced. Businesses recover and things return to something like normal.
- QE continues but the massive injection of cash into the economy starts to result in an increase in inflation and the Bank of England responds by increasing interest rates.
- Despite continuing QE, the market is only prepared to lend to the UK and other governments at a higher rate. As a result bond prices collapse and could drag down equity markets.

Or of course it could be something completely unexpected!

DIY trading

Go on to YouTube and you will find hundreds of sites claiming to show how individuals can become full time traders and need never work again. Their presenters claim that they have turned $2,000 dollars into millions of dollars, and you can achieve the same if you follow their strategy.

Recent volatility has spawned an army of day traders using digital platforms like Robin Hood and it's easy to see why this looks attractive

- Shing Poong Pharma (Korea) was up 969% YTD as at 6 August
- On 20th July Synairgen more than doubled between 9 am and midday
- Eastman Kodak rose over 100% in just over a week in late July

This type of "day trading" is easy with hindsight but extremely difficult without resort to a Tardis and investors face considerable practical problems.

- A large amount of capital is needed to fund them through the inevitable periods when losses are made.
- They don't have access to the level of research and analysis available to a financial institution and may not even understand what they are investing in
- They incur dealing costs and stamp duty.

- Unlike professional traders they probably aren't hedging their positions so are exposed to a big fall in the market.
- Losses could be 100% of the "investment"

In behavioural finance terms they are probably overestimating their ability and falling for the, "if they can make money, I can make just as much" delusion.

In fact they are not really investing but gambling.

- They back hunches
- They trade often
- They get lucky or get wiped out

Moving away from the day trading model it is quite easy to build up your own portfolio of collective funds using one of the many platforms that are available. Some may offer "suggested" funds to match your own perceived risk profile but this is not advice.

The drawbacks to this approach are:

- Lack of diversification in both asset and sector.
- Attitude to risk will be based on a "feeling" rather than on any objective measure.
- The portfolio may not match investor's need for income or growth
- No target for performance or benchmark will have been set
- No rebalancing may take place.
- Securities may not be in tax efficient wrappers

The Long Haul

Equity markets tend to reward patient investors. There will be day to day volatility but as discussed in an earlier part, over the long term the gains should outweigh the losses. Moreover, the long-term investor benefits from dividend payments.

This strategy is called **Buy and Hold**. Investments are purchased with the intention that they are not touched for many years.

Its main benefits are:

- Low cost/low admin
- Dividend stream should increase return over long term.

If the portfolio consists of mainly directly held shares

- It may not be possible to get a large enough diversification.

- Few companies survive for long term. There are fewer than 30 companies that have stayed continuously in the FTSE 100 since it was set up in 1984.
- Investors may miss new opportunities as they avoid switching holdings
- Take-overs or mergers may involve holding being absorbed into a different business.

If the portfolio is mainly fund based:

- The manager may be changed and performance may deteriorate.
- The investment style/strategy may change exposing clients to a different level of risk.

Growth or Value Investing

Individual stocks can be classed as growth or value stocks. Investors whether individual or fund managers can adopt a growth or value strategy.

The classic **growth company** aims to go from a small up and coming business to becoming leaders in their respective field. In their early stages these companies focus on building their revenues rather than profits and only later move to maximising profits. They often build up a dominant market position, acquiring rivals on the way.

They tend to have high valuation as measured by price/earnings ratio but they have a higher growth in revenue than their rivals.

A **value** stock trades at relatively cheap valuations relative to its earnings and long-term growth potential. They tend to have steady predictable business models that generate modest growth in revenue and profits.

Individuals or fund managers adopting a growth strategy will obviously hold growth stocks and this will appeal to investors who:

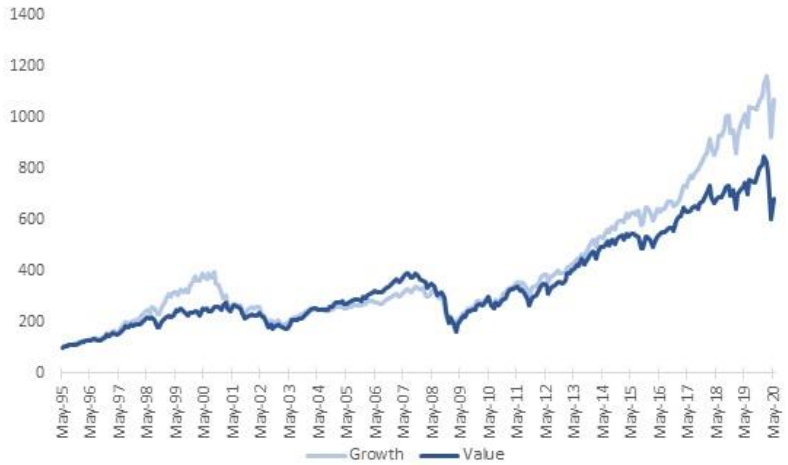
- Are not concerned about receiving dividends
- Are comfortable with a high level of volatility in the share price.
- Feel they can pick out winners in emerging markets
- They have a long time horizon

A Value style will appeal to investors who:

- Want a steady flow of dividends
- Prefer to have a lower volatility in the share price.
- Believe they or the fund manager can differentiate between a company that is undervalued but has good prospects and one that is failing with poor prospects of recovery
- Have a shorter time horizon. Whilst they may not turn things round overnight, other investors may spot its potential and drive the stock price up.

Which is better?

According to Brewer Dolphin, value funds have returned 624% since 1995 whereas growth funds have returned 1,072% over the same period



The coronavirus pandemic has widened the disparity as growth stocks such as the US tech companies have massively outperformed the rest of the market.

Value investing is more sensitive to a slowing economy. Without economic growth value stocks will tend to stagnate

Of course, investors can have some funds that are growth oriented and some that take a value approach.

In the long run it is possible that today's growth stocks turn into value ones. A hundred years ago the growth sectors were oil, car manufacturing and radio. There is also the danger that if they achieve an effective monopoly, regulation may break them up

An extreme form of value investing is **contrarian investing**. Like value investing it looks for undervalued stocks but also deliberately goes against current trends. For example, a contrarian fund or investor might in Summer 2020 invest in travel and leisure companies. The rationale might be that at some point covid restrictions will ease and the share price will revive. It is a high-risk strategy and investors will probably need to be patient and not expect a quick return.

Momentum investing follows on from a growth strategy. Investors buy stocks such as Tesla and Amazon whose share price is soaring. Underlying financial data is ignored together with the share valuation. All that matters is that the share price seems to be going in one direction. The danger is that they are buying at the peak and could lose substantial amounts if the price plunges. The share price tends to be very volatile so investors need to be prepared to accept rapid movement up and down and be prepared to hold their position.

The April 2019 paper asked candidates to explain a **deep value investment strategy**

The answer given was:

- Investing for the long term in undervalued stocks
- Where the price is less than the book value of the total assets

In some ways this is a form of contrarian investing. The argument for it is if the company assets are worth considerably more than its market capitalisation there is a reduced risk. This however depends on those assets being realisable and the company has no other debtors who need to be paid before any money can go to the shareholders

Let's finish by looking at a couple of quotes. The father of value investing in the US, Benjamin Graham, said

"in the short run the market is like a voting machine-tallying up which firms are popular and unpopular. In the long run the market is like a weighing machine – assessing the substance of a company. What matters in the long run is the company's actual business performance and not the investing public's fickle opinion about its prospects in the short run.

Warren Buffet another value investor has said,

"Be fearful when others are greedy and greedy when others are fearful"

Mr Buffet runs Berkshire Hathaway which is the equivalent of a UK investment trust. It is the 35th largest company in the S&P 500. $1,000 dollars invested in 1964 when he took over the company would now be worth $11.6 million in June 2020

Active or passive investing

Passive management means not employing a fund manager to make decisions but using algorithms to replicate the performance of an index. Viewed with some suspicion when they were first launched, they are now form a key part of many portfolios. Almost all major market indices have funds that aim to track them. They can be structured as a unit trust/OEIC or an ETF.

Tracker funds have lower charges than an active one, The Vanguard FTSE 100 Index Unit trust has an **Ongoing Charges Figure (OCF)** of 0.06%.

A fund can use **full replication** buying every share in the index. This can be difficult so two other methods tend to be used;

Stratified sampling

- Shares that are representative of each sector are selected. This may lead to subjective judgements by choosing company A over company B.

Optimisation

- This uses computer modelling to try and broadly replicate the index.

Note that in the April 2019 exam it also gave an option of **synthetic tracking** using derivatives

Funds rarely get exactly the same performance as the index and the difference is called **tracking error** This is expressed as a percentage and the lower this is the closer the fund performance will be to the market performance.

Apart from lower costs the main attraction is that it does what it says on the tin, it delivers the market performance. An active fund can deliver a better performance but it might produce a poorer one.

Most indices are market weighted. The FTSE 100 is effectively a league table with a share's position being based on its market capitalisation. A tracker fund based on that index will have most of its investments in the top 10 shares which can lead to an unbalanced fund.

As at 31st July 2020 the main sectors that made up the **FTSE 100** were:

Oil and Gas	16.6%
Banks	12.7%
Personal and Household goods	12.4%
Healthcare	10.2%

(Source FTSE100 Russell)

This could be considered a little unbalanced. This problem is even more pronounced in the most popular US index, the S&P 500.

Information Technology	27.5%
Healthcare	14.6%
Consumer discretionary	11.2%
Communications	10.9%

(Source S&P indices)

According to Investopedia on June 30 2020 the top 5 shares by weighting were:

1. Microsoft
2. Apple
3. Amazon
4. Facebook
5. Alphabet (parent company of Google)

What about Tesla?. Whilst the S&P 500 is a weighted index like the FTSE 100 a company must have at least four consecutive quarters of making a profit before it is admitted to the index. So far (July 2020) Tesla haven't achieved this.

The advantages and disadvantages of index tracking can be summarised as follows:

Advantages

- Lower costs than actively managed fund.
- Analysis tends to show that few active managers consistently outperform the index
- No risk of being the worst performer
- Takes away the risk of choosing the wrong manager
- It is a type of growth investing as companies grow and move up the table, it becomes a greater part of the holding. If a company's share price falls and it moves down the rankings decline it becomes a smaller part of the fund.

Disadvantages

- The fund follows the index so it must reduce its holding in a company that is falling down the rankings even if the long term prospects are good. Similarly it must increase its holding in companies whose price is going up relative to other constituents in the index even though it is felt that this increase is unjustified.
- There must be a representative index which may not be available in some emerging markets.
- The FTSE 100 is top heavy in that 10 companies make up 50% of the index.
- It will not lie on the efficient frontier since it only takes into account market capitalisation.
- It is unlikely to be the best performing fund
- It can never replicate the index because charges will be made although on the other hand an index does not include dividends. The degree of tracking error is therefore a critical factor in assessing the performance of a fund.

Index funds in the US are estimated to make up 45% to 50% of the market share in pooled funds and this domination can create problems.

When investors invest in a tracker fund it will buy proportionally more of the heavily weighted shares which pushes up the price which increases the value of the tracker fund and attracts more new investors. This might be classed as a bubble!

The efficient market hypothesis

One of the points that underpin index tracking is that a mature market such as London is an **efficient market**. This means that:

- All information about securities is already reflected in their prices.

- Any increase or fall in an individual price is random and cannot be predicted.
- Securities respond immediately and rationally to publicly available price sensitive information and move independently of past trends.

The efficient market hypothesis (EMH) has been further developed into three subgroups:

Weak form efficiency

- This holds that no excess returns can be earned by using data based on historical prices or returns.
- Current prices reflect all stock market information.
- However fundamental analysis of a company's financial statements can identify under or over-valued companies.

Semi strong efficiency

- This holds that share prices adjust rapidly to all public information.
- Therefore fundamental analysis will not identify over or undervaluation

Strong form efficiency

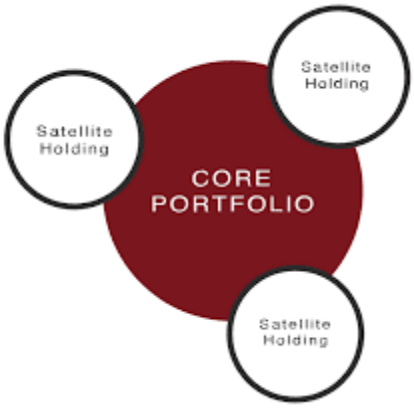
- This holds that share prices reflect all information, public and private, and no one can earn excess returns.

How valid is EMH?

- Research shows that a "buy and hold" strategy tends to outperform buying and selling based on trading rules. This tends to support the weak-form hypothesis.
- EMH assumes that all information is available to all participants but automated trading is the main driver of most major markets and getting information a fraction of a second earlier than a competitor can give the firm a competitive edge.
- EMH can only work in a developed and mature market such as London or New York. It doesn't seem to work as well in a developing market.
- The EMH does not square with bubbles and crashes. If the price of a share reflects all known information why are there rapid rises and falls with no additional information being given to the market?

What effect does EMH have on portfolio construction?

- Technical analysis based on past performance will not lead to outperformance after transaction fees.
- Fundamental (company) analysis can lead to identification of over or undervaluation but EMH suggests that this is of limited use as prices will react quickly to news.
- Tracker funds should be used at least as part of a portfolio
- Where a non-tracker fund is used, the portfolio should be diversified and reflect the client's risk profile. It should also minimise transaction and tax costs.



Following on from this there is a compromise between active and passive management which is a **core and satellite** strategy. Here a core holding is held in passive funds to deliver market returns. This might be split into a range of funds tracking the main indices (e.g.UK, US, Japan)
These will deliver market returns but around this there are specialist funds or possibly directly held shares that aim to give a higher than market return

Environmental, Social and Governance investing

What we used to call ethical investing.

This selects shares that meets set criteria in each of the three parameters.

Environmental criteria might include the company's energy use, waste, pollution, natural resource conservation and treatment of animals. It might consider if the company is campaigning against proposed environmental regulations.

Social criteria looks at issues such as a company's employment policies. Is it subcontracting work to low wage countries?

Governance criteria looks at issues as whether the company uses open and transparent accounting procedures. This should help prevent them engaging in illegal practices or making significant donations to lobby groups that helps the firm get political influence.

It's unlikely that any company would meet all the criteria so an ESG fund would have to select its own standards.

It could adopt a negative approach. This involves identifying companies or sectors that will be avoided. The usual ones are companies involved in tobacco, alcohol, armaments and gambling. Other funds may have stricter criteria.

Positive screening involves identifying companies that meet the fund's ethical criteria and/or attempting to engage with the company to improve their ethical stance.

The traditional view of ethical investing was that it would produce lower returns as it excluded companies with a strong profit performance. Some would argue that if we are moving into a no carbon greener economy, companies with a high ESG score could become the top performers.

That concludes this part so you should now understand:

- How current market conditions affect investment decisions
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