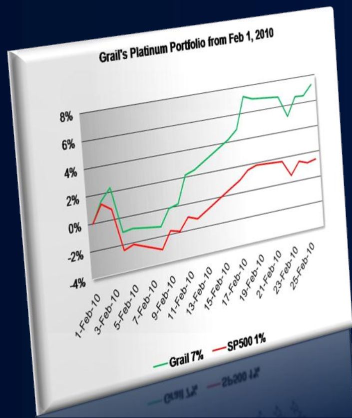


GRAIL SECURITIES (SWITZERLAND)

CHÄSIGASS 7, CH-6331 HÜNENBERG, SWITZERLAND

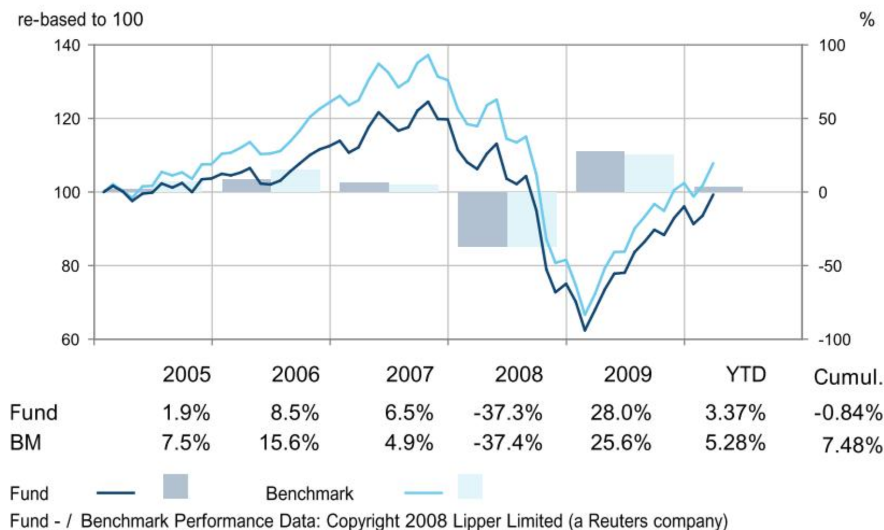
Telephone & Fax: 0041(0)41 781 36 01
Cell Phone: 079 693 26 45
Email: info@greenmail.ch
Website: www.grailsecurities.com

WHY YOUR EQUITY FUND LOSES YOU MONEY

or are you being duped? by IMCZ member John Henry Smith

In spite the debacle of the 2008 bear market, the majority of private investors still prefer to park their money in equity funds, especially those who feel they don't have the skills, time or inclination to manage their own assets. Nonetheless a growing number of discontented investors are dumping them, because they see the stock market showing signs of fatigue in its follow through from 2009, when it recovered 23%. As at April 9, 2010 the SP500 has gained a further 7%, but these investors see a move of about 31% is still needed to fully recover their losses[1]; that is not counting a fund's total expense ratio of about 2%.

The reason for their concern is while equity funds jumped handsomely in 2009 between 23% and 28% in the aftermath of an over extended bear market, they did so only because funds are strongly correlated to their benchmarks, which their managers see as an indispensible hallmark of fund consistency. The CS EF (LUX) USA B Fund here is very representative of this unison relationship:



	2005	2006	2007	2008	2009	YTD	Cumul.
Fund	1.9%	8.5%	6.5%	-37.3%	28.0%	3.37%	-0.84%
BM	7.5%	15.6%	4.9%	-37.4%	25.6%	5.28%	7.48%

[1] Measuring the SP500 from the peak of 1565.15 on Oct 9, 2007 to its trough on Mar 9, 2009 at 903.13, the index lost 752.90 points or 48%

This type of correlation means that recovery to pre-October 2007 levels will be fully dependent on stock market development, and not on any management expertise of fund managers. If the economic recovery is going to be slow the recouping process will extend into an undefined time horizon. Particularly disappointing for investors seeking risk-weighted returns are the cumulative results; here the fund's 5 year cumulative return is -0.84%, and is actually representative of the overall long term performance of the equity fund market.

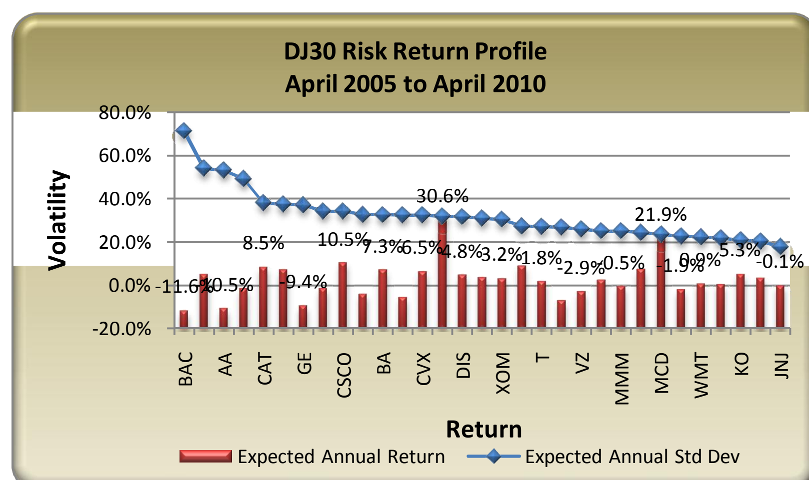
This self-serving pre-occupation with consistency carries a further burden, namely a very high proportion of funds are concentrated in large caps, because that's where investment bankers make their money rather than extracting meagre returns from small and mid cap companies. But did the largest holdings of the Credit Suisse's fund outperform the small and mid cap companies, which are slated as being significantly riskier?

Performance Comparison between the Largest Holdings of CS EF (Lux) USA B Fund and a Selection of Small and Mid Cap Stocks during 2008

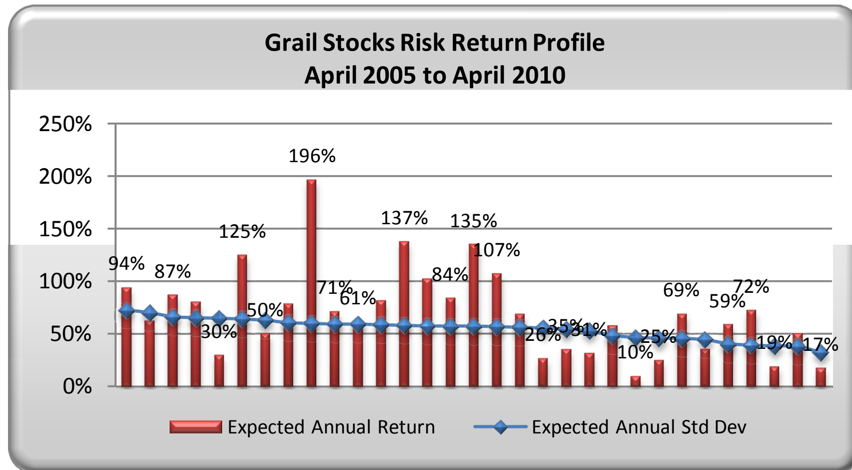
CS EF (Lux) USA B Fund Stocks	Fund Holdings	Market Cap*	Return 2008	Small to Mid Cap Stocks	Market Cap*	Return 2008
Apple	1.98%	213,976	-57%	Valeant Pharmaceuticals	3,357	91%
General Electric	2.94%	195,634	-56%	Dollar Tree Stores	5,226	61%
Merck	1.98%	46,142	-48%	Gentiva Health Services	843	54%
Microsoft	2.24%	255,747	-45%	Panera Bread Co	2,324	46%
Anadarko Petroleum	2.00%	36,602	-41%	SXC Health Solutions	4,015	29%
Cisco Systems	1.73%	147,893	-40%	Emergency Health Services	1,701	26%
Hewlettt-Packard	1.89%	124,853	-28%	Edwards Life Sciences	5,678	19%
JPMorgan Chase	2.50%	179,501	-28%	Tree House Foods	1,541	18%
Occidental Petroleum	2.05%	70,315	-22%	Jo-Ann Stores	1,141	18%
Chevron Texaco	1.69%	154,021	-21%	Ross Stores	6,546	16%
Total Holdings in Fund	**28.81%**					

* In $ Billions

Evidently not, at least not in this sample, which is taken from the higher end of the market! In fact in 2008 the large cap index, the Russell 1000, lost 39%, whereas the Russell 2000, which measures small cap performance, lost only 35%. You may argue that the difference is small, but financial advisors doggedly proclaim that the greater risks are in small and mid caps. This is because, they say, volatility, as measured by standard deviation[2], is greater in these categories than in large caps. The crux of their argument is that the broad market uses this metric is a proxy for risk. But is this hypothesis accurate? Let's compare the DJ 30 stocks with a selection of 30 stocks taken from all three industry segments taken from a Grail portfolio in terms of annual expected standard deviations and returns measured over a period of 5 years.



[2] Standard Deviation measures the dispersion of stock prices around their mean or average



What is immediately clear is that the expected prices of the majority of DJ 30 stocks are well below their standard deviations, indicating that the returns do not compensate investors for the risks taken, whereas in the second portfolio they do with prices well above their standard deviations. Interpreted another way, standard deviation comprises of two components; short and long volatility - values that are below the average and those above it. The second chart shows stocks producing long volatility that is caused by market-driven growth that continually extends the distance away from a stock's mean price, rather like an arrow being shot from a highly strung bow, which can travel a much further distance than by a one weakly strung. The key question an investor needs to ask is to what extent can the long volatility component be considered risk, when this momentum is driven by strong sustainable competitive advantage and high earnings growth over fairly long periods.

As I hope you now appreciate, stocks in the mid to small cap range do not per se bear greater risk, but simply are neglected by bankers and brokers alike in their pursuit of their own profit motives. Consequently these areas, as lucrative as they are to small investors, by and large remain undiscovered to the uninitiated, especially since the regional investment houses have been squeezed out of the market by the bigger players. This is not to say that research into these growth segments is entirely dead, but that finding it is more like finding the proverbial needle in a haystack, or is it a 'haystock'?

An investor bent on breaking the circle of long term losses caused by investment in mutual funds and wishes to seek higher absolute returns does not have to do the donkey-work himself; all he needs to do is find a reliable resource to stock-pick for him his way to large profits, especially if he doesn't have the skills or the time, but most importantly has the inclination!