Understanding Dynamic Fund Ratings

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There is a theory of investing, which states that it is impossible for investors to consistently beat the market's return. Here we look at that theory – the efficient market hypothesis – as well as the proven alternatives which mean you <u>can</u> buy funds and achieve extraordinary success – based on just 2 hours work a year!

The theoretical background

The theory that you (and the fund managers) can't consistently perform better than the stock market underpins the belief that the best way to invest is to buy a fund that ***mirrors*** that index – a so-called index tracking fund. This type of investment requires no active input from a fund manager. It just replicates the components of an index, such as the FTSE 100 or the S&P 500.

But does this theory stand up to scrutiny? No.

One of the very positive aspects of this theory (called the *efficient market hypothesis*, EMH) is that it spawned a huge volume of research, much of it triggered because the theory seemed so instinctively incorrect.

The clear exceptions to "The Theory"

This research highlighted that there are well-established ways to consistently outperform the stock market index.

According to the work of O'Shaunnessy and many others there are four clear ways to outperform the stock market, and (by definition) the vast majority of fund managers.

- Momentum investing
- Small Cap investing
- Value investing
- High Yield investing

For retail investors, these four approaches do so consistently well that they blow a huge hole below the waterline of those who promote index trackers.

Here I am focussing on **momentum investing**, as this underpins our ***Dynamic Fund Ratings***

At its simplest momentum investing means buying winners – buying an investment doing well right now because there is a high probability that it will continue to do well in the immediate future.

The evidence for momentum investing

The idea of using momentum investing as a successful strategy to buy individual shares pre-dates the birth of the EMH in 1952.

Momentum dominates the famous 1923 book, ***Reminiscences of a Stock Operator***, about the legendary trader Jesse Livermore. George Seaman and Richard Wycoff also wrote books in the 1930s that drew upon momentum principles. One of the first academic papers we can trace on momentum investing was in the 1930s.

A number of quite technical papers on the exceptions to the EMH (such as momentum) were written in the 1980s and 1990s (Google "Andrew Lo" and "efficient market hypothesis", for example). But perhaps the most accessible research on this was in the book "***What Works on Wall Street***", first published in 1998, and updated regularly since. Written by James O'Shaughnessy, he was the first person not an employee of Standard & Poor's to gain access to their database – this is the most important and complete repository of data in the world, going back 50 years and more.

This book cuts through the folklore and shows clearly what works. He highlights many more than the four strategies I mention above, but these four are those most easily exploited by retail investors.

We began exploring using momentum to select funds at the turn of the millennium, as we launched our ***TopFunds Guide***. Our research grew and grew over the years and eventually we launched our ***Dynamic Fund Ratings*** based on a straightforward momentum strategy (a momentum approach should always be straightforward).

As I said above, momentum investing simply means buying winners. In the case of our ***Dynamic Fund Ratings*** it means buying funds which have performed best in the last 6 months because of the probability that they will continue doing well in the next 6 months.

In our ***Dynamic Ratings***, the funds which have performed best in the last 6 months (the top 20%) are given 5 stars. Those which have performed worst (in the bottom 20%) are given 1 star.

After 6 months you review these bought funds which ***were*** 5 star. If they are now less than 5 star they are sold, and replaced with new funds which ***are now*** 5 star.

Simple. I said that should take you 2 hours a year. I probably exaggerated – it should be nearer one hour, 30 minutes twice a year.

The evidence of success - Extraordinary Extra Growth For YOU

This evidence is based on the investment of £100,000 in January 2000, the worst time to invest since 1945. The data is to end of December 2016.

In the table below, we not only show the % growth, but, to bring this to life, we also show the EXTRA cash in your pocket today assuming you invested £100,000 in January 2000 compared to the FTSE 100 index.

Dynamic Fund Ratings vs The Rest	**Total Return (%)**	**Extra growth on £100k initial investment (£)**
UK Dynamic Portfolio (using Dynamic Fund Ratings)*	**410.86**	**£325,430**
UK All Companies Sector Avg.	100.71	
FTSE 100	85.43	

* buying the top 3 UK All Companies funds each 6-month period

Can you afford to forego that £325,430? And these sorts of numbers persist across most sectors and markets, not just this one UK sector, just as the research stretching back many decades suggests it should.

So Why Do So Few Exploit These Opportunities?

It’s human nature really, which is what the EMH doesn’t allow for - EMH makes the daft assumption that we are all rational.

Most people don't have the discipline, and are more likely to be sucked into something mediocre (at best) by the siren song of exciting mass advertising, or the personal touch of a plausible and well turned out adviser.

The most boring thing in the world for many people is statistics – they would rather hear an exciting story.

Others believe that the route to success must be complex or everyone would already be doing it. (These people don't get that human nature is the reason why everyone isn't doing it.) It certainly is not technically difficult.

Others may believe it is hard work or time consuming. It certainly isn't. It requires something like Year 9 maths skills, and possibly only an hour of work twice a year – for the potential of extraordinary long-term gains.

Then again, some of us are just lazy.

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