

Timing and Trading – Can you make them work for you?

Summer 2007 has been a pretty tumultuous time for stockmarkets. The Bank of England provided emergency funding to Northern Rock, crude oil prices hit an all time high, an American brokerage house shut down after accruing losses on mortgage backed securities and at least two hedge funds have suffered eye-watering losses.

In the third week in July some indices hit all time highs. In retrospect surely that was a good time to sell? Following the credit crunch stockmarkets dropped by 10% to 15%. In retrospect, unless an investor or his favourite guru called both the top and the bottom very accurately it has been very difficult to arrive at a return that is net better than just leaving the capital invested. A trader would have certainly suffered transactional costs and may have also suffered a tax cost in selling in July and buying in August.

In fact most markets have slowly clawed back the bulk of the losses sustained this summer. As this article is written (late September 2007) most markets are approaching the highs they achieved earlier in the year.

This is not an argument for investing in equities – indeed many of you who will read this will have trimmed back some exposure at your annual review because the performance of equities relevant to other asset classes was particularly good – but it is an argument for not trading too often.

Most private investors do not profit from their trading, in fact it costs them money. If a trader sells an asset and buys another one, they do this because they believe the new asset will outperform the old asset. In fact outperforming the old asset is not enough – the new asset must outperform the old asset after both trading charges and taxation liability.

A paper in 2004 [Why do investors trade too much? Profs B M Barber and T Odean] looked at the records of 66,000 brokerage accounts in the USA. The 20% of accounts with the highest turnover earned 5.5% *per annum* less than the 20% who traded the least. This is a stunning figure that dwarfs some of the other factors that we concentrate on. We are always keen to shave 0.05% or 0.1% of expense from a deal, we are continually reviewing the fund managers we use to see whether we can buy the same asset a little cheaper and we also try (sometimes successfully) to put pressure on the wrap providers we use to trim their costs. These matters are hardly material if the cost of active trading is 5.5% per annum.

Hillier Hopkins LLP (Aylesbury)

2a Alton House Office Park
Gatehouse Way
Aylesbury
Bucks
HP19 8YF
T 01296 484831
F 01296 437157
DX 4154 Aylesbury 1

Hillier Hopkins LLP (Hemel Hempstead)

Charter Court
Midland Road
Hemel Hempstead
Herts
HP2 5GE
T 01442 269341
F 01442 219517
DX 8810 Hemel Hempstead 1

Hillier Hopkins LLP (Watford)

64 Clarendon Road
Watford
Herts
WD17 1DA
T 01923 232938
F 01923 817159
DX 51522 Watford 2

www.hillierhopkins.co.uk

info@hhllp.co.uk

Why do investors trade too often?

Barber and Odean put forward the following reasons:-

1) Over-confidence

Men particularly are overconfident – they believe they have the magic touch when it comes to investment. They also remember winning investments more clearly than they remember losing investments. Barber and Odean concluded that single men reduced their return by 1.4% per annum through active trading.



2) Over confidence leading to a lack of diversification

If investors are overconfident then they will be reluctant to diversify. If an investor has knowledge of what will be the next big performing equity then why hold anything else? Anything else will drag the return of the portfolio down compared to just investing in “the next big thing”.

Most of us know someone who made lots of money by buying stock X at just the right moment. It seems tempting to try and do the same. Sadly the evidence suggests that holding a highly concentrated portfolio increases risk.

Of course some investors beat the market. If returns are distributed normally, it would be surprising if some individuals did NOT outperform. But that is not the same as wise investing. Whether an investor wins or loses over a period, a failure to diversify means that the portfolio was exposed to an unnecessary amount of stock specific risk.

3) Overconfidence and the Internet



There is now on the Internet a lorry load of information available on any individual equity. As investors acquire more knowledge they believe this gives them increased ability to predict price movements. Unfortunately this mass of information may not be relevant in predicting what is going to happen in the future to this equity.

There is also something engaging about online trading. The investor has great control over the execution of trades. The danger is to believe that this control over timing somehow gives control over the outcome of the investment.

Conclusion

I have only referenced one study on the returns that active private client investors achieve. There are several more papers – if you are interested in reading them please give me a buzz. The papers that I have seen all reach broadly the same conclusion – typical retail investors trade too often and enjoy very poor returns.

We have no idea where stock prices will go from here. This may seem an odd statement from a wealth manager but it is an important statement – we really do have no idea whether with the benefit of hindsight we are close to a peak or at the beginning of a bull run. This statement is true every single day. What we do know is that in the long run investment in diversified portfolios of property and equities has produced better returns than the other main asset classes - cash and debt. We know that costs are a drag on investment performance.

We will continue to advise clients to hold diversified portfolios and to keep costs low by trading the portfolio rarely and ensuring that the underlying fund manager is also controlling his turnover related expenses.

Disclaimer

This article is intended for existing investors. Our articles are intended to be informative and sometimes to provide a little amusement. Please take our articles in this context. No client or non-client should take or refrain from taking action based on the contents of this article.

Ben Sherwood

Principal

November 2007

Ben Sherwood © 2007

The above commentary is intended for general guidance. It is essential that any readers seek independent advice before taking, or refraining from taking, action on any of the matters mentioned above. The authors and/or Hillier Hopkins LLP will not take any responsibility for the consequences of any action or inaction taken or not taken as a direct or indirect consequence of reading some or all of the above commentary.

If you are interested in any of the above matters please contact your usual Hillier Hopkins LLP contact.

If you would prefer that we do not contact you for marketing purposes, please e-mail your request to info@hhllp.co.uk

Hillier Hopkins LLP are registered to carry on audit work by the Institute of Chartered Accountants in England & Wales and authorised and regulated by the Financial Services Authority.