

HOW TO FIND YOUR *INVESTMENT STRATEGY*?

By Wilfred Ling

>> You want to save up enough for that retirement fund, so what should you invest in?

>>> You are already retired. What should you invest in?

>> Your child was just born yesterday. What kind of instrument can you use to save up for that expensive tertiary education?



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Above are perfectly sensible questions except that answers to those questions lie in the strategies you want to use. “What” to invest in is often associated with products but investment strategies are not products. Often, people confuse the two. It is easy to ask “what” is good to invest in. But really, there is no answer to that question unless the question of which strategy to use is already addressed.

So what is an investment strategy? Strategy is a grand game plan in order to achieve a certain goal. Your goal can be to save up enough for retirement, or a child’s expensive tertiary education or to inflation-proof one’s nest egg. A strategy is a roadmap to obtain that goal. Once formulated, you should stick with it through thick and thin.

What are the common investment strategies?

Two common investment strategies are **passive strategies** and **active strategies**.

PASSIVE STRATEGIES

With passive strategies, your aim is to get reasonable returns over a long term basis by minimising transaction costs.

Traditionally, a popular passive strategy involves using index funds such as exchange traded funds (ETFs). Index funds simply track the various market indices. It has been said that more than two-thirds of active fund managers cannot outperform the market indices due to the former’s high cost. Passive investors believe this to be so and instead of trying to do better than the market, they simply try to get the market’s return. The idea is quite simple. If the probability of active fund managers outperforming the indices is low, it just means that the probability of the market doing better than active funds is high. As the saying goes, “if you cannot beat them, join them.” If you are a passive investor, you choose the winner by simply tracking the market indices. The idea of passive investment is highly popular in the west but it is almost unheard of in Asia. Just look at the exchange traded funds listed on SGX. It does not take a genius to figure out that there is hardly any liquidity in them. Good ETFs with high liquidity are listed in foreign stock exchanges like AMEX, NYSE Arca and London Stock Exchange.

Although passive strategy is unpopular in Asia, it is more pervasive than most people think. At the end of June 2007, Barclay Global Investor is ranked as the world’s largest manager and sponsor of ETFs with 291 ETFs and assets worth US\$357.4 billion, trading in over 10 markets around the world, giving them a global market share of 53.4%. “Quant” hedge funds

which invest using certain rules is another passive instrument. The difference between “quant” funds and index funds are that the former’s investment rules are a closely guarded secret while index funds’ are usually published.

What kind of investors will be most keen in passive strategies? It will be those uninterested in monitoring their investments, those who wish to minimise transaction costs and feel that active fund managers provide no value-added service. It is also important that the investor is an aggressive investor because it is very hard for a conservative investor to do nothing during a market downturn. Passive strategy does nothing even when market goes down.

ACTIVE MANAGEMENT STRATEGY

In active management, the belief is that you can do better than the market.

The aim is to get better returns than the market. This involves market timing. Two main forms of market timing strategies are **technical analysis** (TA) and **fundamental analysis** (FA). In TA, the chartist looks at chart patterns and formulates an opinion on whether it is a good time to be long, short or simply not invest in the security concerned. For FA, the investor uses various financial ratios to determine whether a company or market is “cheap” or “expensive.” One popular ratio is the Price-to-Earning ratio. Active management is a highly popular strategy. In fact, almost everybody has heard of active management. This is in contrast to passive strategy, which is seldom heard of. The popularity of active management can be due to both demand and supply. There is a heavy demand for active management simply because investors are not comfortable when markets goes down (nobody is worried if the market goes up). When there is a lack of comfort, investors’ first reaction is to seek for answers. These answers can derive from rumours, media, Internet, financial advisers, stock brokers and fund managers. What follows is to act on those answers. Therefore, active management is human nature. On the supply side, it is easier to sell a product or service that is active in management. Thematic products usually sell well. Examples of thematic products are technology, climate change and commodities. Moreover, there is money to earn through active management – at least for the product providers. The management fee for a unit trust typically exceeds 1.5% per annum. Similarly, a discretionary managed portfolio of stocks would typically cost 1% per annum. These costs are not inclusive of the high brokerage cost associated with frequent trading.

One advantage of active management is that it takes into account the investor’s personal preference at any given time. For passive strategy, it is assumed that the investor is emotionless. However, all investors are emotional. The difference is in degree. Passive strategy assumes that there is a defined “market” represented by an index. However, in practice, the “market” is not static and therefore there is no well-defined index. For example, during a bull run, all investors are keen to benefit from the appreciating stock prices. Thus, the

market which they are keen on is the stock market. During the bear cycle, many investors prefer to stay in cash (which means the “market” in fixed deposit) while others prefer to short the market (which means the “market” is the inverse of the relevant stock market index).

Who is more suited for active management? Those who are conservative in their risk-taking, prefer an absolute return approach or who believe that it is possible to obtain value-added service through active management.

