July 2012

Bury FINANCIAL ADVISERS LTD
THE Adviser

Why don't we use tracker for UK equity

On pages 2-4 of our Quarterly Asset Allocation and Fund Selection document, we debate the "pros and cons" of passive and active management.

Here, I would like to demonstrate why we do not generally consider passive funds suitable for the UK equity sector.

Passive investment is where you try and replicate a market or index without making calls on individual stocks. The belief is that active fund managers (i.e stock pickers) cannot consistently outperform the index over a prolonged period of time and higher charges mean that they often under perform. By investing in a passive fund, you are only ever trying to replicate the index and not trying to beat it.

Active investment is where the manager aims to outperform the index through stock picking with reference to the fundamentals of the individual stocks. Although active funds typically cost more, the belief is that they can deliver excess returns which more than offset the additional charges.

Below is a list of the top 10 companies (by market capitalisation) in the FTSE 100 and the industrial sector that they fall within. What I will attempt to highlight is the lack of diversification achieved by selecting a UK equity tracker fund. I will also attempt to show how market capitalisation indexes are flawed in their construction.

Mining	
BHP Billiton	£148bn
Rio Tinto	£86bn
Oil & Gas	
BP	£91bn
Royal Dutch Shell	£135bn
BG Group	£49bn
Banks	
HSBC	£118bn

Telecommunications	
Vodafone	£93bn
Pharmaceuticals	
Glaxosmithkline	£61bn
Consumer Goods	
Unilever	£56bn
Tobacco	
British American Tobacco	£49bn

*As at 31 March 2012, source: Financial Times

The FTSE 100 consists of the biggest 100 private sector companies listed on the London Stock Exchange. Currently there are actually 101 different shares listed on the FTSE100 (useful for trivia purposes) as Royal Dutch Shell have A and B shares in issue and both are listed on the FTSE100.

The market capitalisation of the FTSE100 is approximately £1,549 billion (as at 31st March 2012, source Financial Times).

The top 10 companies (highlighted above) are valued at £886bn or 57.2% of the whole index. This means that by investing in the FTSE100 you are placing half your fortunes in the hands of just 10 companies (10% of the index).

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To take that one stage further just two sectors, Oil & Gas and Mining, equate to £509bn or just under one third of the market capitalisation of the whole index. Again, this means by buying a FTSE 100 tracker 1/3rd of your money would be invested in just two sectors which consists of 5 companies.

This may not necessarily be the worst thing in the world as long as those companies shares are rising and the top 10 constituents remain the top 10 constituents. However, just 5 years ago, 4 of the top 10 constituents were banks. They were HSBC, Barclays, Lloyds TSB and Royal Bank of Scotland.

	May-07	Jun-12	Diff
HSBC	900p	510p	-43%
Barclays	650p	175p	-73%
Lloyds TSB*	550p	25.5p	-95%
RBoS	550p	25p	-95%

* – now Lloyds Group after merger of Lloyds TSB and HBoS

This highlights one of the main portfolios with passive index investing. It can lead to a lack of diversification.

This is a list of the top 10 holdings that we access via our favoured UK Equity funds blended together 50:50. For our UK exposure we currently access the Invesco Perpetual High Income and Axa Framlington UK Select Opps funds. The table below highlights the top 10 companies we have exposure in the above two funds .

Stock Overlap		
GLAXOSMITHKLINE - Held by 2/2	**Position of Stock in each funds Top Ten Holdings**	**Portfolio % 5.90%**
AXA IM UK - Framlington UK Select Opps - Jun 92	2	1.85
Invesco Perpetual Fund Mgrs - High Income - Jan 95	2	4.05
ASTRAZENECA PLC - Held by 1/2		**Portfolio % 4.07%**
Invesco Perpetual Fund Mgrs - High Income - Jan 95	1	4.07
VODAFONE GROUP - Held by 2/2		**Portfolio % 4.05%**
AXA IM UK - Framlington UK Select Opps - Jun 92	5	1.65
Invesco Perpetual Fund Mgrs - High Income - Jan 95	6	2.4
BG GROUP - Held by 2/2		**Portfolio % 3.48%**
AXA IM UK - Framlington UK Select Opps - Jun 92	6	1.5
Invesco Perpetual Fund Mgrs - High Income - Jan 95	8	1.98
REYNOLDS AMERICAN INC - Held by 1/2		**Portfolio % 3.14%**
Invesco Perpetual Fund Mgrs - High Income - Jan 95	3	3.14
BRITISH AMERICAN TOBACCO - Held by 1/2		**Portfolio % 2.98%**
Invesco Perpetual Fund Mgrs - High Income - Jan 95	4	2.98
BT GROUP - Held by 1/2		**Portfolio % 2.44%**
Invesco Perpetual Fund Mgrs - High Income - Jan 95	5	2.44
RECKITT BENCKISER GROUP PLC - Held by 1/2		**Portfolio % 2.18%**
Invesco Perpetual Fund Mgrs - High Income - Jan 95	7	2.18
ROCHE HLDG AG - Held by 1/2	**Position of Stock in each funds Top Ten Holdings**	**Portfolio % 1.90%**
Invesco Perpetual Fund Mgrs - High Income - Jan 95	9	1.9
WEIR GROUP - Held by 1/2		**Portfolio % 1.90%**
AXA IM UK - Framlington UK Select Opps - Jun 92	1	1.9

Immediately it highlights how the two funds blend well together. There are only three companies (within the top 10) that both funds hold. They are GlaxoSmithkline, Vodafone & BG Group.

The top 10 companies account for only 32% of our total UK equity exposure as opposed to 57.2% by purchasing a FTSE100 tracker (highlighted earlier).

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Of the top 10 FTSE100 companies only 4 have been selected by the managers of Axa Framlington & Invesco Perpetual funds. These are BG Group, Vodafone, GlaxoSmithkline and British American Tobacco. The other 6 companies I highlighted as being within the top 10 companies listed on the FTSE100 are not holdings within these two funds. I find this very interesting as it highlights what I have always thought of as a flawed argument of passive investing. Which is that a Market capitalised index is one where the components are weighted according to their market capitalisation. This means BHP Billiton as the largest constituent carries the highest weighting within the index. The simple rule every investor should follow for profitable trading is “buy low sell high.” By purchasing a market weighted index you are more heavily invested in the one thing almost guaranteed to do the worst. These are the largest companies at a point in time that have the highest share price. Its redeeming feature is it is very cheap to replicate an index around 0.25% amc versus 1.5% amc for an actively managed UK Equity fund.

The figures in the graph refer to past performance, which is not a reliable indicator of future results.

Since we have used the combination of Invesco and AXA funds (since April 2011) our active strategy has out performed a passive strategy by 11.412%, net of charge. This we believe has much to do with the arguments we have discussed above. Allowing a fund manager to take active risks i.e. Overweight, underweight and zero weighted positions can be rewarding.

Another position can be taken, a negative weighting. This is where a company is “shorted” because the manager believces the fortunes of the company are that bad, the share price will fall. This results in a profit for the manager. I don’t like this and we don’t use funds that actively do this. This is not to say that any active manager can outperform a passive strategy. One of the filters that we apply when selecting the funds we use is that the fund needs to outperform the benchmark sector average over 3 years. Amongst other filters this eliminates closet trackers which tends to take only very small bets against the index, but at a higher price, and managers who continually make bad decisions.

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