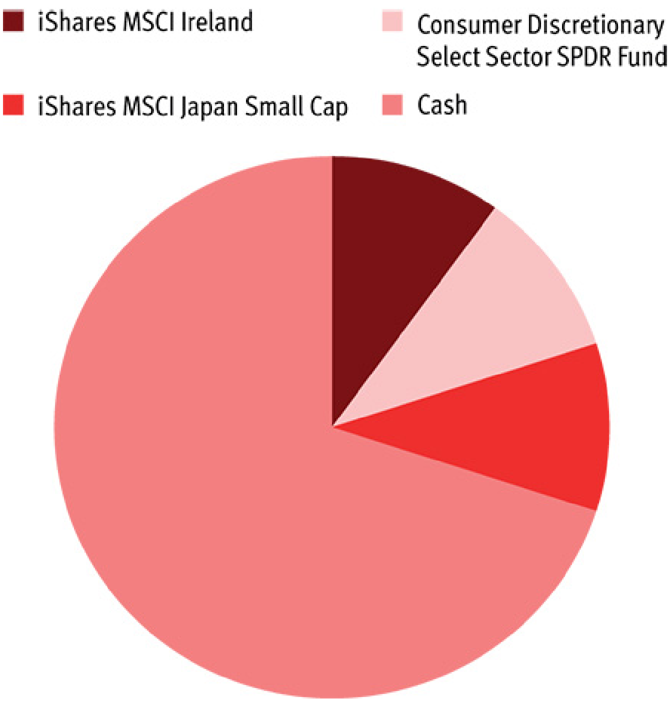
investors CHRONICLE

The ultimate sophistication in investing?

It was Leonardo da Vinci who opined that "simplicity is the ultimate sophistication" and while the -3.47 per cent annual return (to 18 December 2015) for my rules-based global asset allocation system is not the stuff of genius, I am nevertheless pleased to have outperformed most broad equity indices.

The live track record for my US dollar-based proprietary account (trading Tactical Asset Allocation I) begins from August 2015 and is spliced with back-tested performance up until July. As I began trading for real, in the midst of a period of increased volatility in the summer and late autumn, the model largely exited risk markets and, as this pie chart of portfolio holdings shows, the level of cash has remained high ever since.

Portfolio constituents



The system's rules are detailed below, but essentially the idea is to invest in markets that are moving up and to exit markets that are going nowhere or down. In doing so, the goal is to provide an equivalent or superior return to the MSCI World USD Net with lower volatility and suffer less severe peak-to-trough drawdown in bear markets.

I hope to achieve this by investing in risk assets such as stocks and commodities while their momentum (return) is positive and retreating to the reserve asset (cash/bonds) during periods of market crisis. The model rotates into the top 10 performing markets out of a total potential universe of around 60 New York listed exchange-traded funds (ETFs), which includes a few commodity funds such as oil and gold.

For a more detailed explanation of the rules see: http://anthonyfjgarner.net/performance/taa-i/

My overriding investment philosophy

The traditional investment community should make you laugh, or possibly cry. The long-term track records of discretionary fund managers suggest that chance plays a far greater part than skill in investment performance and that the vast majority in the industry are fooling themselves and their clients. In general, investors have paid vastly inflated fees for lousy performance. Give me pure, quantitative, rules-based investing any time.

In terms of a cheaper, 'passive' approach to investing, the rise of index-tracking funds was the first decisive break in the right direction. For example, take the composition of the Russell indices:

■ Rank the US common stocks from largest to smallest market capitalisation at each annual reconstitution period (May 31).

■ Top 3,000 stocks become the Russell 3000 Index.

■ Largest 1,000 stocks become the Russell 1000 Index.

■ Next 2,000 stocks become the Russell 2000 Index.

■ The smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index.

How refreshing. No swaggering nonsense here. No one ripping you off a precious few percentage points annually for attempting the non-achievable feat of providing consistently good returns. What you see is what you get: stocks that prosper will get into the index, stocks that crash and burn will exit. Simple, mechanical trend following.

But it needs to be taken much further. Diversification needs to be international and to cover as many asset classes as possible. Why bet on the dollar and the US to the exclusion of the rest of the world? Or the UK and GBP for that matter. Why just invest in stocks when you have real assets such as commodities, real estate and timber, which may even out the bumps a little with uncorrelated or at least low correlated returns?

Don't bother to forecast. You haven't a hope

Despite many conflicting theories and learned opinions we still have no idea whether we live in a deterministic or random universe. If the former, then like Hari Seldon, the hero of Isaac Asimov's Foundation Series, given enough information and computing power we should eventually be able to accurately predict the fall of every sparrow. If the latter, we are wasting our time with prediction and may as well throw dice.

Some things are much more predictable than others. The trajectory of planets for instance. But when it comes to complex systems such as the weather, human society or financial markets, even if the world is strictly deterministic, prediction in such matters is currently beyond us. Ask yourself, could you have accurately foreseen the hyperinflation experienced in Weimar Germany; the collapse of Barings; the rise of Christianity; or even that Leicester City would top the Premier League at Christmas? If the answer is no, then why is it you imagine you can pick investments any more successfully?

Therefore, instead of trying to forecast financial markets, I believe it is far better to follow a simple set of rules that gets you in and out of a wide range of diversified global investments and over the long term you should do as well as any 'professional'. You will take what the market has to give and will almost certainly be better off than if you had hitched your fate to the latest braggart in the City of London.

Rules for my tactical asset allocation ETF trading system

Momentum ranking

Return (momentum) is calculated as follows: (instrument, close of the day immediately prior to the reallocation day)/(instrument close on the date of the relevant look back period). For each instrument four momentum calculations are made each with a different lookback period: 12-month momentum, six-month, three-month and one-month. The returns thus calculated are averaged, dividing by four. The instruments are then ranked by return from the highest to the lowest.

Each of the four sub-systems choose the top 10 ranking ETFs by past monthly performance and invests in those 10 for the following month. Any existing holdings that have fallen outside the top 10 are sold and any new entrants to the top 10 category are purchased. Existing holdings which remain within the top 10 performers are retained.

Each sub-system reallocates on a different equally spaced day of the month. So there are four reallocation days a month - one for each subsystem. Periodic reallocations occur on a rolling basis and not on fixed calendar dates.

Money management

At heart, the basis of the money management strategy is equal weighting at the time the position is taken. This will change with time as the value of the position increases and decreases. At each reallocation date winners are rebalanced but losers are not rebalanced - in other words, winning positions are cut back to equal weighting while losing positions (if they have remained in the top 10 rank) are not increased to equal weighting. No rebalancing is undertaken unless an instrument is overweight by more than 5 per cent so as to avoid undue turnover.

Profit taking

A profit-taking mechanism is employed to reduce volatility and drawdown. On position entry I calculate a 10 average true range (ATR) profit target.

I calculate the ATR over a 20-day period. I multiply the ATR by 10 and add it to the initial entry price: this is the first 'target'. When (if) reached, I sell 75 per cent of the holding in that instrument and recalculate the profit target using the then latest closing price. I repeat until an exit signal is given by the normal 'top 10' exit rule.

True range for an instrument = (the maximum of the current high and the previous close) - (the minimum of the current low and the previous close). ATR = the average true range over the look-back period (20 days in this case).

Profit-taking trades are permitted on any business day and are restricted to reallocation days.

Trade filters

• Reject any trade where the momentum is negative.

• Reject any trade where efficiency is below the 'efficiency limit'.

In other words, even if an ETF is ranked in the top 10, don't invest if its momentum is negative (ie, it has lost value during the measurement period) or if the stocks behaviour has been 'inefficient'.

Negative momentum/returns is obvious. 'Efficiency' takes a bit more explaining. The 'efficiency ratio' is described by Perry Kaufman on page 134 of his book *Smarter Trading*. Mr Kaufman's efficiency ratio has values ranging from 0 when markets are very noisy and a theoretical +1 when markets are perfectly directional. I will return to the actual calculation of the efficiency ratio in a further article, but it is not an essential part of the program - it could be dispensed with without too much damage.

Reserve asset

The combined effects of profit taking and filters is such that there is usually an element of the portfolio invested in the reserve asset which is cash/bonds. Given low interest rates I am currently using cash only as my reserve asset. During periods of market crisis the allocation to the reserve asset can be expected to climb to 100 per cent. By contrast, during bull markets the allocation to risk assets (stocks and commodities) can be expected to approach 100 per cent.

visible-status-Subscription-Only story-url-Feat2_SophisticationInvesting_220116.xml

More from Investors Chronicle

Bear market signals 25 Jan

News & Tips: Royal Dutch Shell, JD Wetherspoon, WH Smith & more 20 Jan

Tips of the Year 2016 7 Jan

Spotting sell signals 22 Jan

Cash rich, but unloved 12 Jan