Aftershock – Out with the Old, in with the New

Jeremy Smeeton of Global Asset Allocation Looks to Computer Power to Tame the Markets

The financial world shifted on its axis a year ago and we are still feeling the pain.

It is no exaggeration to say that for a few days last September capitalism was teetering on the brink. In America – Lehman Brothers, gone; Bear Stearns swallowed by JP Morgan in a fire sale; and AIG, the world's largest insurer, rescued by the Federal Reserve, moments from collapse.

And in the UK – Northern Rock, Bradford & Bingley, Lloyds TSB and Royal Bank of Scotland all forced to go cap in hand to the taxpayer. A whole country, Iceland, was bankrupted. It wasn't a time for faint-hearts.

And it wasn't just the banks that got hit. Car makers, steel manufacturers, tourism - they all continue to suffer. Almost overnight the world had become a different place and business was going to have to respond.

Here at GAA we had already developed a new model that in some respects defied conventional wisdom. To do that called for innovative thinking – I set my executives and myself a task. What would Bill Gates or Henry Ford have done? The result was the GAA 'Q' Fund, but more of that later.

The Sage of Omaha

Last month I wrote an obituary for Warren Buffett. Don't worry – 'The Sage of Omaha' is still with us. The eulogy was for the investment style made popular by the world's most successful investor over the last 50 years.

In 2008 Buffett's investment vehicle, Berkshire Hathaway, lost almost one-third of its value. Disturbingly, Mr Buffett's folksy down-to-earth aphorisms seemed out of touch with the demands of modern investment markets.

Buffett is famous for the 'Efficient Market Hypothesis' (EMH) – considered investment gospel until recently. Developed in the early 1960s by Professor Eugene Fama, the EMH maintains the stock market can't be beaten on a consistent basis (except by luck) because all available information is already built into stock prices – in other words stock markets are rational.

Irrational Markets

The theory assumes that news is disseminated rapidly and simultaneously and that mass psychology plays no role in financial markets. But as we've learnt, markets are far from perfectly efficient, can be thoroughly irrational and can diverge from economic reality for long stretches.

Paul McCulley managing director of Pacific Investment Management has this to say, 'Markets are efficient and rational most of the time – except when they're not. And when they're not, they behave the way human beings behave, they become bored or greedy. Clearly, the prices on the market are more volatile, less reliable and less rational than is envisioned in any of the rational market theories.'

Hedge funds

Recognising the problem is one thing – solving it is quite another. The period following the Great Depression of the 30s was a fruitful time for active stock pickers in particular Alfred Winslow Jones, recognised as the originator of the modern hedge fund.

Jones' believed some stocks do better than others each month in both rising and falling markets but these are not necessarily the same stocks month-in and month-out. Jones understood this and quietly brought about a revolution in investment methodology. But that was then – what about now?

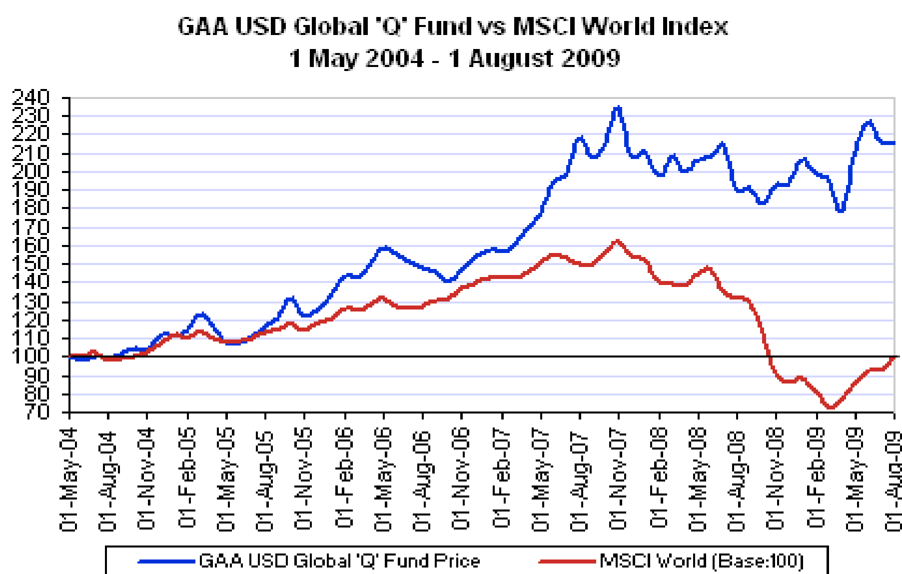
The GAA 'Q' Fund

Five years ago we developed our GAA 'Q' Fund, which has consistently produced positive returns in all market conditions, while at the same time reducing exposure to downward movements in the market.

The fund has achieved this by actively managing risk using dynamic Quant methodology that subjects stock to the most stringent mathematical selection criteria.

Every month it analyses all data available from more than 38,000 stocks typically capitalised at more than US$100 million and preferably at more than US$1 billion across 52 global stock markets. It then selects between 90 and 120 stocks.

The bottom line is that by harnessing the immense data analysis capabilities of modern computers it's possible to identify market anomalies within individual stocks. By holding the most attractive stocks for just 30 days, before analysing everything again, this technology is able to achieve stunning results:



$100,000 invested in GAA 'Q' at launch would be worth $210,370 today. The same amount invested in the MSCI World Index would be worth only $85,730. Markets may not be efficient but a fund that has achieved the following results provides the way to exploit this:

- Annual return for 2007: +33.22% ('Q') vs +7.09% (MSCI)
- Annual return for 2008: -1.94% ('Q') vs -42.08% (MSCI)
- Annualised return since launch: +16.04% ('Q') vs -3.03% (MSCI)

We still retain a modest exposure to Berkshire Hathaway and remain eternally grateful to Warren Buffett for the returns that he generated for our clients.

But in today's world, relying on the efficiency of markets rather than the power of information technology is like trying to win The Tour de France on a penny-farthing.