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Seek out sectors - not star managers

By Stephen Charles

WIDESPREAD speculation about the splitting and future management of the Fidelity Special Situations fund makes this a good time to ask whether investors are best served by relying on a single fund manager and style, or by placing more dependence on selecting sectors.

While there are effectively four main asset classes to invest in - equities, property, bonds and cash – there are many subsectors within these asset classes. Indeed, the Investment Management Association (IMA) lists 28 separate sectors, within which there are more than 2,000 unit trusts and open-ended investment companies (Oeics) available for investment.

But research has shown that more than 90pc of the difference between investment portfolios' returns is determined by asset allocation - the proportion held in shares, property, bonds and cash – of these investment portfolios. Individual stock selection was relatively insignificant.

Fund managers are dictated to by their funds' mandate; they must invest accordingly. Thus, in a falling market of whichever sector the fund is mandated to invest in, the manager has little choice but to remain invested. Compare this to when, say, commodities are roaring ahead; even a child picking commodity shares with a pin could provide a better return.

To illustrate the value of sector selection compared to management expertise, we analysed Standard & Poor's Micropal Unit Trust/Oeics sectors over 25 years and also looked at top funds and laggards over the same period.

'Sector selection is of far greater importance than individual stock picking skills'

As we were going to compare best sectors against worst, we thought it only fair to even the score by allocating the best fund managers to the worst sectors and vice versa for the best sectors. The worst managers in the best sectors hugely outshone the best managers in the worst sectors. The margin was so great that it provided undeniable proof that sector selection is of far greater importance than individual fund management or stock picking skills.

Our research has shown that an investment of £1,000 with the worst performing fund managers in the bestp performing sectors eachs year would have growni to £290,951 over 25 years to January 2005. Conversely, the best fund managers in the worst sectors provided a derisory £385 - a loss of more than 61pc. Clearly management skill was overwhelmed by being in the wrong sectors. Even the average of all sectors provided a respectable £20,948.

As it is impossible to correctly identify the best single sector in advance, it is prudent to invest in a balanced portfolio, taking account of personal circumstances, risk profile and the economic outlook for various sectors.

Investors lacking the patience or time to study sectors should note that an investment into all IMA unit trust and Oeic sectors would have provided a 13pc average annual compound return over the period reviewed. "Going with the flow" with a section of a portfolio makes sense, as following the trend may often be profitable. However, sectors that are suffering may be over-sold, and patience could be rewarded with spectacular returns. Depending too highly on successful sectors may prove costly, as dotcom investors discovered. To illustrate this we looked at recent market history. The IMA collects data relating to sales of unit trusts and Oeics, and we compared the data for the most popular and least popular two sectors in terms of sales during the month of December for each of the six years from 1998 to 2003. We then followed the performance of these sectors over each of the following years. Over the six years to January 2005, the most popular sectors of the previous December would have produced a 16pc profit, while the least popular would have provided a 77pc profit. This period covered a miserable bear market in equities, further flattering the return of the least popular sectors. It is hoped that this research strikes a chord, and heightens awareness of the importance that careful sector balancing has in the role of successful portfolio design.

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Investment column

By Tom Stevenson
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Successful investment is about picking the best shares, right? That's why star fund managers like Anthony Bolton are in such demand. And why we're suckers for investment magazines and tipsheets. **Everyone wants a shortcut to that Midas touch.**

But what if conventional wisdom is wrong and it's nothing to do with all that? What if making money in the stock market is really about getting a handful of big thematic calls right and not, as they say over the pond, sweating the small stuff. In other words, what if it's about asset allocation and not stock picking at all?

You wouldn't expect an active fund manager or penny share tipster to tell you that for the same reason that you don't ask a barber if you need a haircut. There's a body of evidence, however, that we worry too much about individual companies and spend too little time thinking about the big picture. That is certainly the logical response to a table I saw this week detailing the performance records over the past year of the stock market's 44 main sectors.
They ranged from the spectacular - mining, which has risen 39.6pc over the past 12 months - to the dismal - household goods & textiles fell 21.7pc as the consumer battened down the hatches.

In between were pharmaceuticals, up 26.2pc, oil and gas, 19.1pc better, and banks, just 1.9pc up on a year ago. General retailers - no surprise here - are on average 8.9pc down, a serious underperformance during a period when the FTSE 100 index has risen 14.4pc.

Plainly if you'd had the foresight to invest in a spread of mining stocks last October you would have enjoyed a cracking year. Aerospace, automotive, tobacco and electricity would have done you almost as well - all four sectors have risen by more than 30pc.

You would be less happy if you had bought and held a portfolio of media, banking, forestry or steel stocks. Along with retail and household goods, these sectors produced returns of less than 5pc. Four of the six went backwards despite the bull market's third year on the up.

Nor is the importance of sector this year a one-off. A study of unit trusts over the past 25 years by financial adviser Stephen Charles, of AC Financial, shows that the worst managers in the best sectors have easily outshone the best managers in the worst sectors. Not even the best investors can buck a poor trend. Charles reckons a £1,000 investment rolled over into the best performing sector in each of the past 25 years would be worth £290,000 today while the same £1,000 in each year's worst performer would have shrunk to just £385.

Just as interesting as the overall performance of sectors is the consistency of performance within each grouping. Take the miners, for example. If you had limited your investment to the eight mining shares in the FTSE 100 and FTSE 250 indices, you would have beaten the market whichever stock you had invested in.

Vedanta Resources, which you could have bought for 270p a year ago, has been as high as 623p this year and even after the sector's recent retrenchment has doubled. Even the laggard of the sector, Lonmin, has risen by 36pc since the beginning of the year.

At the other end of the scale, it would have been almost impossible to buck the downward trend in retail. Out of the 22 FTSE 350 companies in this sector, only four have beaten the market - M&S, Carphone Warehouse, N Brown and Body Shop. Half of them have underperformed the market by 25pc or more, headed by Kingfisher, Woolies and Matalan, all of which have fared at least 35pc worse than the average.

There's a clear implication. Rather than an individual company's prospects, or the quality of its management or the many other things investors get exercised about, the only thing that arguably matters is which sector's going to be in this year and which out.

A study by Investors Chronicle, reproduced in the 2006 edition of Harriman House's excellent UK Stockmarket Almanac, makes a related point. The IC tested the sensitivity of various sectors to different economic variables. It showed, for example, that construction stocks do relatively badly when the market rises but tend to outperform when retail sales are improving. A bit technical maybe, but it shows that a handful of economic pointers like interest rates and house prices probably account for most of the movement, up or down, in individual stocks. If so, you are arguably better off watching those key stats and leaving others to sweat over a company's balance sheet. Yes and no.

Although picking the right sector is a key first step, the difference between returns within sectors can be breathtaking. AC Financial's research also showed that a £3,500 investment at the beginning of the 25-year period in the worst managed fund in the best sector each year would have grown to £1m, while the average fund in the best sector would have returned just £26m. Maybe we shouldn't write off active fund managers just yet.

The other problem with the "it's the sector, stupid" argument is the fact that you have to spot next year's mining sector without the benefit of hindsight. It would be nice to think that this year's laggards are invariably next year's shooting stars. But you only have to look at technology stocks during the 2000-03 bust to realise the danger of such a simplistically contrarian approach. In 2000, IT hardware, software and telecoms were three of the four worst performing sectors. In 2001 they were the worst three without exception and 2002 was another disaster too.

Rather depressingly, the best way to pick next year's winners seems to be to look at where retail investors are putting their money and to do the opposite. Over the six years to January 2005, the most popular unit trust sectors in the previous December returned a 16pc profit while the least popular provided a 77pc return. Oh dear.

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