

Regulatory information

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Investments in emerging markets are by their nature higher risk and potentially more volatile, than those inherent in established markets.

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Charles Morris

May 2010

Trend Following – Not always what it seems



Agenda

1. Relative Strength
2. Applied technical analysis
3. Gold

Relative Strength

What is Relative Strength?

- Stocks that have already out-performed...continue to out-perform
- Widely reviled by theorists despite strong evidence of the “momentum effect”
- Numerous studies have proven it’s existence.....BUT
- Even more investors have been buried by it

Strengths and Weaknesses

- Why does it work?
 - It steers towards success and away from failure
 - The big trends go on for much longer than expected
 - The winners must pass “go”
- What are the pitfalls?
 - It is a highly cyclical strategy
 - High beta and therefore volatile
 - The strategy cannot cope with the investors' confidence cycle

The Best Strategies in the USA 1954 to 1996

Strategy	\$10,000 becomes	Compound return	Standard deviation	Sharpe ratio
PSR <1, high rel. str., All Stocks	\$12,999,698	18.62%	25.64%	61
Earnings yield >5, high rel. str., All Stocks	\$12,570,451	18.52%	24.48%	61
Cornerstone growth, All Stocks	\$12,552,352	18.52%	25.41%	61
Pbook <1, high rel. str., All Stocks	\$10,258,105	17.95%	23.36%	60
United cornerstone strategies	\$7,583,097	17.10%	19.50%	66
ROE >15, high rel. str., All Stocks	\$7,582,171	17.10%	26.59%	54
EPS higher than last year, best rel. str., All Stocks	\$6,890,629	16.84%	28.19%	52
5-yr EPS ch >mean, Pmargin >mean, EPS higher than last year, best rel. str., All Stocks	\$6,019,821	16.46%	22.23%	57
Yield >mean, positive rel. str., lowest PSR, All Stocks	\$5,753,941	16.34%	21.98%	52
1-yr EPS ch >25%, high rel. str., All Stocks	\$5,578,081	16.25%	28.56%	49
Pbook <1.5, yield >mean, PE <mean, lowest Pcf, All Stocks	\$4,624,623	15.73%	22.85%	52
Low PSR, All Stocks	\$4,311,223	15.54%	25.66%	49
\$25M <capitalization <\$100M	\$4,176,424	15.45%	30.44%	44
Market Leaders, low Pcf	\$4,078,918	15.39%	19.00%	57
Cornerstone value	\$3,625,789	15.06%	16.47%	62
PE <20, high rel. str., Large Stocks	\$3,581,736	15.03%	19.05%	54

James P O'Shaughnessy – "What Works on Wall Street"

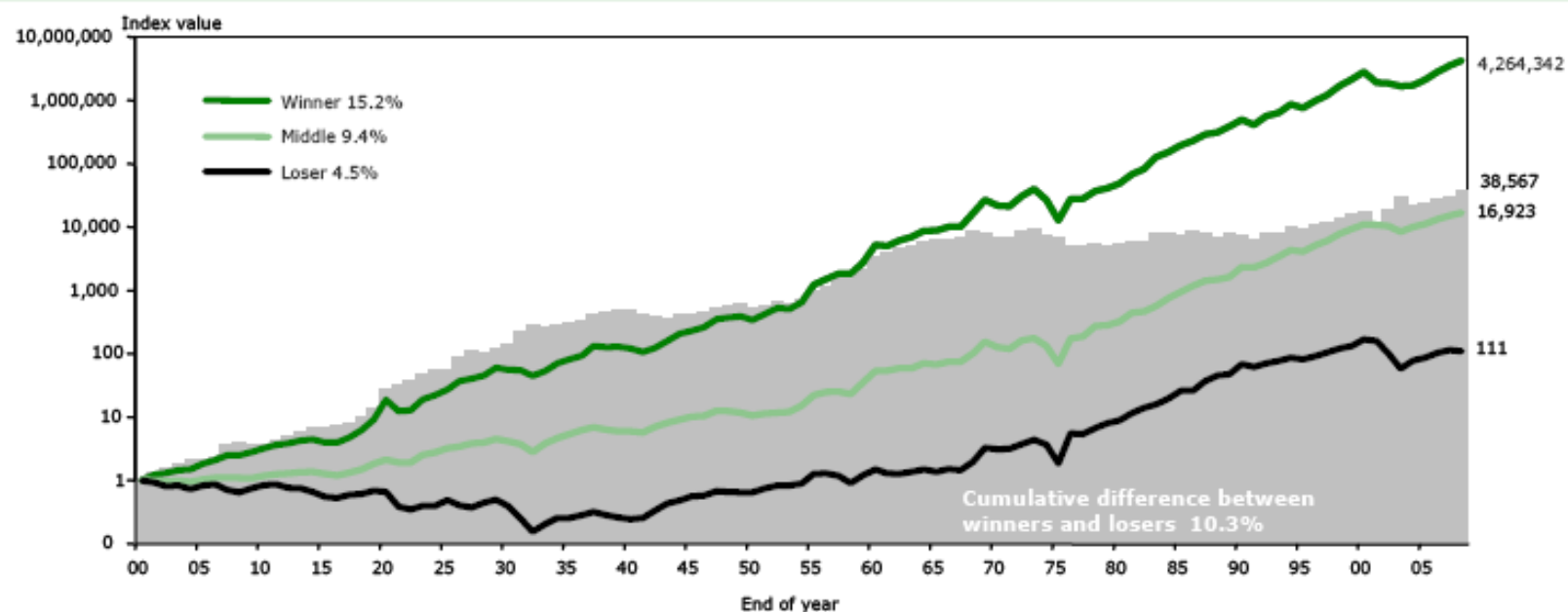
The Worst Strategies in the USA 1954 to 1996

High Pmargin, Large Stocks	\$716,131	10.90%	15.81%	36
High Pmargin, All Stocks	\$691,852	10.61%	20.76%	31
High ROE, Large Stocks	\$662,357	10.50%	18.86%	33
High 5-yr EPS gain, Large Stocks	\$613,441	10.30%	21.59%	28
Market Leaders, high PE	\$599,558	10.24%	16.69%	34
High Pbook, Large Stocks	\$583,955	10.17%	23.06%	27
High 5-yr EPS gain, All Stocks	\$534,963	9.94%	26.57%	27
High Pcfl, Large Stocks	\$488,983	9.70%	22.01%	28
High PSR, Large Stocks	\$454,873	9.51%	20.99%	25
High PE, Large Stocks	\$429,753	9.37%	20.38%	26
High 1-yr EPS gain, Large Stocks	\$400,758	9.19%	18.83%	25
High PE, All Stocks	\$368,197	8.97%	26.75%	23
Low 1-yr rel. str., Large Stocks	\$367,778	8.96%	19.98%	25
High Pbook, All Stocks	\$236,711	7.83%	28.79%	20
High Pcfl, All Stocks	\$224,741	7.69%	27.98%	17
Intermediate-term bonds	\$152,806	6.71%	6.70%	17
90-day T-bills	\$99,854	5.63%	2.71%	0
High PSR, All Stocks	\$64,220	4.53%	27.79%	5
Low 1-yr rel. str., All Stocks	\$29,666	2.62%	26.33%	-1

James P O'Shaughnessy – "What Works on Wall Street"

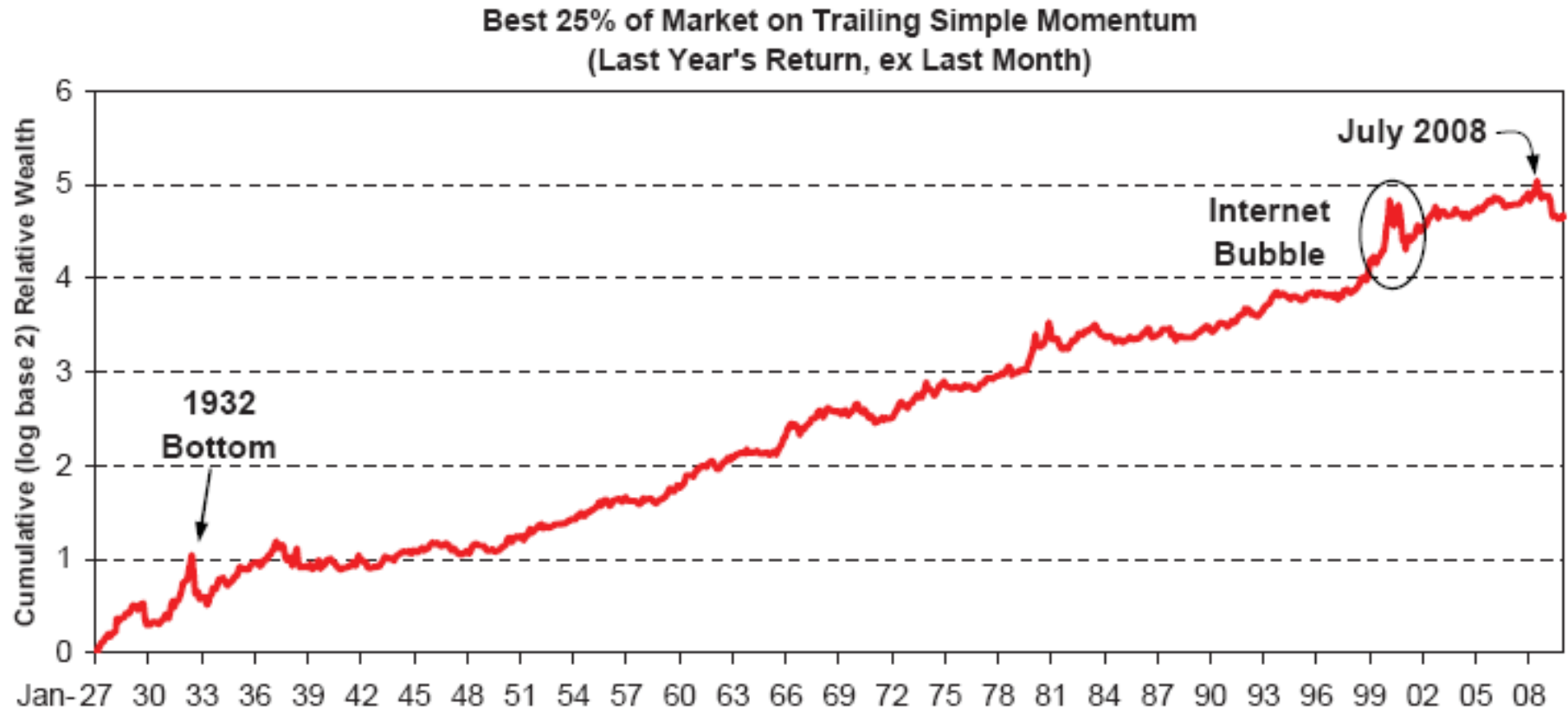
LBS - UK Relative Strength– 1900 to 2007

Figure 9: Annual value-weighted momentum portfolio returns for the Top 100 UK equities 1900-2007



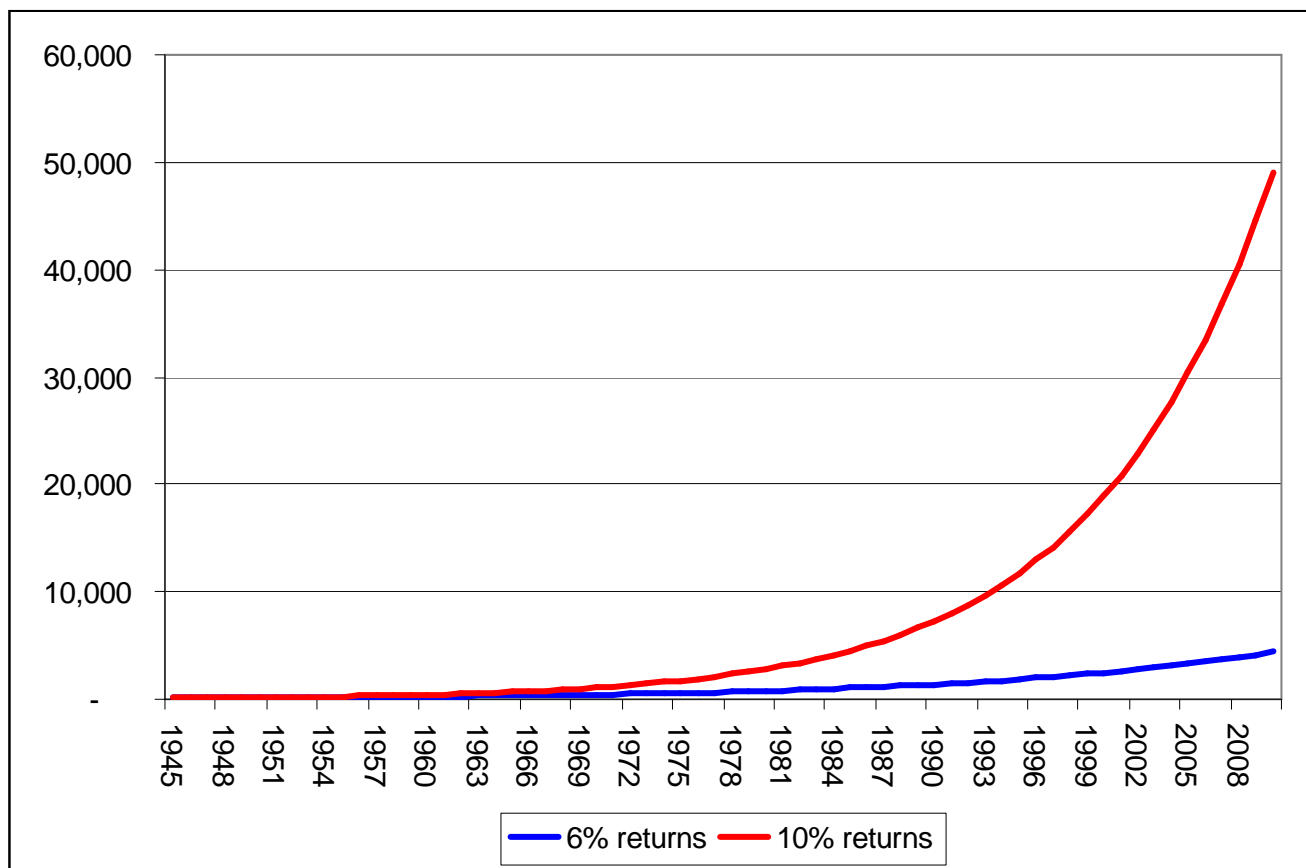
This chart shows value-weighted returns for winner and loser portfolios among the Top 100 equities, defined with breakpoints at the 20th and 80th percentiles. The shaded area is the cumulative difference between winners and losers, and measures the value of a long-short WML portfolio. The momentum process followed here is a 12/1/1 strategy. Source: ABN AMRO/LBS Global Investment Returns Yearbook 2008, chart 26

GMO Performance of best quartile since – 4% excess returns



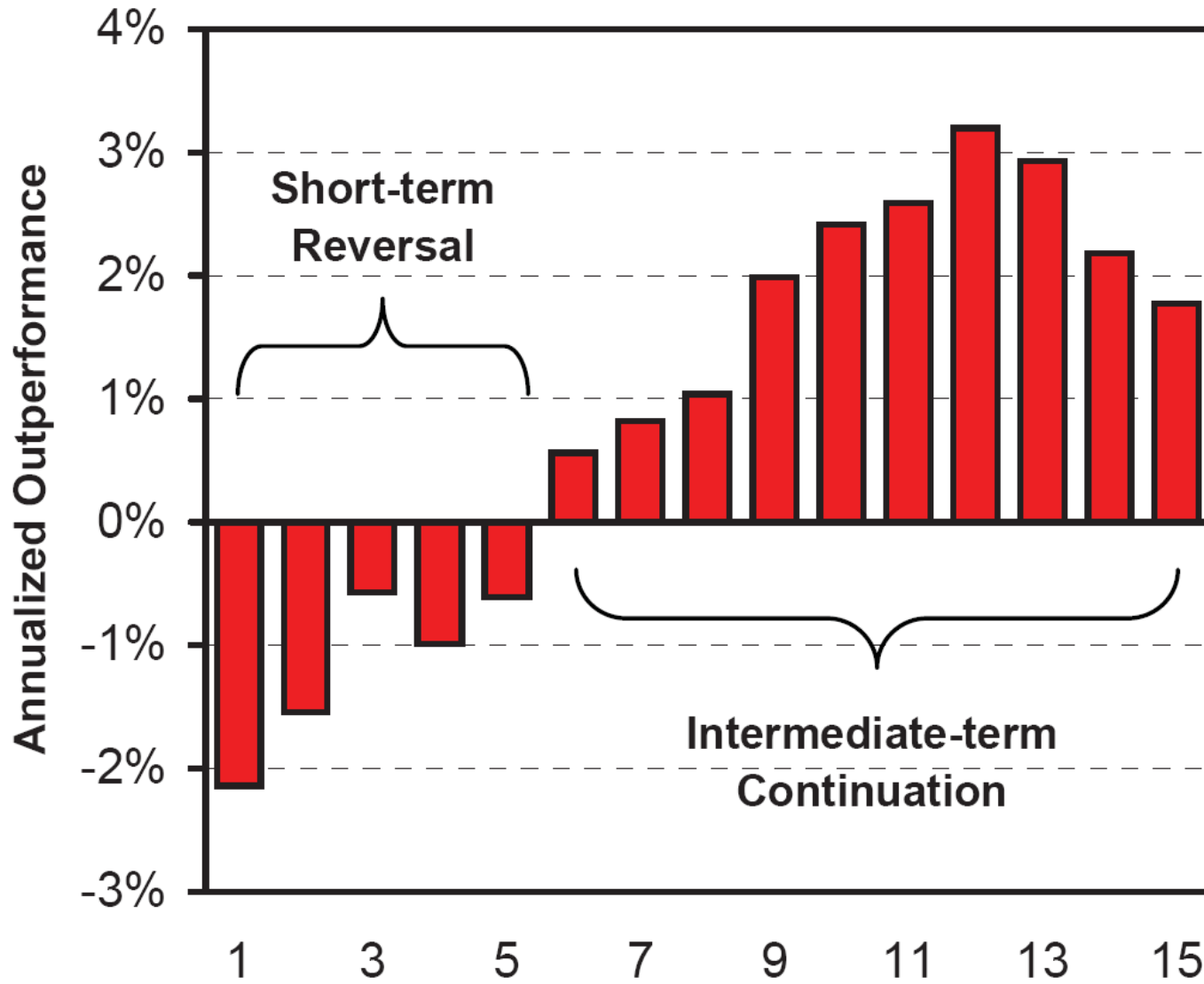
Source GMO

Compound Interest – 6% versus 10% - post war years



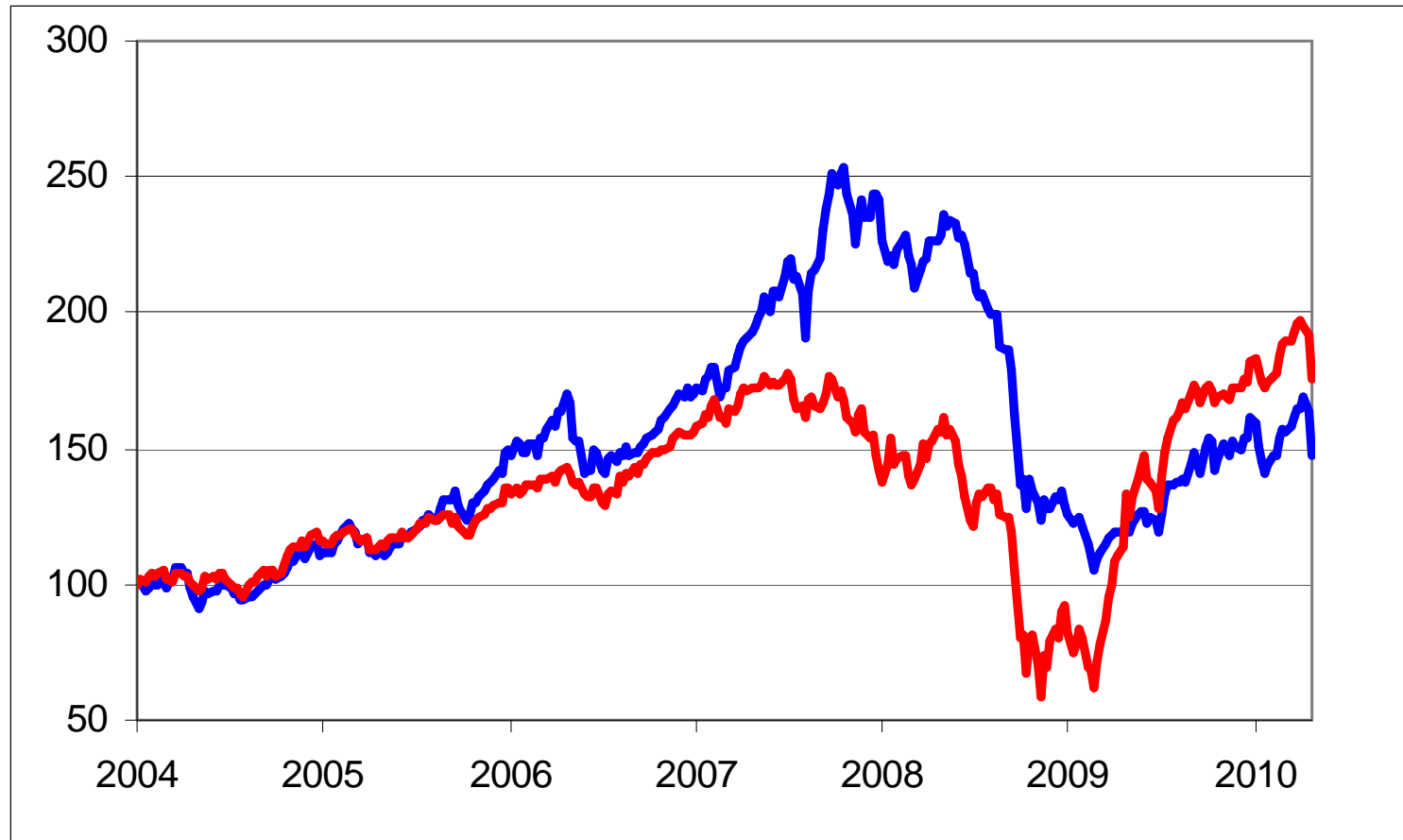
Source HSBC Global Asset Management

GMO Momentum Study – Momentum time horizon



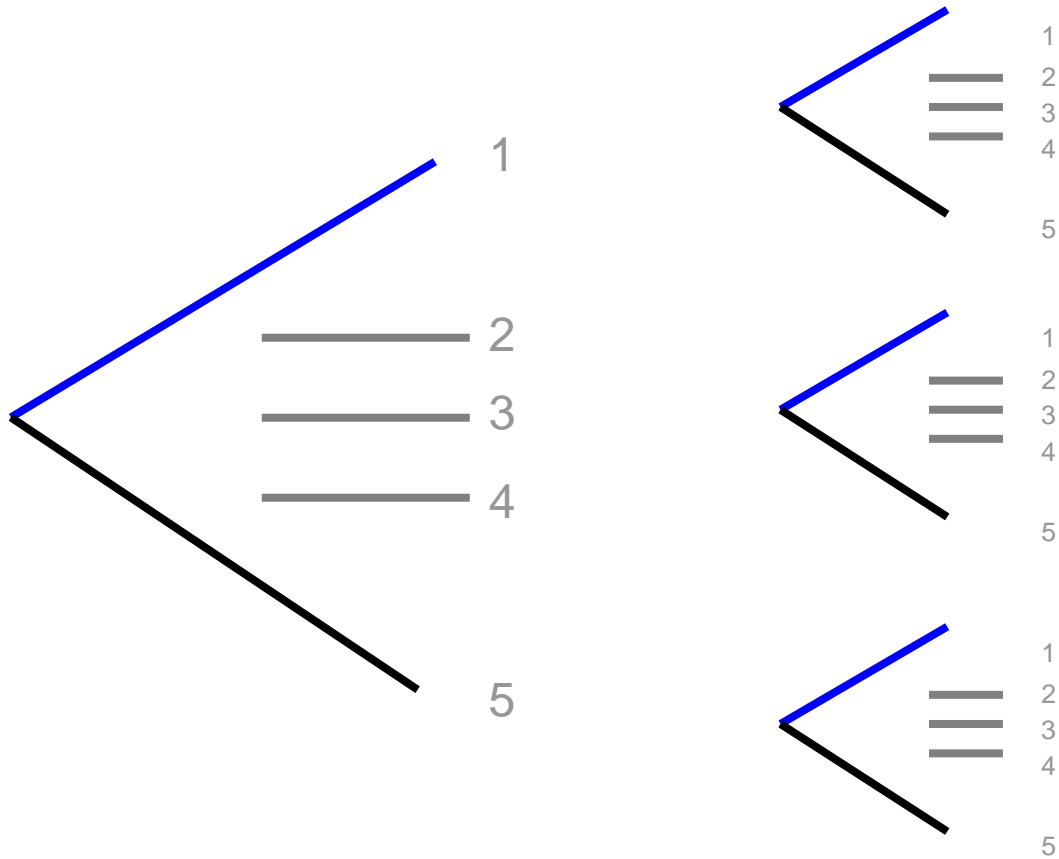
Source GMO

Global Equities Quintiles - Winners Versus Losers – 40 weeks



Source HSBC Global Asset Management

Ranking by Quintile over two time horizons

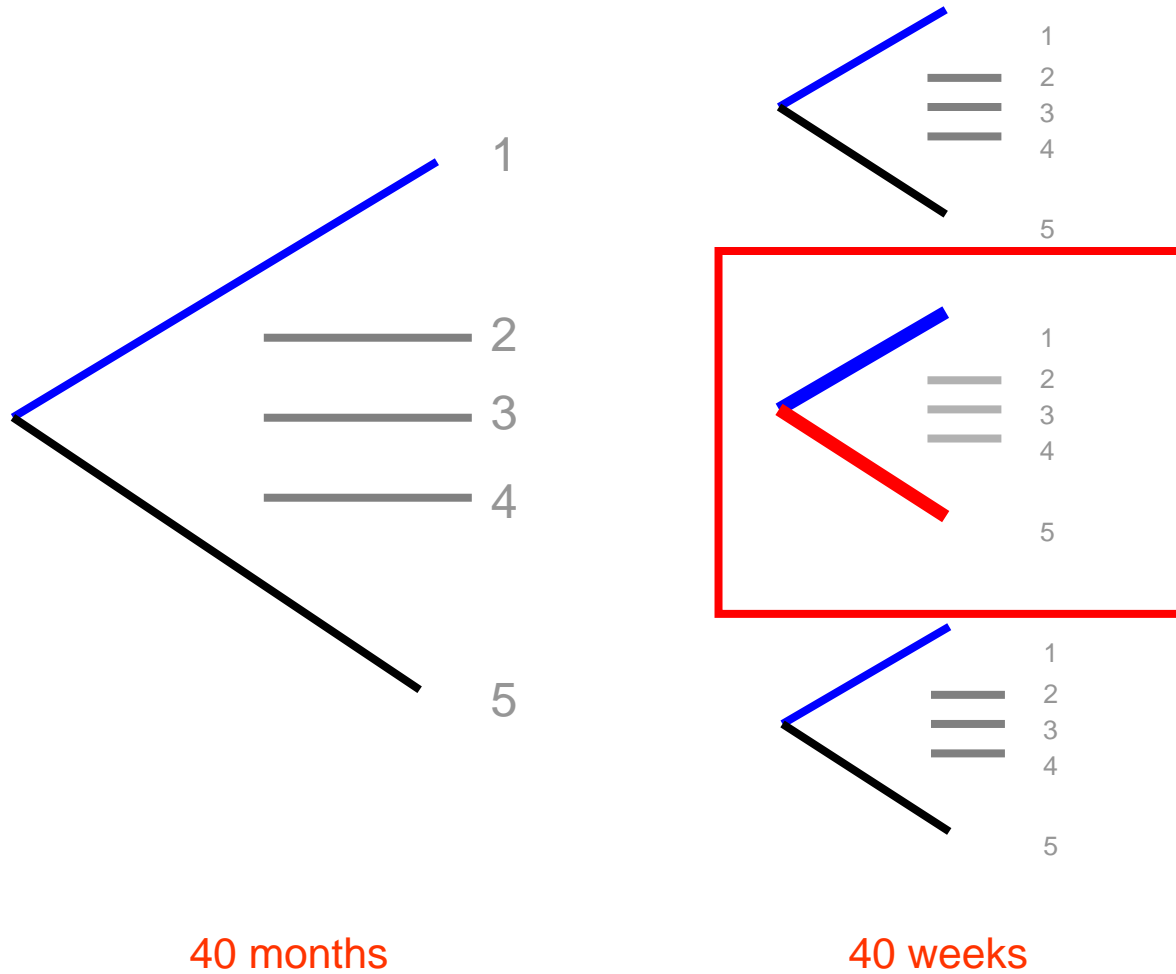


40 months

40 weeks

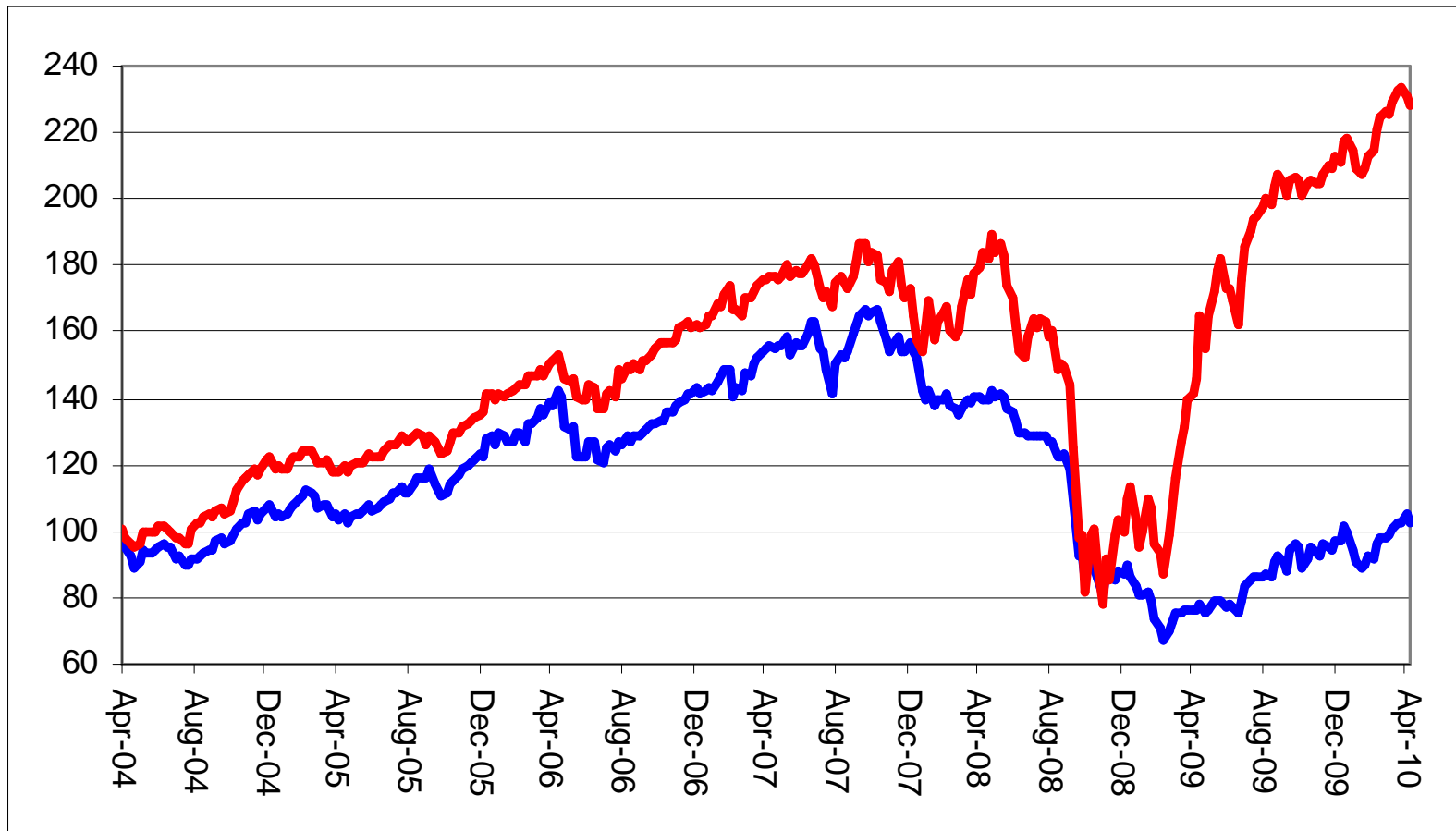
Source HSBC Global Asset Management

Ranking by Quintile over two time horizons



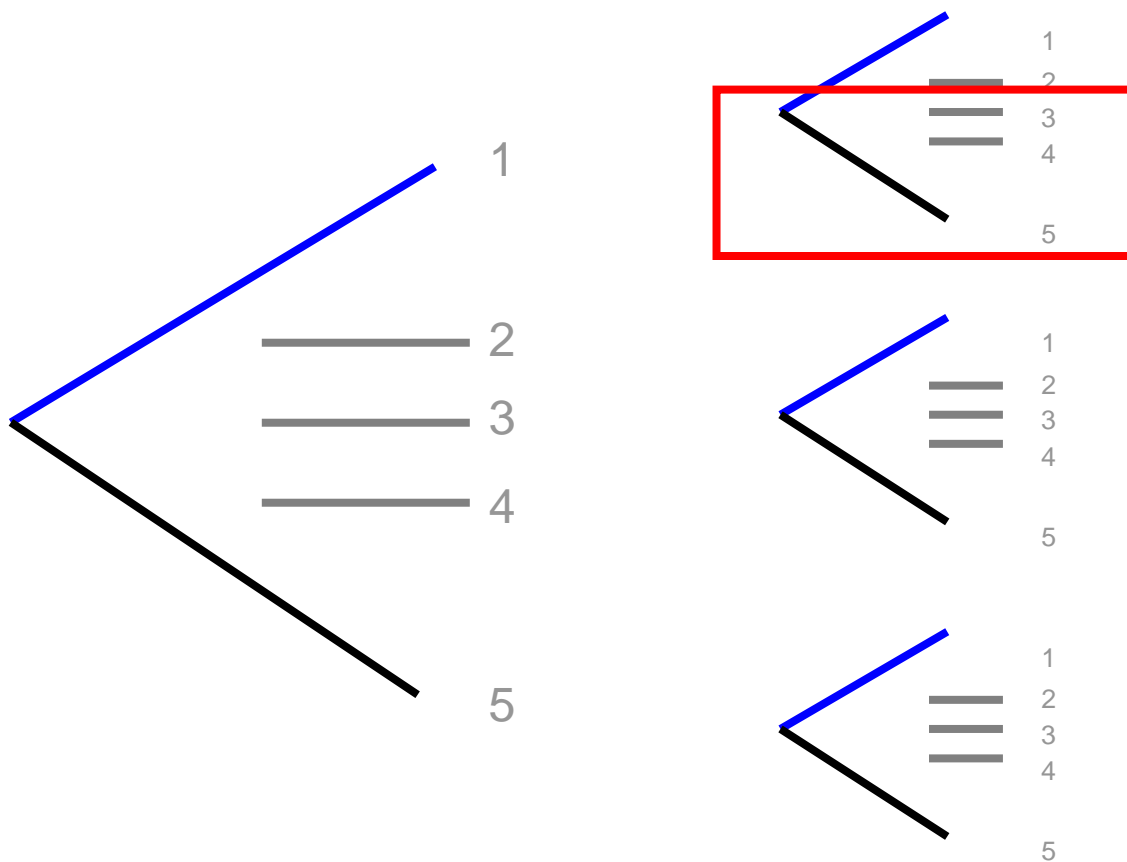
Source HSBC Global Asset Management

Global Equities Quintiles - 40 month neutral – best and worst



Source HSBC Global Asset Management

Ranking by Quintile over two time horizons

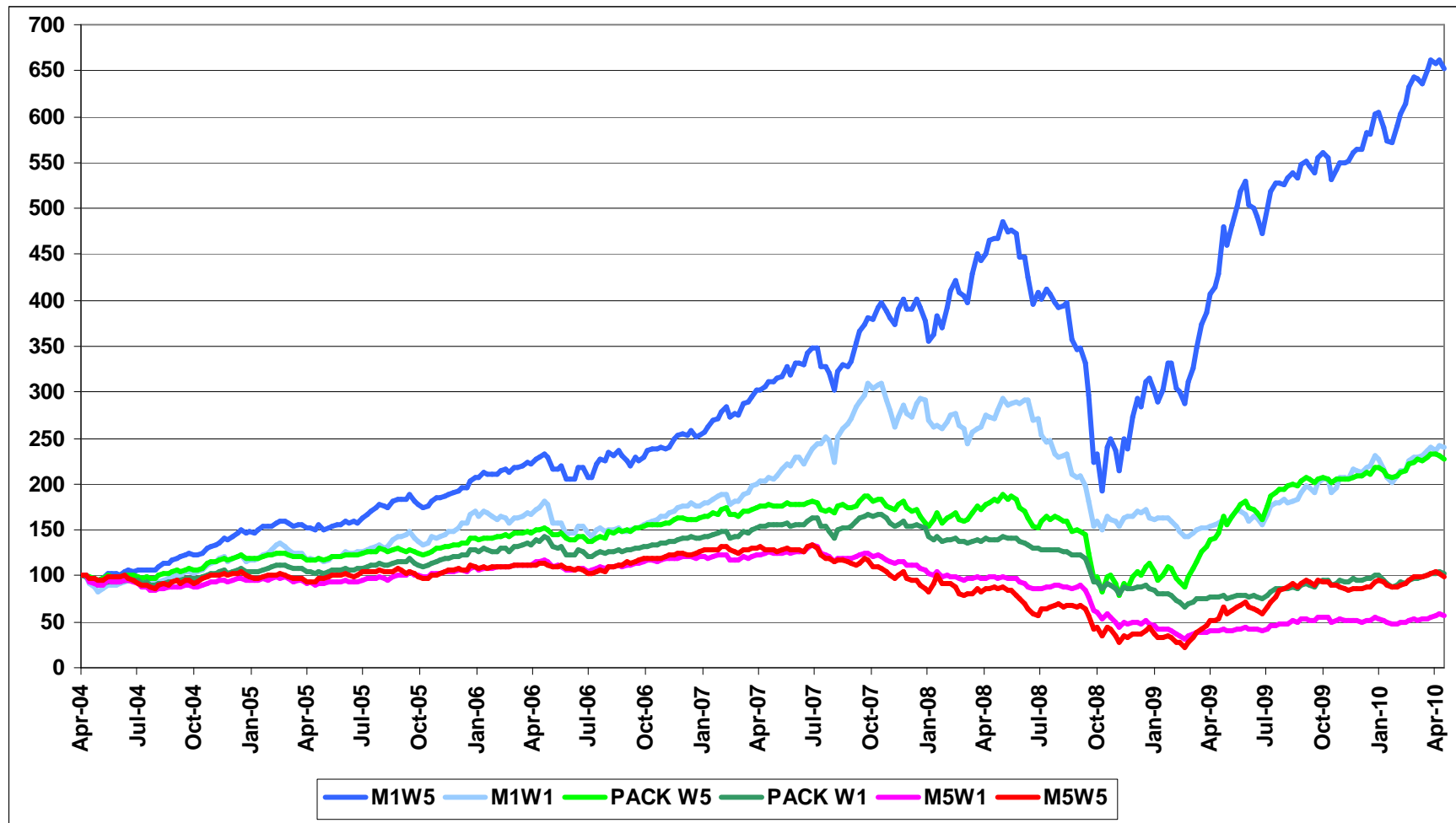


40 months

40 weeks

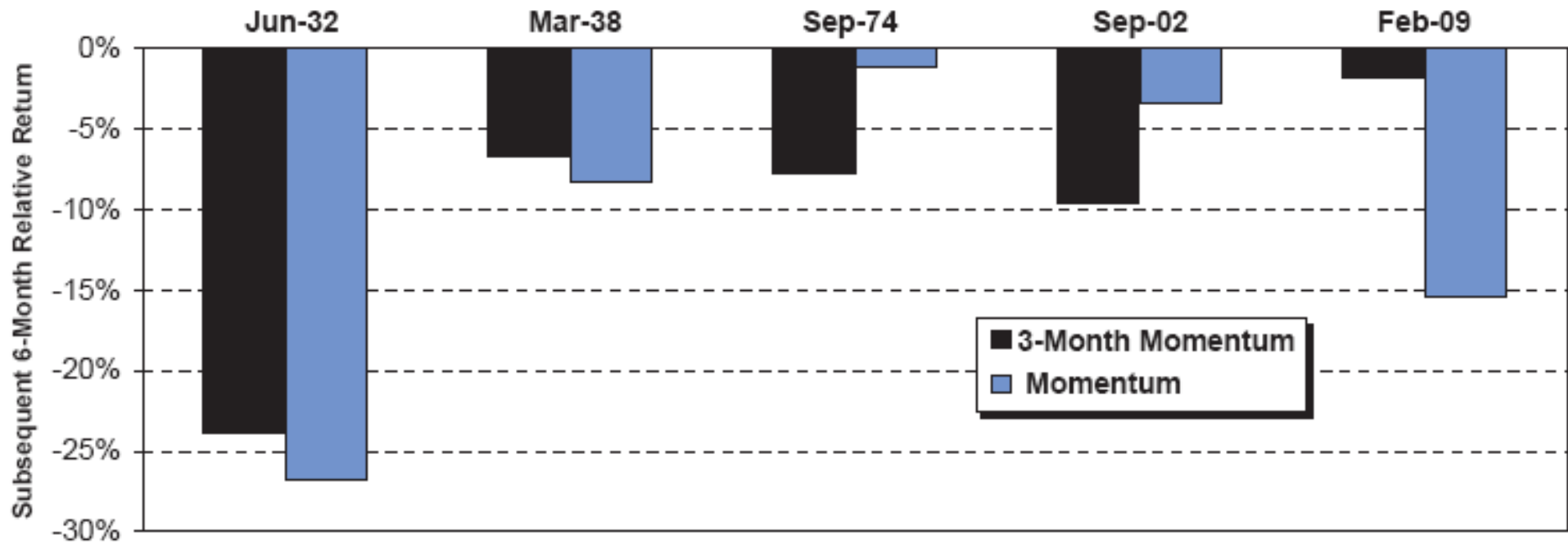
Source HSBC Global Asset Management

All Groups – What works?



Source HSBC Global Asset Management

GMO – Relative Strength at Turning Points



Source GMO

Thoughts on Relative Strength

- The momentum effect is highly effective but unreliable
- Difficult to time
- Risk from crowded trades – trend following is highly susceptible
- Recent reversal is the worst for momentum since the great depression

Designing your Trend Fund

- Capital preservation- stops, sizing, allocation, VaR
- Timing – how can timing and “alpha” be combined effectively?
- Hedging – can you find shorts that correlate with the longs?



Applied Technical Analysis

Diworsification



- We live in a highly correlated world
- Traditional techniques fail when it matters most – ie asset class
- New thinking required about diversification
- How effective is technical analysis?

The Five Styles



- Growth *Leading assets at moderate prices, high beta*
- Quality and Value *Steady assets at fair prices, low beta*
- Long Term Opportunities *Realisable value over time*
- Liquid Uncorrelated *Trading strategies with macro economic drivers*
- Global Government *Government bonds and FX for real returns*

The Five Styles – the role of technical analysis



	Technical	Valuation	Qualitative
Growth	70	15	15
Quality and Value	20	40	40
Long Term Opportunities			
Unlisted	0	50	50
Distressed	0	50	50
Liquid Uncorrelated			
CTA	100	0	0
Global Macro	50	50	0
Global Government			
Bonds	40	40	20
FX	40	40	20



Gold

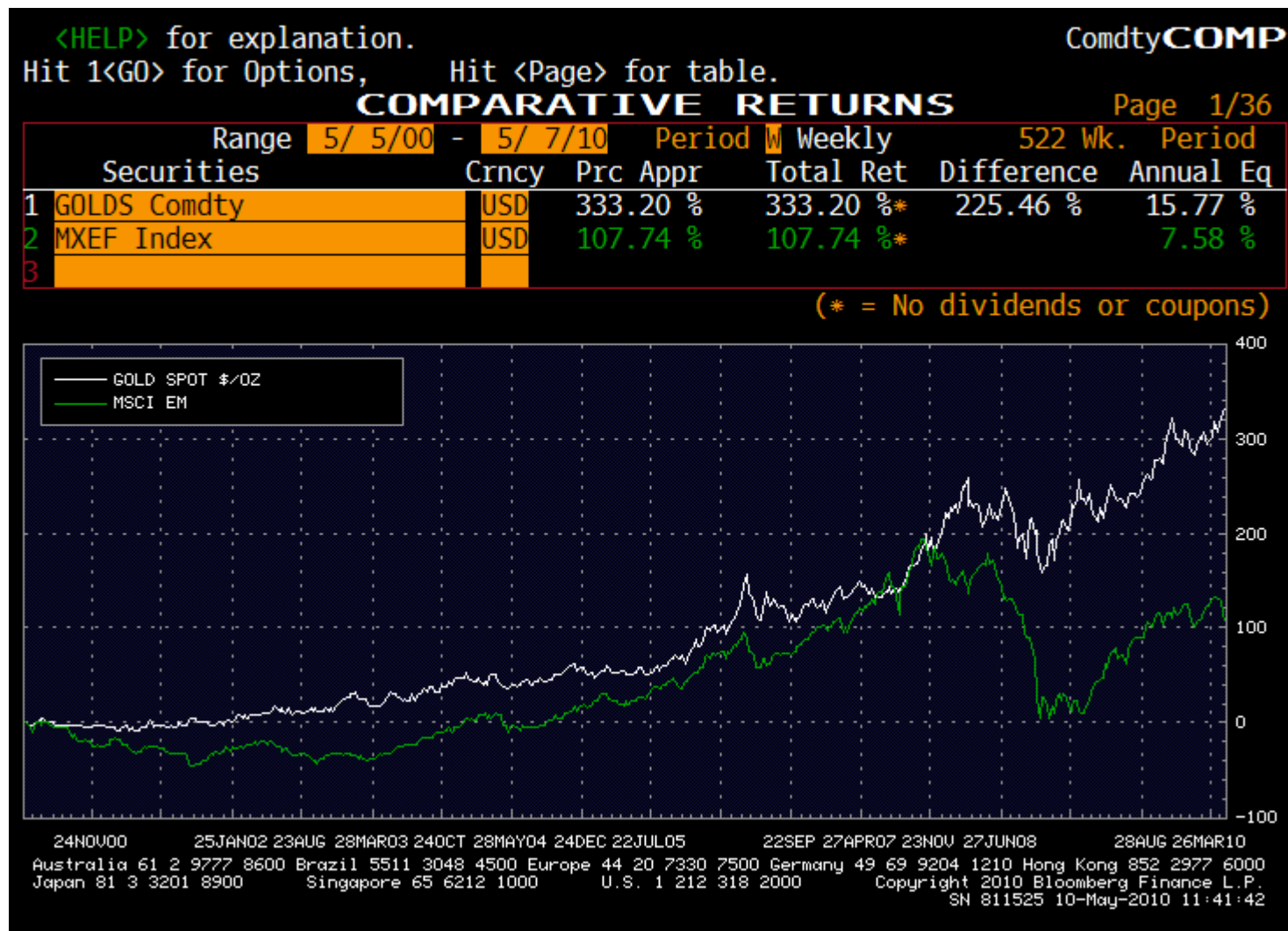
Gold in non – Dollar terms



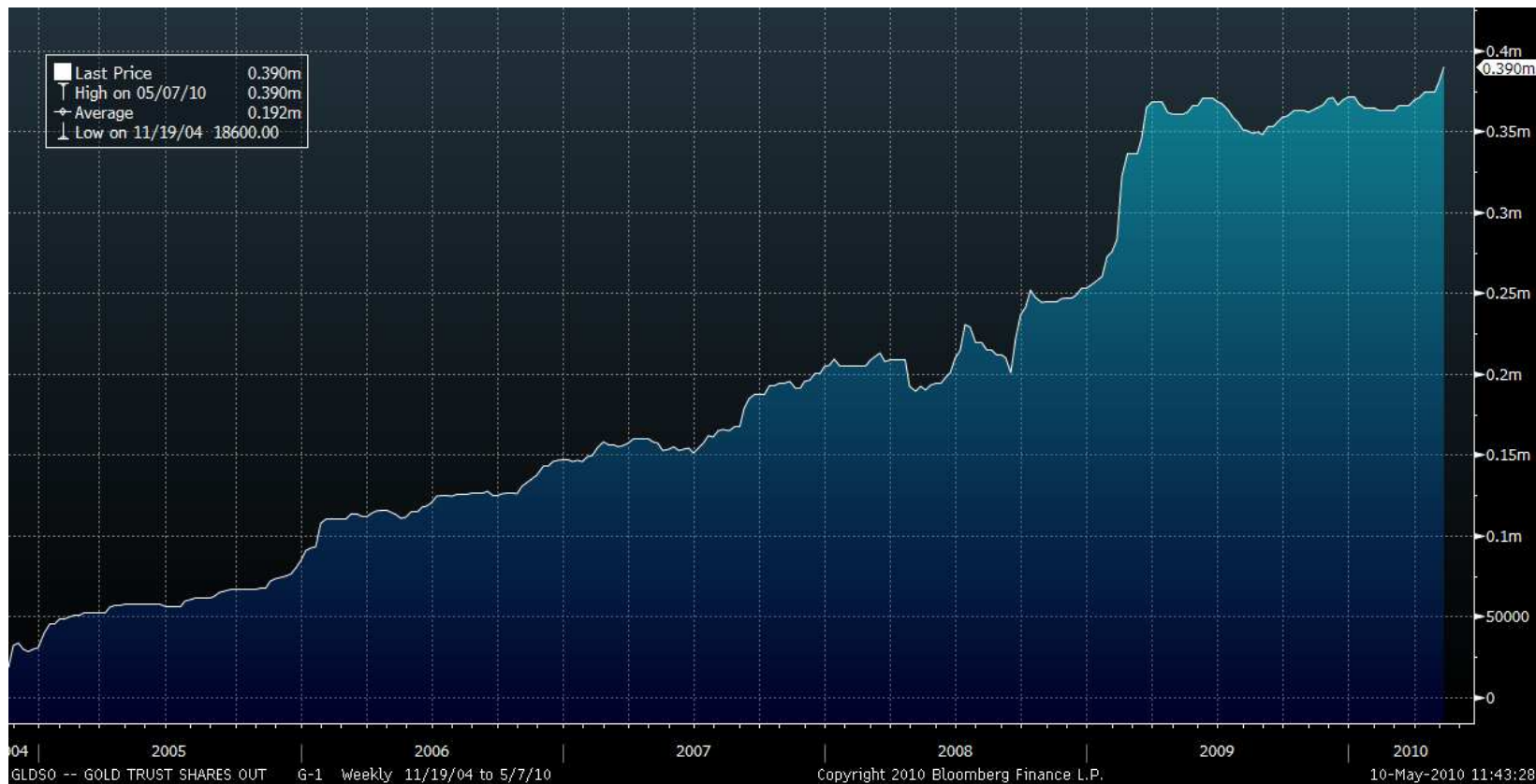
Gold relative to the S&P500 – since 1975



Gold versus Emerging Markets – past decade



Gold ETF – Shares in Issue since 2004



Summary

- Momentum is interesting – don't give up
- Technical analysis is a wonderful tool but there are other tools
- Gold is the only mainstream trade that can thrive in this environment

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