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ARE TRADITIONAL INVESTMENT THEORIES AND TECHNIQUES BECOMING IRRELEVANT?

Matt Davis

In recent times it would seem that relying on the tenets of traditional investment theory has become an excuse for fund managers and investment advisers to be lazy and apathetic.

Many advisers rely on Efficient Market Hypothesis, diversification theory, stock picking and timing to manage their client portfolios. Based on historical data each of these methods have their merits, however, times have changed.

Historically we have never seen a time when volatility has been so consistently high and due to many factors in the fast-paced modern world we live in this is not going to change any time soon.

Whether by design or just because they have found no better answer in this changing investment environment some advisers continue to rely solely on traditional investment theories and techniques. Over the past ten years the result has been that many clients have found themselves unprepared for their retirement or they have not met their overall investment objectives in general.

As previously discussed in my white paper 'Longevity Risk, the Risk of Ruin' it is without question that financial planners are coming under greater scrutiny from regulators and clients. They are feeling more pressure to justify their fees and provide greater value to their clients. In order for the client to feel they are receiving greater value it is key for the financial planner to educate the client that financial advice is not all about investment returns. But at the same time investment returns are important.

At the core of client concern is the need for greater certainty around their financial future. They look to their advisers to safeguard their savings against negative movements in investment markets and when their investments do reduce in value they want their advisers to provide strategies to enable them to recover quickly and get them back on track.

Because of this there is a growing trend away from risk with advisers placing a growing reliance on the use of cash in their clients' portfolios. It's not just about avoiding risk, clients want growth but with greater clarity around the investments they are making. Recently investments like structured products and agribusiness have undermined investor confidence. In general these products have not lived up to their forecast expected returns, their opaque construction renders them difficult to understand leaving clients wondering why they are not receiving the returns advertised.

Financial markets have changed, clients want simplicity and financial planners need to adapt to these changing conditions. Gone are the days where we can advise clients to simply buy and hold a portfolio of shares or managed investments and expect those investments to provide the growth clients need to fulfil their objectives in the specified time frame.

With traditional investment theories and techniques losing their relevance in today's financial markets what alternatives do financial planners and investment advisers have?

Traditional investment methods

Passive vs. active management

Usually investing in the share market is done with the purpose of generating an income and growth from the capital invested, depending on your philosophy and your life stage one may be more important than the other.

In theory some investors express their acceptance of a return that reflects the market and choose to invest in a passive manner. In my experience however their belief begins to waver when the market and their investments generate consistently negative returns.

For others a market rate of return is always unacceptable and they employ active techniques like stock-picking and timing in an attempt to outperform the market. Unfortunately though no-one has a crystal ball and this can be equally as disastrous as it is advantageous, depending on their choices.

"I'd compare stock pickers to astrologers, but I don't want to bad-mouth astrologers." – Eugene Fama

Passive investment management tends to be associated with managed funds and index funds where the funds' portfolio mirrors, or is highly correlated to, a market index. Many subscribers of passive investment management believe in Efficient Market Hypothesis (EMH).

Eugene Fama the father of EMH, formulated the theory in the 1960s. The theory states that it is impossible to beat the market as the price of a share always reflects all the relevant information available about a company at the time. The nature of the information that affects a share price is not necessarily company specific or limited to financial news. Economic, political and social news, whether factual or hearsay, will be interpreted and reflected in individual share prices and the overall performance of the market.

According to EMH, because of the information that is available, shares will always trade at their fair value making it impossible to purchase undervalued shares or to sell shares at inflated prices. Applying this theory it should be impossible to outperform the market either through expert share selection or market timing and the only way to generate higher returns should be to purchase riskier investments, i.e. the risk/return frontier.

The proponents of EMH argue that it is near impossible to pick the market correctly on a consistent basis, in efficient markets prices fluctuate randomly and cannot be predicted with accuracy over the short or long term.

In order to create growth within their client portfolios many subscribers of the EMH theory prescribe higher risk equity investments to their clients. They manage the unpredictable risk inherent within equity investments through diversification, for example by having exposure to all of the companies listed within the ASX200 the overall risk of the portfolio is dampened. The theory being that it is unlikely that every one of the companies within the ASX200 will 'crash and burn'.

Hence the increasing popularity of ETF and Index managers, this method does dampen the risk of individual share investment however it does nothing to alleviate market risk. If an investors' portfolio includes all the shares in the market and the market falls so to does the value of their portfolio.

While in the past the EMH theory coupled with diversification may have provided a valid blueprint from which to construct portfolios, with increasingly consistent and dramatic market volatility this method is becoming obsolete.

Enter active management ...

"Ships will sail around the world but the flat earth society will flourish. There will continue to be wide discrepancies between price and value in the market place and those who read their Graham & Dodd will continue to prosper" – Warren Buffett

This quote came from *'The Superinvestors of Graham-and-Doddsville'* an article written by Warren Buffet promoting value investing, published in the Autumn, 1984 issue of *Hermes*, Columbia Business School magazine.

The article was based on a speech given on May 17, 1984 at the Columbia University School of Business in honour of the 50th anniversary of the publication of Benjamin Graham and David Dodd's book *Security Analysis*. The speech and article challenged the idea that equity markets are efficient through a study of nine successful investment funds generating long-term returns above the market index. All of these funds were managed by Benjamin Graham's alumni, pursuing different investment tactics but following the same *'Graham-and-Doddsville'* value investing strategy.

In 1984 Warren Buffett likened proponents of EMH with the flat earth society, it may be that 28 years on we now have enough historical data to prove that EMH is in fact a flawed theory. Is Warren Buffet the modern day Pythagoras? What would he have us believe?

Mr Buffett is a supporter of the obvious argument against EMH theory: that through research, stock-picking and timing investors can beat the market on a consistent basis and he is not alone. His mentor Benjamin Graham (Graham-Newman Corporation) and his contemporaries such as Sir John Templeton (Franklin Templeton Investments), T. Rowe Price Jr. (T. Rowe Price), John Neff (Wellington Management Co.) and Peter Lynch (Fidelity Magellan Fund) were all successful proponents of this theory, practicing and proving what they preached.

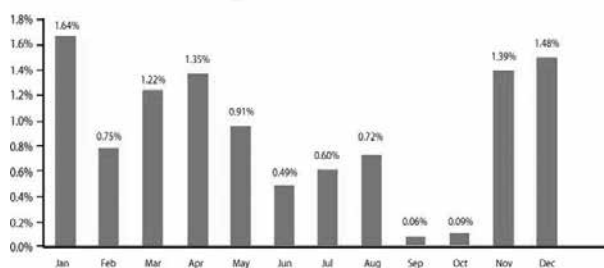
While all of our best investors can attribute their outperformance to active management each of them also had their own methods of divining which companies would outperform and why. They would rely on research, market knowledge and experience but all had the same objective: to outperform the market or index they were benchmarking to, and invariably they did.

Further support for the active management argument is proffered by the market itself with events such as the

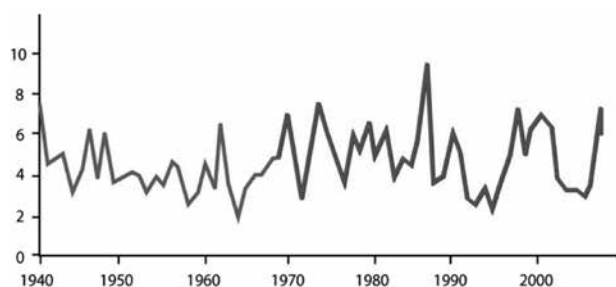


The quote

In 1984 Warren Buffett likened proponents of EMH with the flat earth society, it may be that 28 years on we now have enough historical data to prove that EMH is in fact a flawed theory.

Figure 1: S&P 500 average monthly total return (Jan 1950 to March 2009)

Source: Plexus Asset Management (based on data from Prof Rober Shiller and I-Net Bridge)

Figure 2: Year by year standard deviations of monthly market returns 1940 – 2008

Source: Dimensional

crashes of 1929 which instigated the depression, 1987 where the US share market fell 20% in a single day and the tech crash of 2001. All evidence that share prices can and do deviate from fair values.

The question is, can these crashes and corrections be predicted with certainty?

Obvious patterns do exist in share markets for example, the Presidential Election Cycle theory developed by Yale Hirsch concluded share markets are weakest in the year following a US presidential election, after this year markets improve and the cycle begins again. While the theory was accurate from the early to mid 1900's events of the late 20th Century suggest that the theory cannot be relied upon with markets rising in the years after Bush and Clinton were elected.

According to research based on the S&P 500 from January 1950 to March 2009 a more significant share market pattern can be evidenced: September is the worst performing month of the year closely followed by October which is a 'danger month' being host to many of the greatest share market crashes –including 1929, 1987 and 2007.

Based on this research it is reasonably safe to assume there is a high probability that the stock market will perform badly in September and October but that is unlikely to be sufficient to form the basis of an active managers' 'activity' for an entire twelve month period.

Another interesting pattern that has been observed is in the comparison of the performance of fund managers over rolling

periods. It has been found that, more often than not, the best performing fund manager in one year was among the worst performing managers in the subsequent year.

“Good past performance seems to be, at best, a weak and unreliable predictor of future good performance over the long term.” ASIC 2002

This shows us that while Buffett et al. have been proven to make profitable investment decisions more often than they made unsuccessful decisions this is definitely not the norm in the funds management universe.

Historically elements of both active and passive portfolio management techniques have been proven to be merit-worthy but markets have changed. Do these traditional techniques have merit in the current rapidly changing environment?

First we must ask ourselves, what is changing and why would these changes render our traditional methods impotent?

Volatility

Volatility has always been the nemesis of share market investors but our traditional investment management techniques were developed, tried and tested during times of lower volatility.

“Volatility has risen across the world since about 1970, relative to their long term averages” – BIS quarterly review 2006

The past 40 years have witnessed an increase in the frequency of volatility in share markets. Along with an increase in frequency we have also witnessed an increasingly greater disparity between highs and lows. The market is finding lower lows and higher highs more frequently than it has at any other time in recorded history.

As you can see from the chart volatility in market returns for the period between 1970 and 2008 has been significantly higher than the period between 1940 and 1970.

Why?

The advent and rapid advancement of Information Technology has enabled every market participant to be connected to the market and the world, receiving information and analysis cheaply and easily with a mouse click.

Computers, communication tools and their applications have also provided the impetus for market microstructure improvements with the emergence of online broking, reducing commissions and enabling investors to have direct access to the share market, irrespective of sophistication.

With information at their fingertips and the ability to trade in real-time from the comfort of their home or office the temptation for many is to react to the headline and review later.

Lower costs, greater speed and more participants mean more trades. Greater trading volumes boost liquidity and increase volatility.

Leverage has also been a major contributor to increased volatility. Traditional methods of creating leverage such as Margin Lending and drawing down on home equity for investment have given way to more sophisticated leverage instruments such as Contracts for Difference (CFDs). The ability to trade large values of shares for minimal outlay and the ensuing forced sales that occur when markets fall have both contributed to greater volatility.

This leads us to explore the changing time horizon of investors. Many years ago people invested in shares to receive consistent and

high dividends, capital appreciation was considered secondary and people held equities for years. In the past few decades this has changed, the time horizon or period in which an investor holds a share has reduced dramatically.

Based on the NYSE index data (refer to Figure 3) in 1940 the mean holding period for US investors was around seven years. This stayed the same for the next 35 years to 1975 but by the time of the 1987 stock market crash the average holding period had fallen to under two years. By the turn of the century it had fallen to below one year and was around seven months by 2007.

This is a staggering statistic and speaks volumes about investor sentiment and impatience in general. With the advent of internet based trading systems and educational investment programmes being sold via wealth enhancement spruikers many investors now treat the stock market as a casino. Trading their hard-earned money to 'get rich quick', in reality the most certain bet they could make is that volatility is here to stay.

If active managers are indeed correct and buy and hold is irrelevant does it mean that long term investing is extinct too?

Buy and put in the bottom draw forever, like our grandparents did, is a method that will no longer reap just rewards. Volatility has seen to that. But long term investing is alive and well. The active vs. passive management debate will continue but at the end of the day:

- It is near impossible to profitably predict the market on a consistent basis over a long period of time. Very few have done it successfully and even fewer have managed it in periods of high volatility which are now the normal.
- It is also clear that passive index investment management over the last 10 years has failed to deliver investors with returns. The charts show S&P ASX 200 returns for both five and 10 years.

From 2006 to 2011 (Refer to figure 4) the five year point to point return on the ASX 200 was 14.8%. Worse than the cash return over the same period and with significantly more risk than cash.

From 2001 to 2011 (Refer to figure 5) the 10 year point to point return on the ASX 200 was 18.5%. \$10,000 invested on December 31 2001 would be worth approximately \$18,500 on December 31 2011. Again worse than the cash return over the same period with significantly more risk.

Like sands through the hourglass ...

Time is of course subjective, what may seem a lifetime to a 20 year old is but a drop in the ocean to a retiree. Given that we are all investors, even if our only investments are our superannuation savings, what is the most realistic, relevant time frame that should be applied to the assessment of the effectiveness of an investment theory?

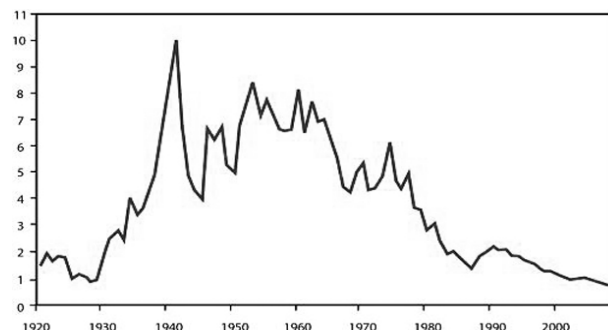
Passive index investment managers would argue that the five-10 year time frame in the above examples is too short and would accordingly produce a chart dating back to the 1970s (or before), a time frame of some 40-odd years.

The question that this gives rise to: how many 20 year olds are seriously thinking about saving for their retirement?

In the 1970s today's 60 year olds were more interested in their firsts. First loves, first jobs, first homes, first children.

As individuals grow older and move into their 30s and 40s their earnings capacity increases and they experience their most

Figure 3: NYSE index data



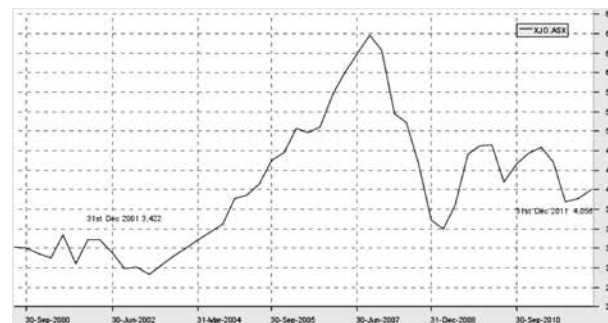
Source: NYSE, GMO

Figure 4: The five year point to point return on the ASX 200 was 14.8% (2006-2011)



Source: Iress

Figure 5: The 10 year point to point return on the ASX 200 was 18.5% (2001-2011)



Source: Iress

productive years in terms of income earned. During this time they are usually thinking about paying off mortgages and keeping their children fed, clothed, entertained and educated, no mean feat in this consumer driven age.

Then the 50's crashes in, as welcome as a ginger step-child and they start thinking panicking about their retirement. Unless we can change human nature it is safe to assume that most people do not think about or have the capacity to seriously save for their retirement until they are five-10 years away from the conventional retirement age.

Figure 6: Peak to trough declines in stock prices (%)

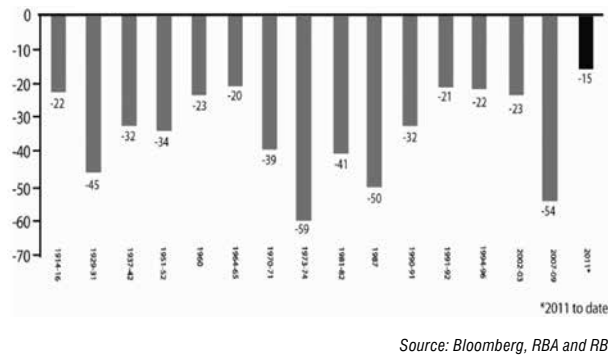
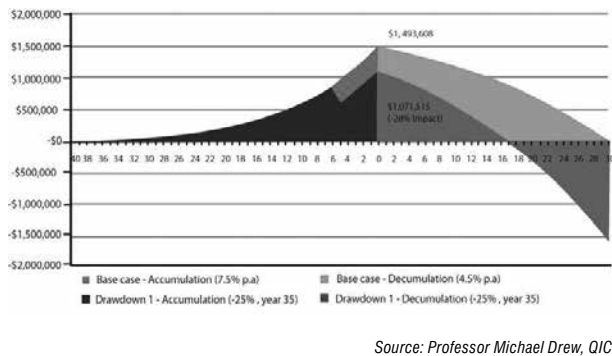


Figure 7: Accumulation



Based on this, in reality, there is a five-10 year window in which people have the capacity and the motivation to contribute to and grow their retirement savings. It is during this period that a major crash or correction would have a significant impact on the retirement plans of investors.

Unfortunately share market crashes are inevitable. The chart above shows some of the larger declines in the Australian share market over the past 100 years. As can be seen, there are 15 occasions during which the share market has declined by at least 20%. This equates to one sharemarket crash (widely accepted as a decline of 20% or more) every six years. Therefore it is likely that within a five-10 year period investors will experience at least one share market crash.

The graph above simulates a portfolio that has been accumulated by a retiree over 40 years and the effect that a 25% loss could have on the portfolio if it occurred in the five years before retirement. Because the investor has the most capital at stake in these last 'accumulation' years, the loss can destroy up to 1.5 times the investor's lifetime contributions and reduce the investor's possible annuity income by one-third. As can be seen, rather than paying out over 30 years post retirement, the portfolio will last just 18.

This type of disastrous outcome is what is being faced by many investors today. With stock markets more volatile than ever before investors face the risk that formerly healthy portfolio balances could suddenly and drastically be slashed just when they are needed the

most. An investor nearing retirement should be mindful that, if their share portfolio drops by 50%, it then must increase by 100% before they are back to square one.

Is there an alternative?

Maybe successful long term investment outcomes can be achieved by combining the attributes of both passive and active management, a hybrid of both, allowing financial planners and advisers to provide clients with greater than market returns, less portfolio volatility and more certainty around their retirement plans?

An active manager doesn't have to be a day trader or rely on research, the media and speculation to generate a return better than the market.

A passive long-term investor doesn't have to buy and hold forever and accept the market rate of return.

Derivatives

Derivatives such as exchange-traded options (ETOs) are not used widely in the financial planning community or by retail investors due to their perceived complexity and because there are a limited number of dealer groups and advisers licensed to provide advice on derivative strategies.

The concept of the Option has been in existence since ancient times. However more recently in Holland during the early 1600s trading in tulip options blossomed. At first, tulip dealers used call options to make sure they could secure a reasonable price to meet the demand. At the same time, tulip growers used put options to ensure an adequate selling price.

However, it wasn't long before speculators joined the mix and traded the options for profit. Unfortunately, when the market crashed, many speculators failed to honour their agreements. The consequences for the economy were devastating. Not surprisingly, the situation in this unregulated market seriously tainted the view most people had of options. After a similar episode in London one hundred years later, options were declared illegal.

A similar story can be told with ETOs which have been exploited by their use in risky strategies like speculative trading, to gain leverage, for covered calls, and in spread trading. All of which are short-term strategies employed in the hope of generating short-term gains. They have nothing to do with the long-term investment management strategies they were originally created for.

By utilising ETOs for their original purpose investors can employ options to take advantage of volatility in the share market without aggressively trading their portfolio and exposing it to the possible losses that these strategies could entail.

Exchange traded put options

A put option endows the buyer with the right, but not the obligation, to sell a parcel of shares for a specific price, at a predetermined date in the future. When used in its purest form the put option is very much like an insurance policy. The components of a put option are:

| | |
|----------------|--|
| 'Strike Price' | Insured amount per share |
| 'Term' | The length of the insurance policy which can range from one month to two years |
| 'Premium' | Price of each option. The premium is a function of both the time to maturity and whether the option is 'in', 'at' or 'out' of the money. |

If the current share price of BHP is \$40:

- An 'out-of-the-money' put option would have a strike price below \$40.00
- An 'at-the-money' put option would have a strike price of \$40.00
- An 'in-the-money' put option would have a strike price above \$40.00

In practice:

An investor buys 10 contracts of a BHP Sep 2012 \$40.00 Put Option*

Each contract gives the investor the right, but not the obligation, to sell 100 of their BHP shares for \$40 each. The investor can exercise this right at any time up to the expiry date in September 2012.

* 1 contract = 100 shares

Another feature of Exchange Traded Options is their exercise style. European or American?

'European style' Only allows the holder to exercise or utilise their insurance at maturity (in the example above September 2012).

'American style' Allows the holder to exercise or utilise their insurance at any point in time up until the maturity date.

Derivatives aren't always a dirty word

The manner in which derivatives are utilised under a Protected Equity Portfolio Strategy (PEPS) is designed to provide investors with more certainty around their investment outcomes before they commit their capital to the share market. It greatly reduces volatility and allows investors to take advantage of market movements rather than being a victim of them.

The PEP strategy enables financial planners to create more certain financial models by significantly reducing the investment return variable. In addition the PEP strategy allows clients to maintain a higher exposure to shares for longer without the traditional risks associated with share ownership.

PEPS is not a buy and hold strategy and it is not an actively managed strategy. It is a hybrid of both. For every share that is purchased a put option is purchased underneath as insurance against a fall in the stock price. The use of derivatives also allows clients to lock in gains during rising markets and protects against losses in falling markets.

The following case study illustrates how a financial planner can utilise derivatives to create a protected equity strategy for their clients.

Case study

Adam is a financial planner, in the past his asset allocation strategy for Australian equities has included direct shares.

Adam prefers direct investments especially for his SMSF clients, they are more in line with the philosophy of a do it yourself fund and his clients understand what they are investing in. Adam is also in favour of direct investing because he knows that the share market has the greatest ability to provide his clients with the growth they require to increase their retirement savings.

While Adam promotes direct investments to his clients he is more concerned about the volatility of the share market than he has been in the past. Previously his clients have been invested in direct shares and the market fell dramatically, this meant that his clients' retirement plans suffered too. As a result he is concerned about recommending shares to his clients again.

Adam is wondering if derivatives might be appropriate to manage his clients' expectations this time.

Many of Adam's clients were invested in large cap Australian shares with high exposure to three shares in particular: BHP, ANZ and Wesfarmers.

Direct investment vs. protected equity

January 2007 – January 2012

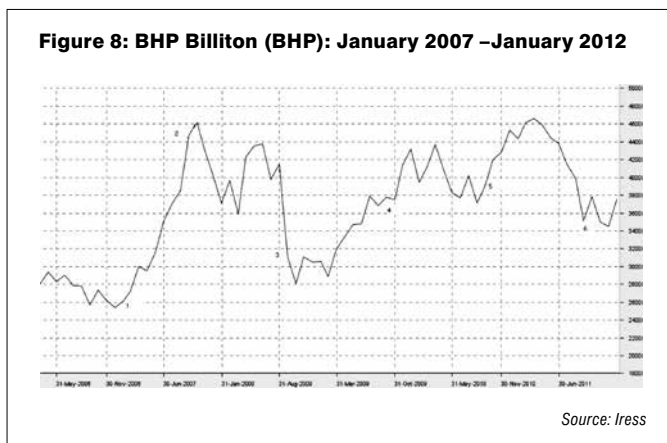
When utilising derivatives the optimal insurance is achieved when the put options are purchased with between nine and 12 months to expire, depending on the share. The timing is set to coincide with the ex-dividend dates of the shares because the dividend income is used to offset the cost of the put option.

At maturity if the market value of the share is above the purchase price a new put option is purchased closer to the current market value, effectively locking in the gains but not realising them. If the share price is below the insured level at maturity the insurance is activated and the shares are sold at the protected level, realising a loss.

Depending on market sentiment and the spread between the current value and the strike price, shares in the same company are subsequently repurchased. This results in the client owning more shares with a lower cost base, another put option is also purchased closer to the new strike price, protecting the downside once again. The strategy is carried out until the investor believes the shares have no more upside or there is a better investment elsewhere.

By this means the investment in the share is more along the lines of a buy and hold strategy (passive) and the options are bought or exercised depending on the share price at expiry (active).

BHP Billiton (BHP)



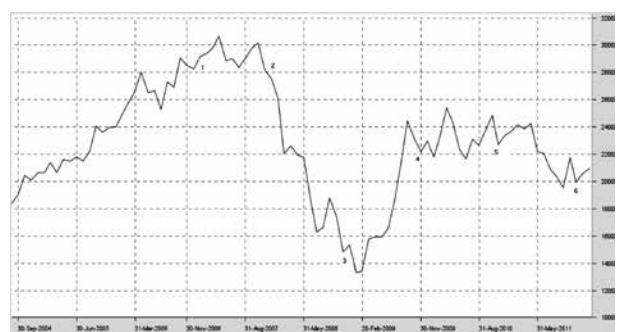
| | |
|-----------------------|---|
| January 2007 | BHP Trading @ \$26.04(Chart Ref. 1) |
| Buy | BHP @ \$26.04 |
| Buy | BHP Sept 07 \$24.00 Put |
| September 2007 | BHP trading @ \$44.55(Chart Ref. 2) |
| Expire | BHP Sept 07 \$24.00 Put |
| Buy | BHP Sept 08 \$41.50 Put – insuring 59.37% gain |
| September 2008 | BHP trading @ \$31.00(Chart Ref. 3) |
| Exercise | BHP Sept 08 \$41.50 Put – realising 59.37% gain |
| Buy | BHP @ \$31.00 |
| Buy | BHP Sept 09 \$29.00 Put |

| | |
|-----------------------|---|
| September 2009 | BHP trading @\$37.00(Chart Ref. 4) |
| Expire | BHP Sept 09 \$29.00 Put |
| Buy | BHP Sept 10 \$34.50 Put – insuring 11.29% gain |
| September 2010 | BHP trading at \$38.91 (Chart Ref. 5) |
| Expire | BHP Sept 10 \$34.50 |
| Buy | BHP Sept 11 \$36.50 Put – insuring 17.74% gain |
| September 2011 | BHP Trading at 35.02 (Chart Ref. 6) |
| Exercise | BHP Sept 11 \$36.50 Put – realising 17.74% gain |
| Buy | BHP @ \$35.02 |
| Buy | BHP Sept 12 \$32.50 Put |

Note: Out-of-the-Money options have been used

ANZ Bank (ANZ)

Figure 9: ANZ Bank (ANZ): January 2007 –January 2012



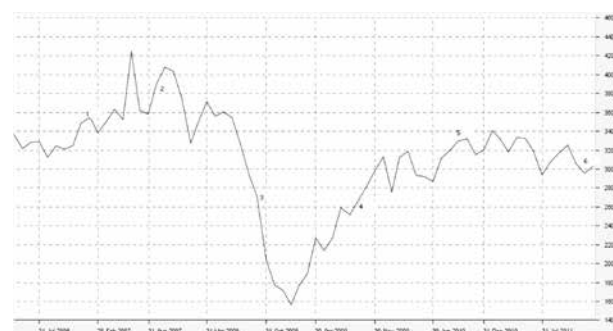
Source: Iress

| | |
|----------------------|--|
| January 2007 | ANZ trading @ \$29.11 (Chart Ref. 1) |
| Buy | ANZ @ \$29.11 |
| Buy | ANZ Nov 07 \$29.00 Put |
| November 2007 | ANZ trading @ \$28.16(Chart Ref. 2) |
| Exercise | ANZ Nov 07 \$29.00 Put – realising 0.38% loss |
| Buy | NZ @ \$28.16 |
| Buy | NZ Nov 08 \$28.00 Put |
| November 2008 | ANZ trading @ \$14.80(Chart Ref. 3) |
| Exercise | ANZ Nov 08 \$28.00 Put – realising 0.57% loss |
| Buy | ANZ shares at \$14.80 |
| Buy | ANZ Nov 09 \$14.50 Put |
| November 2009 | ANZ trading @\$22.15(Chart Ref. 4) |
| Expire | NZ Nov 09 \$14.80 Put |
| Buy | ANZ Nov 10 \$22.00 Put – insuring 48.65% gain |
| November 2010 | ANZ trading at \$22.65(Chart Ref. 5) |
| Expire | NZ Nov 10 \$22.00 Put |
| Buy | ANZ Nov 11 \$22.50 Put – insuring 52.03% gain |
| November 2011 | ANZ trading at \$19.90(Chart Ref. 6) |
| Exercise | ANZ Nov 11 \$22.50 Put – realising 52.03% gain |
| Buy | ANZ @ \$19.90 |
| Buy | NZ Nov 12 \$19.50 Put |

Note: At-the-Money options have been used

Wesfarmers (WES)

Wesfarmers (WES): January 2007 –January 2012



Source: Iress

| | |
|-----------------------|---|
| January 2007 | WES trading @ \$35.36(Chart Ref. 1) |
| Buy | WES @ \$35.36 |
| Buy | WES Sept 07 \$35.00 Put |
| September 2007 | WES trading @ \$38.93(Chart Ref. 2) |
| Expire | WES Sept 07 \$35.00 Put |
| Buy | WES Sept 08 \$38.50 Put – insuring 8.88% gain |
| September 2008 | WES trading @ \$27.04(Chart Ref. 3) |
| Exercise | WES Sept 08 \$38.50 Put – realising 8.88% gain |
| Buy | WES @ \$27.04 |
| Buy | WES Sept 09 \$26.50 Put |
| September 2009 | WES trading @\$26.49(Chart Ref. 4) |
| Exercise | WES Sept 09 \$26.50 Put – realising 2.00% loss |
| Buy | WES @ \$26.49 |
| Buy | WES Sept 10 \$26.00 Put |
| September 2010 | WES trading at \$32.89 (Chart Ref. 5) |
| Expire | WES Sept 10 \$26.00 Put |
| Buy | WES Sept 11 \$32.50 Put – insuring 22.69% gain |
| September 2011 | WES trading @ \$31.59(Chart Ref. 6) |
| Exercise | WES Sept 11 \$32.50 Put – realising 22.69% gain |
| Buy | WES @ \$31.59 |
| Buy | WES Sept 12 \$31.50 Put |

Note:

1 Out-of-the-Money options have been used

2 Had the manager actively managed the put options and exercised earlier between points 3 and 4 the return would have been substantially more

Had Adam used the PEP strategy five years ago (Jan 2007) the investment outcome of his clients would have been significantly different. Following is a comparison of traditional passive buy and hold investing and the realised returns of the Protected Equity Portfolio Strategy as outlined in the transactions above.

BHP

| | Jan-07 | Jan-08 | Jan-09 | Jan-10 | Jan-11 | Jan-12 | Total Return |
|--------------------------|---------|---------|---------|---------|---------|---------|---------------------|
| Share Price | \$26.04 | \$37.05 | \$30.50 | \$39.40 | \$44.25 | \$37.48 | |
| Traditional ¹ | | 42.28% | -17.68% | 29.18% | 12.31% | -15.30% | 43.93% ³ |
| PEPS ² | | | 59.37% | | 17.74% | | 77.11% ³ |

ANZ

| | Jan-07 | Jan-08 | Jan-09 | Jan-10 | Jan-11 | Jan-12 | Total Return |
|--------------------------|---------|---------|---------|---------|---------|---------|----------------------|
| Share Price | \$29.11 | \$26.01 | \$13.27 | \$21.73 | \$23.67 | \$21.41 | |
| Traditional ¹ | | -10.65% | -48.98% | 63.75% | 8.93% | -9.55% | -26.45% ³ |
| PEPS ² | | -0.38% | -0.57% | | 52.03% | | 51.08% ³ |

WES

| | Jan-07 | Jan-08 | Jan-09 | Jan-10 | Jan-11 | Jan-12 | Total Return |
|--------------------------|---------|---------|---------|---------|---------|---------|----------------------|
| Share Price | \$35.36 | \$32.72 | \$15.55 | \$27.51 | \$34.03 | \$30.30 | |
| Traditional ¹ | | -7.47% | -52.48% | 76.91% | 23.70% | -10.96% | -14.31% ³ |
| PEPS ² | | 8.88% | -2.00% | | 22.69% | | 29.57% ³ |

Note:

¹ Based on unrealised gain/loss of buy and hold strategy

² Based only on realised gains/losses made when selling shares. Unrealised gains/losses on the last purchase to date have not been taken into account. The shares remain protected.

³ Dividends, expenses and taxation have not been taken into account

While continuing to hold the shares allows Adam's clients to receive dividends and franking (which are also received when Put protection is in place) Adam's clients are still carrying an unrealised capital loss on two out of their three shareholdings.

Only time will tell how long it takes for them to regain their ground and then provide a capital return. The opportunity costs of these investments are also open to speculation.

A one-trick pony

Exchange Traded Options can also be used to repair portfolios and increase growth.

Like Adam's clients many share market investors hold portfolios that have still not recovered from the Global Financial Crisis (GFC) and based on the last 12 months of share market returns portfolios are likely to have fallen even further behind.

"A share that falls 50% needs a 100% gain to break even" – Simple mathematics

A question that many investors who have held direct share portfolios over the last four to five years are now asking is: how can I repair my portfolio or at least reduce the average cost of my shares to lower the cost base and sustain a faster recover? The traditional approach to this problem has been to dollar cost average but there is an alternative and this will be the topic of my next white paper.

The new world of smart advice

Long term investment is not dead, it's evolving.

Financial planners need to change the way they perceive long term investing, think outside the square and adapt modern investment methods and strategies to embrace the increased share market volatility that exists in this fast-paced, information driven world. **FS**

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