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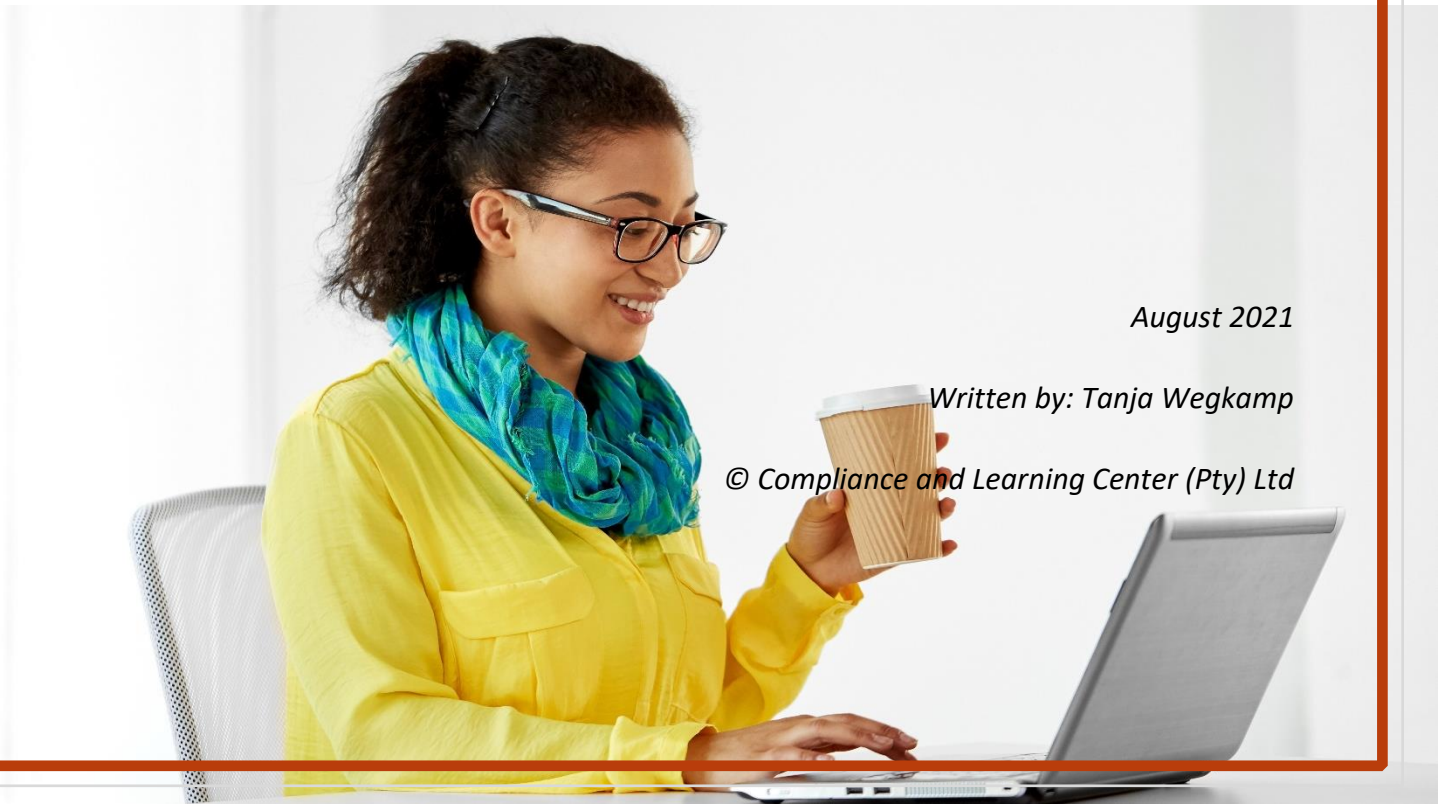
Study Guide

PORTFOLIO STYLES, INVESTMENT STRATEGIES AND MARKET THEORIES: ONLINE CPD COURSE 2022 /2023



August 2021

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Course summary

The course outlines and describes the basic portfolio styles, investment strategies and market theories and concludes with the interrelationship between these three aspects. Although the course focuses on concepts related to equity style investments; the views can be adjusted to fit the inclusion of most asset classes in an investment portfolio.

Time allotted for course

The course consists of 4 topics with an assessment that needs to be completed. The time allotted for each aspect is as follows:

Topic number	Title	Word count	Level	Time allotted
Topic 1	Introduction	477	Intermediate	10 minutes
Topic 2	Portfolio styles	1 627	Intermediate	40 minutes
Topic 3	Investment strategies	3 157	Intermediate	75 minutes
Topic 4	Market theories	1 063	Intermediate	25 minutes
	Assessment			60 minutes

Total time	**3.5 Hours**

Assessment and certification

After completion of the workshop, the learner must complete an electronic assessment on the learning management system.

- **Form of Assessment:** Multiple Choice Questions
- **Number of Questions**: 20 questions
- **Duration:** 60 minutes
- **Competency Mark:** 65%

Upon obtaining a competency mark of 65%, the learner will receive a certificate of completion. The learner will be afforded an opportunity to re-do the workshop should a competency mark not be attained.

Course accreditation

CPD Category: Online program

COB Category: Long-term Insurance | Pension Fund Benefits | Structured Deposits | Investments | Forex Investments

Accreditation valid until: 1 August 2022 to 31 July 2023

CPD Hours Allocated: 3.5 hours | points on completion and pass of assessment

Approval Number:

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TOPIC 1 INTRODUCTION

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Explain the motivation for participation in the financial markets.
- Describe terminology related to investments and the financial markets.

1.1 Course outline

The course aims to give students a broad outline of the most relevant and widely used styles, strategies and theories used to define and refine different approaches to investment in the financial markets.

This first topic considers the most popular portfolio styles followed when selecting investments for a portfolio. The second topic outlines possible strategies for selecting investments to be included in a portfolio, and the text concludes with an overview on some of the market theories attempting to understand and explain the psyche of the financial markets.

1.2 Motivation for participation

There are four reasons to participate in the financial markets, namely: investing, speculation, arbitrage and hedging.

Investment is the act of doing something in the hope of future gains. In the event of finance, an investor not only wants their asset to remain safe but to also grow in worth. An investment portfolio is a basket of assets that an investor holds. The portfolio is structured to reflect the financial needs and risk appetite of the investor.

The term speculation refers to the act of conducting a financial transaction by taking a view on which direction the market will take in the near future.

The simplest form of arbitrage is purchasing an asset in the market where the price is lower and simultaneously selling the asset in the market where the asset's price is higher.

Lastly, hedging is an investment technique designed to offset a potential loss on one investment or asset by purchasing a second investment that is expected to perform in the opposite way.

1.3 Glossary of Terms

The following terms are often referred to in the financial markets:

- **Bear market:** A period marked by severe investing losses, a receding economy and a decline of at least 20% in the stock market from a recent high.
- **Bonds:** Bonds are investment securities where an investor lends money to a company or a government for a set period, in exchange for regular interest payments. Once the bond reaches maturity, the bond issuer returns the investor's money.
- **Bull market:** A bull market is a market that is continuously rising and where the economy is sound. It occurs when a major stock market index rises at least 20% from a recent low.
- **FTSE:** FTSE stands for the Financial Times Stock Exchange Group, also known by the nickname of Footsie. The FSTE is an independent organisation, which specialises in creating index offerings for the global financial markets, similar to the Standard & Poor's (S&P).
- **Issued shares:** Issued shares are the number of shares the company is authorised to sell.
- **Outstanding shares:** Outstanding shares refers to a company’s shares already held by all of its shareholders.
- **Stocks/shares:** Refers to financial equities, specifically securities that denote ownership in a public company and represents a claim on the part of the corporation's assets and earnings.

TOPIC 2 PORTFOLIO STYLES

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe what is meant with the term portfolio style.
- Describe the advantages and limitations of portfolio styles.
- Identify investor characteristics influencing the compiling of an investment portfolio.
- Describe the major portfolio styles covered in this course.
- Define the term market cap.
- Describe the three measurements used to determine an investment's intrinsic value.

2.1 INTRODUCTION

Portfolio style refers to the approach followed when compiling an investment portfolio for an investor. It is the way that a portfolio's investments are chosen so that it meets a particular orientation. Common styles can be distinguished from one another based on risk tolerance, growth vs value orientation, and/or market capitalisation.

2.2 ADVANTAGES AND LIMITATIONS OF PORTFOLIO STYLES

A portfolio can be made of a single style or a combination of styles to accommodate the preferences and needs of the investor. Choosing a portfolio style provides the foundation on which an investment decision for the portfolio is made. Adopting an appropriate style assists in ensuring that the objectives of the investment portfolio are met with minimised risk, uncertainty and costs.

However, portfolio styles have limitations. Average investors find it difficult to outperform the market due to lack of expertise and resources. Even though a lot of research, analysis, and historical data are considered before investing, most of the decisions are taken on a predictive basis. Sometimes, the results and returns may not be as anticipated, and it may delay the investors from achieving their goals.

2.3 DETERMINING INVESTOR CHARACTERISTICS

Apart from considering the objective of the investment portfolio, the following investor characteristics must also be considered when analysing the portfolio styles most suited to an investor:

- Interest, understanding and experience of financial markets.
- Risk appetite.
- Financial resources at their disposal.
- Financial goals, including their preferred investment period.
- Personal factors such as age, health, relationship status and having dependents.
- Trust in the financial markets, industry and role players.

The following sections consider the popular portfolio styles: active or passive management, risk-based, growth vs value and market capitalisation.

2.4 ACTIVE VERSUS PASSIVE MANAGEMENT

Active management entails investment funds managed by money managers that strive to maximise returns for investors by selecting holdings that they believe will outperform an index. The money manager makes tactical decisions to buy or sell certain assets in the fund, based on one or more of the following:

- The money manager's view of opportunities in the market.
- Attempting to achieve superior growth in the fund, i.e. better growth than the average growth in the market.
- To protect investors' capital by losing less value when markets fall, by opting out of certain assets and exposure to specific market sectors.

Passive fund management means that a fund will track the market, which is often characterised by a specific index, for example, the FTSE/ JSE Top 40 index, which tracks the 40 biggest companies on the Johannesburg Stock Exchange. Passive funds are essentially run by computer and will replicate all of the assets in a particular market, or represented in a specific index, to give a return that mirrors the return in the market.

Passive management lends itself to investors that believe that the passive fund may outperform the returns of an actively managed fund mainly due to the higher fees of on actively managed funds. The higher fees associated with actively managed funds are a result of the added expenses of additional researchers and fund managers. Historically passively managed funds have outperformed actively managed funds in general. [1]

Increasingly, fund managers are also trying to make the best of both worlds using a blended approach where parts of a portfolio may be passively managed, whilst other parts may be actively managed.

2.4.1 When is active and passive management an appropriate style for investors?

Active management is appropriate for investors who want to invest in specialised equity markets that require specialised knowledge and expertise to take advantage of inefficient pricing. For example, emerging markets, small-cap stocks and companies involved in resources and metals mining. Active management may also be appropriate for investors who want an experienced professional to make tactical investment decisions to outperform the market and to shield them from negative market volatility.

Passive management is appropriate for investors who want a well-diversified holding of well-known popular shares (such as large-cap shares, for example, as tracked by the FTSE/ JSE Top 40 index), and who are comfortable to ride out the short-term market fluctuations.

2.5 RISK-BASED STYLES

There are three broad risk styles, namely conservative, moderate and aggressive. An investor's style can also fall between two styles, as in moderately conservative and moderately aggressive. The investor's risk tolerance is assessed by striking a balance between the investor's expectation of return and their attitude towards risk.

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[1]Source: Active_Passive_Barometer_Midyear_2020.pdf (morningstar.com)
https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Active_Passive_Barometer_Midyear_2020.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=24360

2.5.1 Conservative risk-based

With this style, the investor aims to preserve their capital and want their funds safe from risk. The investment objective is shorter-term, or there is a goal to earn income through interest payments.

This type of style lends itself to cash investments such as fixed deposits or call accounts, money market instruments and bonds where there is little risk.

However, there are usually also smaller returns, especially in the case of cash investments. Interest may be earned, but depending on the investment, it may not keep up with inflation, which means the real rate of return is negative.

Definition: Real Rate of Return

Real rate of return is the annual percentage of profit earned on an investment, adjusted for inflation. Therefore, the real rate of return accurately indicates the actual purchasing power of a given amount of money over time.

2.5.2 Moderately conservative

The moderately conservative investor is seeking capital protection, but also a return above inflation. The portfolio may comprise cash/ money-market instruments, bonds and perhaps a small level of equities and property.

2.5.3 Moderate risk-based

The moderate risk-based investor is seeking average returns and is prepared to take on some risk to beat the inflation rate. However, the investor is more circumspect in their style than an aggressive investor and not ready to take on a high amount of risk. Typically, the investment term is five years or longer.

A balanced portfolio that includes some cash or money market instruments, bonds, some property and large-cap equities, where the capital remains relatively safe, and changes to investment value is usually slow and gradual. The cash and bonds components offer a degree of protection, whilst the property and equity components offer capital growth without taking on too much risk.

Definition: Market Capitalisation

Market capitalisation (referred to as 'cap' in the industry) is the number of shares of stock a company has outstanding, multiplied by the share price.

Outstanding shares is the number of shares issued by a company.

2.5.4 Moderately aggressive

The moderately aggressive investor is seeking above-average returns through capital growth. The portfolio may comprise mainly equities, with a portion invested in other asset classes to limit the investment exposure to the equity market to a degree.

2.5.5 Aggressive risk-based style

The aggressive investor has a long-time horizon and is seeking the highest possible return over time and is willing to take on a high amount of risk, without capital protection to reach that goal. Investing in equities, or alternative investments such as derivatives.

2.6 GROWTH VERSUS VALUE APPROACH

An investor needs to decide if they are looking to invest in companies that are rapidly growing and that they believe have a strong future potential (growth style) or would instead invest in companies that have stable track records and are under-priced currently (value style).

Growth style investment focuses on companies that reinvest their profits to fuel future growth. Such investments typically have high growth rates, high return on equity, high-profit margins and low dividend yields. Whilst value style investing focuses on buying stable stocks at a reasonable price.

The following measurements are considered essential in determining the intrinsic value of the investment:

- **The price-earnings ratio:** This ratio is also known as P/E ratio, P/E, or PER. This is the ratio of a company's share (stock) price to the company's earnings (net income) per share. The ratio is used for valuing companies and for finding out whether they are overvalued or undervalued.

- **Price–sales ratio:** This ratio is also known as the P/S ratio or PSR. This ratio is a valuation metric for stocks. It is calculated by dividing the company's market capitalisation by the revenue in the most recent year; or, dividing the per-share stock price by the per-share revenue.

- **The dividend yield**: The dividend yield or dividend-price ratio of a share is the dividend per share, divided by the price per share. It is also a company's total annual dividend payments divided by its market capitalisation, assuming the number of shares is constant. It is often expressed as a percentage.

2.6.1 Market capitalisation

As mentioned, market capitalisation (referred to as 'cap' in the industry) is the number of shares of stock a company has outstanding, multiplied by the share price.

The market value of small caps outstanding shares is much smaller than mid or large caps. They are often considered to provide the opportunity for investors to make much higher returns with their growth potential, inversely they also have the potential for more significant losses as they are more susceptible to volatility.

When considering equity investments mid and small-cap portfolios invest at least 80% of the market value of the portfolios in shares which have a market cap smaller than the company with the lowest market cap in the FTSE/JSE Large Cap Index, or an appropriate foreign index published by an exchange. 100% of share purchases must be in the investable universe at the time of sale. Due to both the nature and focus of these portfolios, they may be more volatile than portfolios that are diversified across the broader market. SA Benchmark: FTSE/JSE Mid Cap Index (J201T).

Definition: Investment Universe

The total range of investments from which a fund manager can choose – as defined by a fund's stated investment objective.

On the other hand, large caps, also referred to as blue-chip companies have a lengthy, stable background and come with a lot less risk. They have a reliable and profitable history and are not likely to go out of business without warning. However, they are not expected to grow quickly, either.

Large cap equity portfolios invest at least 80% of the market value of the portfolios in large market cap shares which have a market cap greater than or equal to the company with the lowest market capitalisation in the FTSE/JSE Large Cap Index, or an appropriate foreign index published by an exchange. 100% of share purchases must be in the investable universe at the time of purchase. SA Benchmark: FTSE/JSE Large Cap Index (J205T).

TOPIC 3 INVESTMENT STRATEGIES

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe what is meant with the term investment strategy.
- Identify and describe investment strategies.
- Distinguish between popular fundamental analysis tools.

3.1 INTRODUCTION

Investment strategy is a broad term used to describe the method of selecting assets to be included in a portfolio by evaluating investments, industry sectors, and economic trends. Investment strategies can consist of complex investment analysis or more simplistic approaches.

The topics following considers the following popular investment strategies:

- Fundamental analysis
- Technical analysis
- Top-down versus Bottom-up
- Cost averaging
- Contrarian

3.2 FUNDAMENTAL ANALYSIS

Fundamental analyses aims to discover the inherent value of a security. If the inherent value of a security is higher than its current market price, it may be a good asset for long term investment. Useful fundamental analyses requires a careful study of the general market, the company's competitors and the company itself.

In terms of equity instruments, fundamental analysis valuate a company's shares to determine its intrinsic, real or fair market value and analyse the factors that could influence its price in the future. It requires examining the macroeconomic, microeconomic, company and security-specific data to determine whether a particular share is trading above or below its intrinsic value.

The general market needs to be studied to determine whether economic trends are in favour of or against the company. For instance, is it a bear or a bull market? Has the company adapted to macroeconomic trends such as automation and technology?

The company's competitors also need to be studied to see whether the company has a reasonable market share and whether they are at risk of being replaced.

Thirdly, the company needs to be examined to determine profitability, sound management structure and growth potential. Therefore, company financial information such as the company's revenues, earnings, future growth, return on equity, profit margins, and other data are analysed to determine its underlying value and potential for future growth. All of this data is available in a company's financial statements.

Financial data of a company can be converted to ratios and indicators to provide a broader picture of financial health. The most important indicators used in fundamental analysis focus on determining earnings, growth and value in the market. Some of these include the following:

- **Earnings per share (EPS):** Neither earnings nor the number of shares can portray much about a company's value on their own, but when they are combined, it is one of the most commonly used ratios for company analysis. EPS tells us how much of a company's profit is assigned to each share. EPS is calculated as net income (after dividends on preferred shares) divided by the number of outstanding shares.

- **The price-earnings ratio (P/E):** This is the ratio of a company's share price to the company's earnings (net income) per share. The ratio is used for valuing companies and for finding out whether they are overvalued or undervalued.

- **Projected earnings growth (PEG):** PEG anticipates the one-year earnings growth rate of the share.

- **Price-to-sales ratio (P/S):** This ratio is a valuation metric for shares. It is calculated by dividing the company's market capitalisation by the revenue in the most recent year; or, dividing the per-share share price by the per-share revenue.

- **Price-to-book ratio (P/B):** This ratio, also known as the price-to-equity ratio, compares a share's book value to its market value. It is calculated by dividing the share's most recent closing price by last quarter's book value per share. Book value is the value of an asset, as it appears in the company's books. It's equal to the cost of each asset less cumulative depreciation.

- **Dividend payout ratio:** This ratio compares dividends paid out to the stockholders, to the company's total net income. It accounts for retained earnings—income that is not paid out but rather kept for potential growth.

- **Dividend yield:** The dividend yield or dividend-price ratio of a share is the dividend per share, divided by the price per share. It is also a company's total annual dividend payments divided by its market capitalisation, assuming the number of shares is constant. It is often expressed as a percentage.

- **Return on equity:** The Return on equity is calculated by dividing the company's net income by shareholders' equity. This may also be expressed as the company's return on net worth.

3.3 TECHNICAL ANALYSIS

Technical analysis is a way of understanding what has happened to the price of an asset in the past and predicting what will happen to it next. It is used to predict short-term market movements. The unique characteristic of technical analysis is that it focuses on price movements. This is in contrast to fundamental analysis, that focuses on the underlying factors to determine the future price of the asset.

In financial trading, technical analysis is a method used to forecast the direction of the market price or the strength of the trend by analysing the past market price. Technical analysis trading focuses on charts and other technical indicators to forecast the market.

When technical analysts assess a share, for example, they ignore everything about the company behind the share. They are not interested in its earnings, economic future, or the quality of its products. All they look at is what its share price has done in the past and which implications this history allows for the future.

Technical analysis adopts the strong form of the Efficient Market Hypothesis (Considered in Topic 4), based on the assumption that everything that is known about a share is already factored into its price.

Based on this view, the three fundamental principles behind technical analysis basics are as follows:

1. Market price action discounts everything. So, wherever the market is trading now, that's the fair market price. All the hopes, fears and market expectations are all factored into the price.

2. Markets move in trends. The markets take a while to get to wherever they are going to go.

3. History tends to repeat itself, so price levels that were vital in the past can often be significant in the future.

Many different technical analysis theories have been developed and refined. The subtopics following will consider two of these theories: the Dow theory trading strategy and the odd lot technical analysis theory.

3.3.1 DOW THEORY TRADING STRATEGY

The Dow Theory was a revolutionary method that changed the way share investors traded forever. The Charles Dow principles for analysing market movements are also at the foundation of technical analysis. Charles Dow was not only the co-creator of the Dow Jones Industrial Average, but he was also a co-founder of the prestigious Wall Street Journal.

Charles Dow developed the first stock market index Dow Jones Industrial Index (DJIA). Dow believed that it was better to analyse the stock market as a whole rather than to focus on single securities. The Dow Theory is a collection of market concepts discovered by Charles Dow that aims to reveal how market trends typically behave. Dow believed that the share market price moves the same way as the tides of the ocean rolling into the beach. This is what Charles Dow wrote in the Wall Street Journal more than a century ago:

"A person watching the tide coming in and who wishes to know the exact spot which marks the high tide sets a stick in the sand at the points reached by the incoming waves until the stick reaches a position where the waves do not come up to it, and finally recede enough to show that the tide has turned. This method holds good in watching and determining the flood tide of the share market."

The Dow Theory in the share market aims to accomplish three things:

1. Alert of possible trend changes.

2. Keep the investor on the right side of the market trend technical indicators.

3. Create a straightforward methodology to trade on in the financial markets.

Dow used the Dow Jones Industrial Average (DJIA) and the Dow Jones Transportation Average (DJTA) to determine the flood tide of the stock market.

In short, the theory states that the market is in an upward trend if one of its averages (i.e. industrials or transportation) advances above a previous important high and is accompanied or followed by a similar advance in the other average.

For example, if the Dow Jones Industrial Average (DJIA) climbs to an intermediate high, the Dow Jones Transportation Average (DJTA) is expected to follow suit within a reasonable period.

The subsections following considers the six primary components of the Dow theory.

(I) The market discounts everything

The Dow theory operates on the efficient markets hypothesis (EMH), which states that asset prices incorporate all available information.

Earnings potential, competitive advantage, management competence—all of these factors and more are priced into the market, even if not every individual knows all or any of these details. In more strict readings of this theory, even future events are discounted in the form of risk.

(II) The market behaves in trends

Dow has classified the observed trends into the following three types:

- **Primary trend:** The primary trend is defined as the big picture trend that is in play for at least one year or more. The primary trend can be visible more on the higher time frames like the daily and weekly charts. The primary trend usually includes extensive price movements that are going to move at least 20% or more.

- **Secondary trend:** The secondary trend or the intermediate trend is a counter-trend move against the primary trend. The secondary trend is smaller in duration, usually lasting between three weeks and up to three months.

- **Minor trend:** The minor trends work the same way the secondary trend works in relationship to the primary trend. These are minor up and down moves that can last anywhere between three days to three weeks. According to Charles Dow, the minor trends are primarily seen as the day to day noise.

The view is that the weekly time frame should be used to determine the primary trend, the daily chart to determine the secondary trend and intraday charts to determine the minor trend. When there is an alignment between these three trends, a trading opportunity may exist.

(III) Primary Trends Have Three Phases

A primary trend will pass through three phases, according to the Dow theory.

In a bull market, these are the accumulation phase, the public participation (or big move) phase, and the excess phase. The accumulation phase is the starting point of a new trend where the smart money is buying into a share. Then the share starts pushing up, which attracts the eye of the general public aka the retail traders. At this stage, everyone starts to pile in before the peak point is reached. Uninformed investors continue to buy while at the same time, smart money sells their shares which forms the excess phase.

In a bear market, they are called the distribution phase, the public participation phase, and the panic (or despair) phase.

(IV) Indices Must Confirm Each Other

For a trend to be established, Dow postulated indices or market averages must confirm each other. This means that the signals that occur on one index must match or correspond with the signals on the other. Suppose one index, such as the Dow Jones Industrial Average, is confirming a new primary uptrend, but another index remains in a primary downward trend. In that case, traders should not assume that a new trend has begun.

For example, a rise in the Dow Jones Industrial Average (DJIA) might suggest, the railroads would be profiting from moving the freight this business activity required. If asset prices were rising, but the railroads were suffering (the Dow Jones Transportation Average (DJTA) decreases), the trend would likely not be sustainable. The converse also applies: if railroads are profiting, but the market is in a downturn, there is no clear trend.

(V) Volume Must Confirm the Trend

Volume should increase if the price is moving in the direction of the primary trend and decrease if it is moving against it.

Low volume signals a weakness in the trend. For example, in a bull market, the volume should increase as the price is rising, and fall during secondary pullbacks. If in this example, the volume picks up during a pullback, it could be a sign that the trend is reversing as more market participants turn bearish.

(VI) Trends Persist Until a Clear Reversal Occurs (Trends stays in motion)

A trend is assumed to be intact until it has given definite signals that it has reversed. A trend is more likely to stay in motion than to reverse.

A reversal in the primary trend is signalled when the market is unable to create another successive peak and trough in the direction of the primary trend. For an uptrend, a reversal would be signalled by an inability to reach a new high followed by the failure to reach a higher low. In this situation, the market has gone from a period of successively higher highs and lows to successively lower highs and lows, which are the components of a downward primary trend.

The reversal of a downward primary trend occurs when the market no longer falls to lower lows and highs. This happens when the market establishes a peak that is higher than the previous peak, followed by a trough that is higher than the last trough, which are the components of an upward trend.

One challenging aspect of implementing Dow theory is the accurate identification of trend reversals. Reversals in primary trends can be confused with secondary trends. It is difficult to determine whether an upswing in a bear market is a reversal or a short-lived rally to be followed by still lower lows, and the Dow theory advocates caution, insisting that a possible reversal be confirmed.

Take Note

Charles Dow relied solely on closing prices and was not concerned about the intraday movements of the index. For a trend signal to be formed, the closing price has to signal the trend, not an intraday price movement.

3.3.2 ODD LOT THEORY

Odd Lot Theory is a theory of technical analysis based on the assumption that odd-lotters (small investors who deal in fewer than 100 shares at a time) are poorly informed and have a low-risk tolerance. Therefore small individual investors are always wrong, and it is a good idea to trade contrary to their trading patterns. By identifying the least-informed investors and making investments opposite to them, the market can be outperformed.

The odd lot theory suggests that it is essential to find out information about groups of less than 100 because such investments are usually not made by professional investors. The method of finding out the daily record of odd lots is by gathering information on the number of shares which are purchased each day, those which are sold in the market and also those shares which are sold short.

The theory suggests that by charting out the ratio of odd purchases to odd sales, it is possible to find out the direction of prices because it indicates the buying activity of the common man. If the odd purchases are less than the odd sales, then it suggests that there is a positive purchase, on the other hand, there can be a negative purchase also. The odd purchases minus the sales are shown in a chart against a market index.

Once the direction of the buying activity of the common man is ascertained, the theory recommends making investments opposite to them to outperform the market.

3.4 TOP-DOWN VERSUS BOTTOM-UP

Top-down investing means making investment decisions based on the outlook for the economy and what that is likely to mean for individual assets. A top-down investor would begin by analysing what trends they expect to see in areas such as growth, inflation, interest rates and currency movements. These are macroeconomic trends. Hence top-down investing is also known as macro trading. The investor then looks for ways to profit from these developments.

Bottom-up investing, sometimes known as stockpicking, is very different. The investor focuses on individual securities rather than broader trends. For example, they might invest in a share because they believe that it offers an attractive dividend yield that is likely to rise over time. Or they could expect it to improve profitability by selling off poor-quality parts of the business and focusing on what it does well. The performance of a company will depend on the overall economy to some extent so that bottom-up investors may give some weight to macroeconomics. But their strategy involves understanding the company rather than forecasting the economy; they won't buy a share purely to play an economic trend.

3.4.1 So which approach makes the most sense?

In some areas, such as currency trading or commodities, a top-down approach is a primary way to trade where returns are entirely dependent on macroeconomic factors. The bond markets tend to be macro-focused, but there are niches where a bottom-up approach dominates because the choice of individual securities is crucial. These include distressed-debt investing (buying bonds in companies that are in trouble) and some high-yield bond strategies (purchase bonds in the riskier companies).

Shares are the main asset class where investors have a choice of a top-down or a bottom-up approach. More equity managers tend to be stockpickers (or at least claim to be), but there is no shortage of funds that focus on significant trends and themes. What's more, the growing number of sector and thematic exchange-traded funds (ETFs) makes it easier for investors to invest using the top-down approach.

However, while top-down investing may seem to be more straightforward (it means less digging around in accounts), it may be significant that almost all notable equity investors have been bottom-up investors. Macro trading is undoubtedly more challenging than it looks.

3.5 COST AVERAGING

Cost averaging involves making regular investments in the market over time. The benefit of this strategy is that it avoids the pitfalls of trying to invest in the market at the right time.

When investments happen regularly, the investor captures prices at high and low levels. More shares will be purchased when prices are at low levels, and fewer shares will be bought when prices are at high levels.

These periodic investments average out the per-share cost. Depending on the currency, the share trades in, it will be referred to as Rand Cost Averaging (RCA), Dollar Cost Averaging (DCA) or Pound Cost Averaging (PCA).

3.6 CONTRARIAN

"Be fearful when others are greedy, and greedy when others are fearful," as stated by Warren Buffett summarises the contrarian philosophy.

Contrarian investing is characterised by purchasing and selling in contrast to the prevailing sentiment of the time. A contrarian believes that specific crowd behaviour among investors can lead to exploitable mispricing in securities markets.

For example, widespread pessimism about a share can drive a price so low that it overstates the company's risks, and understates its prospects for returning to profitability. Identifying and purchasing such distressed shares, and selling them after the company recovers, can lead to above-average gains.

Conversely, widespread optimism can result in unjustifiably high valuations that will eventually lead to drops when those high expectations do not pan out. Avoiding (or short-selling) investments in over-hyped investments reduce the risk of such reductions. These general principles can apply whether the investment in question is an individual share, an industry sector, or an entire market or any other asset class.

In short, a contrarian seeks opportunities to buy or sell specific investments when the majority of investors appear to be doing the opposite, to the point where that investment has become mispriced.

TOPIC 4 MARKET THEORIES

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe what is meant with the term market theory.
- Describe four market theories
- Explain the relationship between portfolio style, investment strategy and market theory.

4.1 INTRODUCTION

Market theories attempt to explain the workings of financial markets, including the determination of prices. However, some market theories also explore the actions of investors in the markets. A market theory is an attempt to impose a framework on which portfolio styles and investment strategies can be built.

While it is useful to know these theories, it is also important to remember that no unified theory can explain the financial world. During specific periods, one theory seems to hold sway only to be toppled soon after. In the financial world, change is the only real constant.

The following sections consider these market theories:

- Efficient Market Hypothesis
- Fifty-Percent Principle
- The Greater Fool Theory
- The Rational Expectations Theory

4.2 EFFICIENT-MARKET HYPOTHESIS (EMH)

This hypothesis states that asset prices fully reflect all information available to the public. According to the EMH, shares always trade at their fair value on exchanges, making it impossible for investors to purchase undervalued shares or sell shares for inflated prices. Therefore, it should be impossible to outperform the overall market through expert share selection or market timing, and the only way an investor can obtain higher returns is by purchasing riskier investments.

The primary outcome of this theory is that price movement is random and do not follow any patterns or trends. This means that past price movements cannot be used to predict future price movements. Instead, prices follow a random walk - an inherently unpredictable pattern.

There are essentially the following three forms of the EMH:

1. **The weak form of the EMH:** This form claims all past market prices and data are fully reflected in asset prices. The implication of this is that technical analysis will not be able to consistently produce excess returns, though some forms of fundamental analysis may still provide excess returns.
2. **The semi-strong form of the EMH:** This form asserts that all publicly available information is fully reflected in asset prices. The implication of this is that neither technical nor fundamental analysis can be used to produce excess returns.
3. **The strong form of the EMH:** All information, public and private is fully reflected in asset prices. The implication of this is that even insider information cannot be used to beat the market.

There are many challenges to the EMH:

- *The existence of stock market anomalies:* Stock market anomalies are inexplicable patterns in asset price returns which happen regularly and is an expected and known phenomenon in the stock market. Examples are the shares of small firms offering higher returns than those of large ones and the 'January effect', which shows that higher returns can be earned in the first month of the year.
- *Behavioural finance*: Behavioural finance examines the psychology underlying investors' decisions. This is used to explain phenomena such as share price over-or under-reaction to new information. It implies that there are areas of predictability in the markets and that contrarian strategies of buying losers and selling winners can generate superior returns.

4.3 THE RATIONAL EXPECTATIONS THEORY

The rational expectations theory is different from the efficient market hypothesis in that investors act as to what they see is what to expect in the future. An investor will only spend on investment according to what he rationally believes will take place in the future.

If the investor notices that a share is undervalued, he will buy it; other investors will also buy in since they saw him buying an undervalued share. If a lot of investors are influenced to buy that undervalued share, then its market price will push up. The investor creates a self-fulfilling prophecy that helps bring about the future event.

4.4 FIFTY-PERCENT THEORY

The 50% principle is usually applied in short term investments. It predicts that before continuing an observed trend will undergo a price correction of one-half to two-thirds of the price change. This means that if a share has been on an upward trend and gained 20%, it will fall back 10% before continuing its rise. This is an extreme example; as most times, this rule is applied to the short-term trends that technical analysts and traders buy and sell on.

This correction is thought to be a natural part of the trend, as it is usually caused by skittish investors taking profits early to avoid getting caught in a real reversal of the trend later on. If the correction exceeds 50% of the price change, it is considered a sign that the trend has failed, and the reversal has come prematurely.

4.5 THE GREATER FOOL THEORY

The greater fool theory proposes that you can profit from investing as long as there is a greater fool than yourself to buy the investment at a higher price. This means that money can be made from an overpriced share as long as someone else is willing to pay more to buy it from you. There are a lot of first-time investors that are fooled with overpriced shares.

Eventually, you run out of fools as the market for any investment overheats. Investing according to the greater fool theory means ignoring valuations, earnings reports, and all the other data. Ignoring data is as risky as paying too much attention to it, and so people ascribing to the greater fool theory could be left holding the short end of the stick after a market correction.

4.6 THE INTERRELATIONSHIP BETWEEN PORTFOLIO STYLE, INVESTMENT STRATEGY AND MARKET THEORY

The adaption of a market theory together with the utilisation of one or more investment strategies can be used to determine the buying and selling signals to follow for a portfolio in line with the chosen portfolio style. In other words, the portfolio style, investment strategy and market theory are combined to create the plan to structure and maintain the portfolio; it is agreed upfront which action will take place in which event.

For example, we believe that the weak form of EMH applies to market behaviour with some market anomalies from time to time (our market theory). Therefore, the portfolio will mostly be actively managed with a smaller part passively managed (the needs of the client determine this split) – this outlines our portfolio style. Fundamental analysis will be followed as the primary investment strategy. Therefore, the portfolio will buy a share if the share is 20% undervalued, and it will be sold when the market price equals the intrinsic value.

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