To trade, or not to trade?

Whether a fund is run actively or passively the question of balancing between faithfully following the model or process and incurring trading costs is a perennial one. Although it might seem that traditional market capitalisation trackers might not have a problem with this in practice they are faced with many of the same issues as active managers when it comes to index rebalancing, new issues, rights issues and other corporate actions.

At the heart of the dilemma is the question of determining if the additional costs of trading will be recouped by a better return in the long run. Some hard-line adherents of traditional trackers will take the view that the returns are almost immaterial as the objective of the fund is to track its designated index as closely as possible. In the case of new issues that may mean that a tracker fund has to use derivatives to ensure getting adequate exposure in a thin market where stock may just not be available. Active fund managers may find a favourite stock has performed as he or she had hoped, or better, and it now represents a worryingly large percentage of the portfolio. That leaves it exposed to any bad news that might damage the share price or perhaps vulnerable to a forced sale in adverse conditions if he or she is hit with redemptions.

The only thing we know for sure is that trading costs money. Most directly these are the costs of commission and the spread, but also include the indirect cost of foregoing further gains from that share in capital growth or dividends. Reinvesting the proceeds also incurs the costs of commission, stamp duty for UK shares and once again the spread between the buying and selling price. Although this last element is less of a problem in larger, more liquid shares than in smaller tightly held shares it is still a cost.

The alternative is to ride with the discrepancies between what allocation the portfolio should have with what it actually has. This is where traditional market cap trackers gain; they just run the winners and gain from the well-documented momentum effect. Shares that have recently done well continue to do well. Less popular shares fall by the wayside and eventually become a part of the dust in a portfolio.

This is fine in a bull-market. Expensive stocks get more and more expensive and everyone is happy; except those fretting about valuations. The logical conclusion of this was epitomised by the dot com crash in 2000 when very expensive shares suddenly fell in price awfully quickly.

More recently we have seen corrections on smaller scales and the mechanics are usually the same. Highly valued shares suffer a reduction in growth forecasts which reduces the expected earnings and, to compound the problem, those earnings are now accorded a lower multiple. So the shares suffer a double hit of lower earnings and lower valuation. The only way to avoid that is to not own the shares, which only an active fund can do. A tracker fund has to suffer the consequences unless it weights its portfolio by some measure other than market capitalisation and that usually implies a bias towards a value. That can give it a lower exposure to expensive shares.

A non-cap weighted passive or active fund then has to address the issue of when to reduce an overweight position, no matter how it was created. The simplest way is sell down the position to its model or index weight but that incurs trading costs. An alternative is to wait and use flows into and out of the portfolio to adjust the fund back to its model or index weights. In that way new money is added to the most underweight positon and redemptions are funded by selling the most overweight holdings. In practice running a fund that is a little bit different from its ideal holdings, in other words accepting the tracking error, makes little difference in the short term and means it mimics some elements of a traditional market cap tracker.

Holding on to shares captures the momentum effect in full and then the question becomes how large should that position be allowed to become? Market cap trackers rebalance back to index weights every quarter so there is little danger of any one stock becoming dangerously large, although the index can still become over exposed to one sector as was demonstrated in 2000. The salvation for passive funds though is that they hold so many stocks compared to traditional active funds that their stock specific risk is much lower.

For investors using other approaches a simple solution is to use new money to add to the most underweight positions relative to the model or index. Other investors, without the benefits of new money coming in, are best advised to sit tight and do nothing. Of course, if they hold a wide range of companies their portfolio will tend towards a badly constructed tracker fund, i.e. one with a large tracking error. However, the alternative of trading out just leads to a worse return than the market. And no one wants that.