Briefly Noted

Downside Volatility Determines Trend-Following Profits

Trend-following strategies are designed to give "buy" signals when prices are rising and "sell" signals when prices are falling. The success of such strategies is significantly dependent on the volatility of the underlying asset following the issuance of a signal to buy or sell, according to a recent study. This has a bigger impact than the rules used for determining when signals are issued.

An investor following a trend signal would buy an investment if its price crossed above a certain marker such as a moving average. (A moving average plots the rolling average price on, say, each trading day in the form of a continuous line.) Once the investment's price falls back below the trendline, a sell signal is generated. The sell signal prompts the investor to either allocate to a risk-free asset (e.g., cash) or short the investment.

The profits from buying the investment will be the same as a buy-and-hold strategy over the holding period following the buy signal. The possibility of realizing higher excess returns from that point on will be dependent on the magnitude of the investment's price decline, when the investment rebounds and the incurred transaction costs.

Associate finance professor Adrian Zoicas-Ienciu gave the following example of the potential outcome following a sell signal: "If the price continues to decline while the investor holds the risk-free asset or shorts the risky asset, the sell signal is correct. If the price rebounds, the investor loses the opportunity of this positive return, records a negative trading cost return and an actual negative return if she shorts during the sell exposure."

This is why the magnitude of the decline following the sell signal determines the profitability of the trend-following strategy. "The more intense and/or longer the downtrend, the more superb the trend-following excess returns regardless of its actual forecasting ability," explained Zoicas-Ienciu.

Such excess returns have historically been episodic. Trend-following worked well during market crashes over the period of 1927 through 2016. Its rate of success, however, was either very high or very low over the 64 subperiods measured. The study's author attributed this as implying that the success of trend-following is primarily dependent on how prices changed over the periods of time measured.

Source: "What Drives Trend-Following Profits?," Adrian Zoicas-Ienciu, SSRN, April 2017.

The Most Active Investors Trade Far More Than the Rest of Investors

The most active investors trade far more frequently than the overwhelming majority of investors do. Clients of a British broker whose trading activity ranked in the top 10% initiated an average of 69 trades per year. This compares to 23 trades per year for the next decile group of investors (those whose trading activity ranked them in the top 80th to 90th percentile). In contrast, the remaining 80% of investors traded an average of just six times per year.

The most frequent traders also committed more dollars per trade then their less active peers. Those in the top decile allocated a median of 1,195 pounds (about $1,528 at April 2017 exchange rates) per trade versus 926 pounds (about $1,184) for the bottom 80% of investors. They also sold far more frequently, an indication of higher levels of portfolio turnover. Sell transactions accounted for nearly 39% of all trades for the most active 10% of investors. In contrast, sell transactions accounted for approximately 28% of trades for the bottom 80% of investors, as measured by trading frequency.

There were common traits shared by many of the most active traders. They were significantly more likely to be men than women. They were comparatively young as a group. (Age was found to a have a negative relationship with trading frequency, with the number of trades decreasing relative to increases in age.) These traders tended to use both the internet and the telephone to place trades. Though the internet was most commonly used to place trades, telephone usage may have been related to accessing advisory services. The study's authors found a positive relationship between using professional advice and more frequent trading.

An age difference also existed in the use of stop losses. The investors who most often used stop losses were "significantly younger on average than investors who did not."

The findings were based on analysis of data obtained from a United Kingdom brokerage firm. This firm was described as having an approximate 6% share of the total UK market as of year-end 2009. Data was provided for 7,200 investors over the period of July 2006 through December 2009.

Source: "Who Trades Profusely? The Characteristics of Individual Investors Who Trade Frequently," Daniel W. Richards and Gizelle D. Willows, Global Finance Journal, 2017.

Workers Are Less Confident About Retirement Than Retirees Are

Workers are less confident about their ability to retire comfortably than retirees are. The Retirement Confidence Survey found 60% of workers described themselves as being confident about having enough money to live comfortably throughout their retirement years. This is not only down from 64% in 2016, it is also below pre-financial crisis levels.

Approximately two-thirds of workers say that they are very or somewhat confident about covering basic expenses in retirement. Only 54% think they will be able to cover medical expenses and just 43% think they will be able to cover long-term care expenses.

One contributing reason for the lack of confidence among workers is a perceived lack of knowledge about how to manage retirement savings. Only 53% say they know how much to save. Just 51% feel comfortable about choosing investment products or funds for their retirement savings. Furthermore, only 52% are confident about successfully transitioning from saving for retirement to being retired.

A bigger factor is savings, or a lack thereof. Only six out of 10 workers say that they or their spouses are saving for retirement. Just 56% say they are currently saving for retirement. Among surveyed workers who provided information about their wealth, 47% said that the total value of their household savings and investments is less than $25,000 versus 35% who have $100,000 or more.

Retirees were far more optimistic. Nearly 80% say that they have enough money to live comfortably. Eighty-five percent describe themselves as having enough money to cover medical expenses. Long-term care, however, elicits far less confidence, with just 55% of retirees believing they have enough money to cover such expenses.

Workers' expectations about when they'll retire also differ from when retirees say they retired. The median planned retirement age among workers is 65. About two out of five workers plan to work until at least age 70. About 48% of retirees say they retired earlier than expected; the median retirement for all surveyed retirees was 62. Hardships such as health problems, disabilities, layoffs and caring for a family members were cited as reasons for earlier-than-anticipated retirement ages.

The Retirement Confidence Survey is the longest running survey of its kind. This year's survey interviewed 1,671 individuals ages 25 and over in the United States.

Source: "The 2017 Retirement Confidence Survey," Lisa Greenwald, Craig Copeland and Jack VanDerhei, Employee Benefit Research Institute, March 21, 2017.

Most Mutual Funds Do Not Outperform

The difficulty of selecting an actively managed mutual fund that will outperform its benchmark in the future was highlighted in reports from S&P Dow Jones Indices. The SPIVA U.S. Scorecard found fewer than 18% of all domestic funds beat their benchmark over the previous 10- and 15-year periods. The Persistence Scorecard found a mere 7% of domestic mutual funds consistently outperformed the S&P Composite 1500 index over periods of three consecutive years.

The two scorecards complement each other, but are separate. SPIVA stands for "S&P Indices Versus Active." It measures the percentage of mutual funds that have outperformed their index benchmarks. The Persistence Scorecard measures the likelihood of a mutual fund whose performance ranks within the top quartile for a given category continuing to stay in the top quartile over the following three and five years. Combined, they measure the ability of an active mutual fund manager to realize higher returns than both the relative benchmarks and peer funds.

As noted above, fewer than 18% of all U.S. domestic funds beat the broad-based S&P 1500 index over the past 15 years. (This is the first time S&P Dow Jones Indices has published 15-year SPIVA data.) Over the shorter period of five years, fewer than 15% of actively managed mutual funds bested the index's returns.

In addition to the issue of returns, the likelihood of a fund investing in the same type of securities (e.g., mid-cap growth), a practice referred to as "style consistency," waned as the period of time measured grew. About three-quarters of domestic funds maintained their style over the past five years. This number dropped to 54% for the past 10 years and just 39% for the past 15 years.

In terms of persistence, just under 20% of the 1,034 large-cap funds in existence as of September 30, 2013, outperformed the S&P 500 index over the next 12 months. By September 30, 2015, just 15.7% of those funds beat the large-cap index. By September 30, 2016, none of those funds continued to consistently outperform the S&P 500. Only real estate (29% for three annual periods ending September 2016) and large-cap value (6%) showed evidence of persistency.

Sources: "SPIVA U.S. Scorecard," April 17, 2017, and "Fleeting Alpha: Evidence from the SPIVA and Persistence Scorecards," Aye Soe and Ryan Poirier, March 10, 2017, S&P Dow Jones Indices.