IHA Consultants

INDEPENDENT HEALTHCARE ACTUARIAL CONSULTANTS, INC.

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IHA Consultants Investment Review

Modern Investment Rules for Individual Investors

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IHA Consultant's Investment Review

Modern Investment Rules for Individual Investors

Today's passive investing silver lining is the promise of low cost and settling for average returns. For those investors seeking excess returns – some degree of active management is required. We would like to explore three rules of modern investing – the ones we believe are most important: 1) diversify, 2) active portfolio management, and 3) stock analytics within the confines of the individual investors investment objective.

Investment Objective

Invested funds strategy utilizes a sufficiently diversified foundation with a top active management layer that seeks out excess short-run return opportunities as well as mitigates losses for portfolio growth.

Rule 1: Diversify

Portfolio growth is generated by buying low and selling high. All that is required is knowledge of: a) which stock(s) are expected to increase, b) the optimal buy/sell price, and c) the optimal buy/sell date.

An individual investor armed with such knowledge would **NOT** diversify and would chose the maximal return trade strategy. Such perfect knowledge is not attainable giving rise to diversification as a means of mitigating risk.

Although most investors accept the wisdom of diversification, they do so inefficiently. The typical investor relies on third party either ETF or mutual fund manager(s) whose asset allocations are inefficient – e.g. over diversified and built using historic data relationships which may or may not be representative of the future. These third-party managers employ static model optimization methods using past data which does NOT guarantee optimization for future periods and fails to model the evolution (dynamics) which is a severe limitation. By relying on the third-party manager, the investor has lost control and is unaware of 'return(s) that were attainable – but precluded by fund policy practice(s).'

Immutable Facts:

Combing asset knowledge and low brokerage transaction fees is all that is required for successful investment.

Either the investor manages the portfolio (full control) or pays someone else to manage it (gives up some control).

Yield is generated by buying low and selling high.

All that is required is knowledge of:
Which stock(s) are expected to increase.
The optimal buy/sell price.
The optimal buy/sell date.

There is a trade-off of diversification and yield. Too much diversification sacrifices yield.

Diversification by itself does not prevent portfolio devaluation.

Passive management NEVER beats the benchmark index return.

Rule 2: Active Portfolio Management as Top Layer to Diversified Core

Most individual investors have experienced mutual fund related portfolio loss as participants in their employers 401(k) or 529 plan. Actively managed funds underperform their passive benchmarks, especially net of expenses.[1]

Actively managed funds can be viewed as having (1) unskilled, (2) zero-alpha, and (3) skilled fund managers, net of expenses, even with cross-fund dependencies in estimated alphas. This separation into skill groups allows several new insights. First, we find that the majority of funds (75.4%) pick stocks well enough to cover their trading costs and other expenses, producing a zero alpha, consistent with the equilibrium model of Berk and Green (2004). Further, we find a significant proportion of skilled (positive alpha) funds prior to 1995, but almost none by 2006, accompanied by a large increase in unskilled (negative alpha) fund managers—due both to a large **reduction in the proportion of fund managers with stock picking skills** and to a persistent level of expenses that exceed the value generated by these managers.

Our study indicates that a large subgroup of investors appear to either be unaware that they are being overcharged (Christo ff ersen and Musto (2002)), or are constrained to invest in high-expense funds (Elton, Gruber, and Blake (2007))

High active share portfolios: If you **want your portfolios to beat the market**, then they should **not look like the market**. Many people have argued this point, but none more eloquently than the legendary Bill Miller. His run of 15 straight years of beating the Standard & Poor's 500 Index is one of the most famous investing streaks of all time. **Miller argues that investors have figured out that 70 percent of all active managers are "benchmark huggers" — meaning they mimic the indexes while charging higher fees.** Investors should either move to pure passive, or if they want an active manager, find someone with a high active share.[2]

As discomforting as this should be to those who seek alpha, **the future wherein enhanced stock picking ability is available for a fund manager or for the individual investor is now reality.**

➡ **Using IHA Consultants stock price prediction analysis web app, stocks with next trade day expected excess returns are identified - as well as identification of optimal buy price and buy date, lastly identification of optimal sell price and sell date. Portfolio downside loss risk is mitigated by daily trade day reporting and monitoring.**

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[1] See, for example, Gruber, Martin, 1996, "Another Puzzle: The Growth of Actively Managed Mutual Funds, *Journal of Finance*; Jensen, Michael, 1968, "The Performance of Mutual Funds in the Period 1945 – 1964, *Journal of Finance*; and Lehmann, Bruce and David Modest, 1987, "Mutual Fund Performance Evaluation: A Comparison of Benchmarks and Benchmark Comparisons, *Journal of Finance*.

[2] Barry Ritholtz, "Active Money Management Isn't Going to Disappear", Bloomberg News, August 12, 2018. High active share means high rate of replacing current portfolio with better gain opportunities by buy and selling stocks.

Portfolio growth is generated by dramatic increase in stock picking skill as a result of using IHA Consultants stock price prediction analysis web app as reported below (see **Exhibit 1 – Abbott Labs, Amazon, Apple, Google and Intel period ending Aug. 10.**):

- Realized individual stock returns ranging from 1% to 14+% over 20 trade-days using **short-run individual stock optimal buy/sell prices and dates.**
- Lower Sharpe ratio stocks (as determined from historic data) can and do produce higher than expected realized returns than higher estimated Sharpe ratio stocks.
- Trade-off exists: weight to capture short-run opportunities (sacrifice some amount of long run yield.) and vice versa.

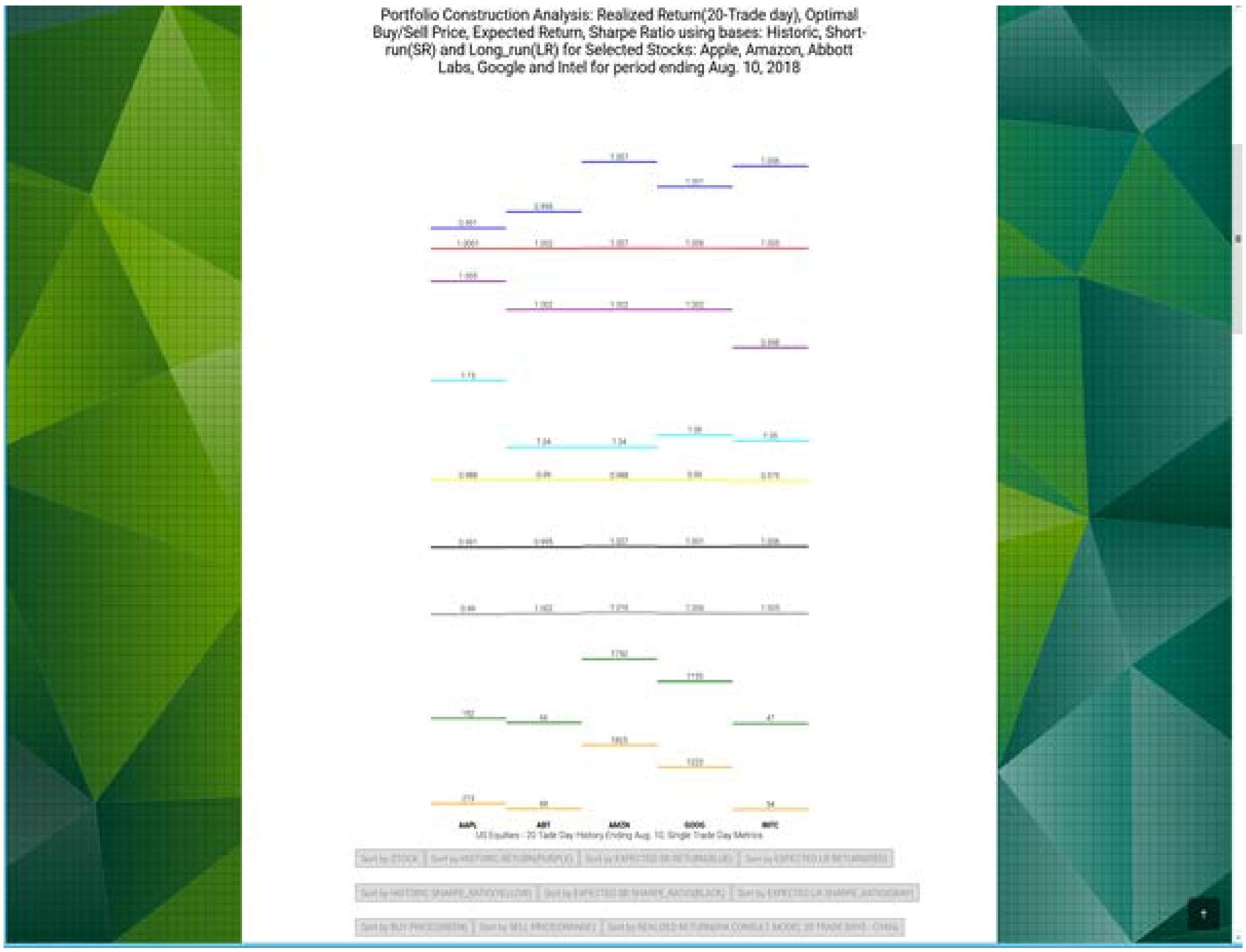

Exhibit 1- (https://devihacluster.com:7443/stockanalysis)

Rule 3: Stock Analytics

Stock picking by fund managers (without analytics) is inconsistent, subject to hot and cold runs and in the end is not up to the task for ensuring funds are put to optimal use. Comparative advantage in trading stocks, in excess of passive returns, will be due to the integration of a combination of stock analytics and stock price prediction modeling. **Stock**

price prediction modeling based solely on big data or on latest technology must surely fail as it cannot fully incorporate human idiosyncratic behavior e.g. irrational expectations.

Without stock analytics and stock price prediction models, the best fund managers could achieve only 0.6% alpha which when netted with expenses vanished or became negative alpha. If we were to include these costs in the calculation of alpha, it is much less likely than even 0.6% that any fund could generate an alpha. Alpha is a long run average statistic and excess returns are fundamentally a short-run opportunity. Only by capturing short-run excess return opportunities can one achieve portfolio growth since in the long run equilibrium will dominate and alpha will be insignificant.

So how do we proceed? The best way to couple current stock analysis with IHA Consultants' stock price prediction web app.

- **Without** IHA Consultant's stock price prediction web app, actively managed funds generate significant turnover, as their managers continually attempt to replace overvalued securities with undervalued securities.
- **With IHA Consultant's stock price prediction web app, actively managed funds generate significant turnover as their managers continually attempt to replace overvalued securities with undervalued securities *AT THE OPTMAL BUY/SELL PRICES*.**

What about Taxes?

Because taxes on capital gains, especially short-term gains, are hardly trivial, we should estimate expected returns, standard deviations, and correlations from after-tax returns when constructing portfolios. That way, we can use optimization to construct portfolios that are tax efficient as well as mean-variance efficient. Moreover, we should harvest tax losses judiciously to offset future gains but, in any event, we'll take a positive after-tax gain opportunity over a potential tax savings since realized potential gain may be more than known tax savings.

Our Closing Argument

Perhaps you cling to the common belief that you are not able to manage your own portfolio more effectively than actively managed funds (mutual funds) or passively managed funds, such as ETFs. If so, the following example should help to cement our case. Exhibit 1 reports the expected and realized returns for 5 representative stocks – Abbot Labs, Amazon, Apple, Google and Intel. Many mutual funds and ETFs hold substantial amounts of these shares. Ask yourself, for a given expected return why would I pay more than I would be required? Intel at $ 47 is optimal over Amazon at $ 1,170 for a 1.006 expected daily return. Why would a fund manager or ETF own so much Amazon stock? The standard answer is due to historic covariance but that may or may not be true in the future. The volatility of Intel stock is very low and therefore the expected maximum potential gain is low. Chances are that you will not lose money owning Intel stock, but you will NOT gain significant excess returns. Without IHA Consultants' stock price prediction web app, it is improbable to capture short-run excess Intel stock gain opportunities which was **5% (pre-tax) in 10 trade-days.**

The realized 20 trade-day returns using IHA Consultants stock price prediction web app ranged from 4% to 6% and Apple as outlier at 15%. Assuming monthly compounding and average monthly (pre-tax) return of just 2% (being conservative by taking ½ of 4%) is equivalent to 26.8% annualized. Moreover, you have the benefit of each day's expected trade range price which guards against downside loss. With online transaction costs around $5 per stock per trade, transaction costs and access to stock trade are no longer barriers.

Doesn't it make sense to have a 20 trade-day rather than a 10-year investment horizon? If you maximize return opportunities over each month for 10 years you are guaranteed (in probabilistic sense) to have a higher return than any other method which claims to be optimal over say annual periods and at the very least match the same result. For the 20-trade days ending Aug 10, the average index fund returned 1% with many negative. Mutual funds fared worse.

A common myth in the industry is, "It is very hard, if not impossible, to justify active management if your goal is to grow wealth." This same myth is then used a second time to justify passive low-cost investment strategies. **The root cause is insufficient skill in stock selection combined with excessive administrative fees**. Passive investment minimizes the administrative cost to the detriment of capturing short-run excess return opportunities and settles for the index return. **In 2008 fiscal crisis, passive invested strategies were crushed as the whole as the market sagged. Active strategies had a chance of mitigating losses but for the most part also failed**. **If, on the other hand, you as individual investor or as a fund manager used IHA Consultant's stock prediction web app, the optimal sell indicators would have been reported in 1 trade-day and continuously thereafter. You would have had full control to execute brokerage trades and safeguard your portfolio.**

Legal Disclosures:

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