

Winning in the Financial Crisis

In my previous August article „Beyond Warren Buffett“ I highlighted the possibility of achieving some decent gains in the Commodities market in a period when stock markets have been dwarfed by the widespread financial crisis.

This held true in the first part of this year but, as predicted by the likes of Marc Faber (Culpan, 2008), as early as June commodities experienced a strong correction; from July till all the previous gain achieved this year have been erased. The graph below is highly illustrative of what has happened to the main commodity indexes (UBS Bloomberg CMCI, S&P GSCI, RJ/CRB, Rogers):



Commodities Indexes: Data Bloomberg 7 October 2008

The Rogers International Commodity Index (RICI developed by legendary investor Jim Rogers) is currently in negative territory for 2008 with -5.52% performance, whilst the RICI Agriculture lost 25.78% year to date (ABN Amro, 2008).

In an even more dramatic scenario investors in the OPTA ETN notes issued by Lehman Brothers and linked to the performance of the Lehman Brothers Commodity index are now worthless as the issuer is now insolvent. As a „mea culpa“ I did indeed mention the Lehman Brothers Commodity Index Total Return Pure Beta in my „Beyond Warren Buffet Article“ (in the unpublished draft and not in the published final abridged version) and even went as far as saying that issuer risk is usually minimal.

In the current precarious and highly leveraged financial situation that affects many banks this idea of low issuer risk no longer holds true.

Is this the end of the commodity bull market? According to Jim Rogers (Onsanit, 2008) this big correction is to be seen as a buying opportunity and is not the end so long as the supply/demand balance is not greatly modified and the World's economy does not collapse.

However, there are exceptions to the generally negative situation and not all commodities have been doing so poorly. Gold for instance, famous as a safe haven when confidence in everything else is scarce, has returned a pretty respectable 10.70% over the last 12 months (ZKB, 2008).

That said, can I still recommend a non-leveraged investment in the commodity market ? Not to the faint of heart. Volatility is likely to stay high across commodities.

The majority of people are naturally risk averse (Davis, L. E. & North, D. C. 1971, p.19), and not just small investors. Institutional investors are too constantly looking for solutions to insure risk. This desire for a more calculated risk explains the widespread popularity of credit default swaps to protect a buyer from a possible issuer default. (Maginn. J.L. & Tuttle, D.L., 2007, p.389)

Can we really avoid risk in financial market? Classical capital market theory suggests that above average returns are not achievable without embracing above average risk (Vaga, 1994 p.190), hence we could consider ways not to eliminate risk but to minimise it.

Given our natural risk aversion we could infer that an ideal investment provides above average returns with limited risk.

In terms of picking shares directly and creating a balanced and profitable portfolio this not to all easy. The main limitation is represented by investors' tendency to sell low and buy high. This occurs because, under fear, we tend to sell (Peterson, 2007 p.86) and, under the enthusiasm of previously high returns, we buy too high.

As a result of insufficient financial markets expertise, many small investors are entering the markets via mutual funds. The benefits, using the words of Vanguard Fund John Bogle (1993), are fourfold: a) diversification b) professional management c) liquidity and d) convenience.

Many of these principles are obviously correct: it is almost impossible to achieve a broad diversification in any asset class with a small amount like \$2000 without a fund. Likewise the majority of non-professional investors have little time to follow their investments, whereupon convenience assumes an important role. Another element I wish to add is frustration: managing your own portfolio of stocks can be frustrating in bad times. Some investors might even see a failure in their portfolio as a personal failure in selecting the wrong investments.

Some legendary investors like Warren Buffett go as far as saying that not even fund managers can beat the Index (Wiederman, 2008) and therefore recommend that the many of us with little time should invest in an index, i.e. a passively managed fund.

Yet in a bear market like this is an Index fund like the Vanguard 500 (as advised by Buffett) a good opportunity ? My answer is "no." A year to date performance of -26.87% (Morningstar, 2008) and a 5 years average return of 2.22 annualised is anything but impressive.

I have recently compared the performance of several investment funds in Switzerland (mutual funds are here simply called investment funds), and surprisingly one category of funds emerged as a winner: Real Estate Funds.

Swiss Real Estate Funds function in a similar way to Real Estate Investment Trusts: essentially you are not buying quotas of a fund investing in real estate companies but part of fund that owns and managers a number of properties. You are co-owner of a small (or large) fraction of their real estate portfolio.

These funds usually return a good cash distribution that comes from the rented properties and, depending on their new NAV valuation, sell at an higher premium.

Two examples are well worth mentioning as winners in this gloomy market:

Mi-Fonds (CH) Immo A from Migros Bank invest mostly on Swiss residential properties and returned a very respectable 6.93% YTD (including the 3.8% annual distribution). Over the last five years it returned an annualised 5.53%, always outperformed the benchmark and never closed a year with a loss. This fund trades with an Agio of 14.79%. Agio is the premium from its NAV. In simple words it trades at a higher price than the value of its properties, as is common in a good fund. The total expense ratio is at a modest 0.57% (Migrosbank, 2008).

Swisscanto (CH) Real Estate Fund IFCA is also heavily concentrated on residential real estates (86% of the total portfolio) and returned an impressive 13.55% YTD. The annual average since launch is similar to the one of Migrosbank at 5.08% annualised. The all in one fee is again a reasonable 0.60% per annum.

As a comparison, note that the standard saving account in Switzerland pays 1 to 2% per annum, so gaining double that, when equity funds have lost on average 20% and even bond funds are in negative territory, is certainly positive.

Obviously property, given the U.S. crisis, is not a good investment everywhere.

The Swiss situation is fairly particular. First, Switzerland is still mostly a rental market. Only 37% of the Swiss population live in their own property (Postfinance, 2008). Second, the ownership of properties by foreigners, beside some exceptions in tourist areas, is highly restricted. In essence only Swiss citizens, EU residing permanently in Switzerland and other Swiss permanent residents can buy property.

Outside Switzerland the situation varies, but in many countries, like Japanese REITs the losses have been substantial. The Japanese REITs index, to which US investor can participate via an ETN issued by Northern Trust, has lost 30.30% (Nets ETF, 2008) in the last three months and is currently trading at a 7.74% discount.

U.S. based REITs are not doing as badly as we would expect. The Vanguard REIT Index Fund Investor Shares (VGSIX) lost 11.34% this year but has achieved a 12.93% 5-year annualised return that is well above the S&P 500 (Vanguard, 2008). Essentially it lost less than the S&P 500 this year and returned a much better performance over the last five years with lower volatility.

Final words

Real Estate Investment Trusts or Real Estate Funds (that hold proprieties or quotes of another REIT and not stocks of Real Estate companies) are usually a good investment. Their rental income translates to an annual cash distribution and they do not require of the investor any particular expertise in the real estate market. Obviously you should pay attention to the fund provider, his previous performance and portfolio, but, once the choice is made these funds can beat, especially in dire times, stock indexes. For personal investments, as my colleague and friend Dr. Roy Damary often suggests in the class, the most important investment an individual should think of is buying their own flat/house. One lesson learned in this turmoil is that if you employ little or no leverage in your purchase you will not be impacted by the financial crisis. If you do not yet own your propriety, you should save towards this end with CDs or a traditional guaranteed saving account. If you have extra cash to invest in real estate, investment trusts are an interesting opportunity, especially in Switzerland. Winning in this financial crisis means not losing and preserving your asset. Over time REITs and properties should help you in achieving this result. Additionally you should consider getting exposure to equities right now. You can easily do this through a mutual fund. The best time to buy is when everyone is selling and not when everyone is buying !

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