

Easy Pickings on The Nairobi Securities Exchange (NSE)

Posted May 2016 by **PK Mwangi**

In identifying how to maximise your return as an investor, while keeping the costs to achieving that return at a minimum, we revisit two sets of contrasting investment styles or strategies, namely

- value (or contrarian) vs momentum investing, and
- active vs passive investing

A value strategy refers to an investment style that involves scouring the investment space to identify undervalued assets that are mispriced and constituting these in one's investment portfolio.

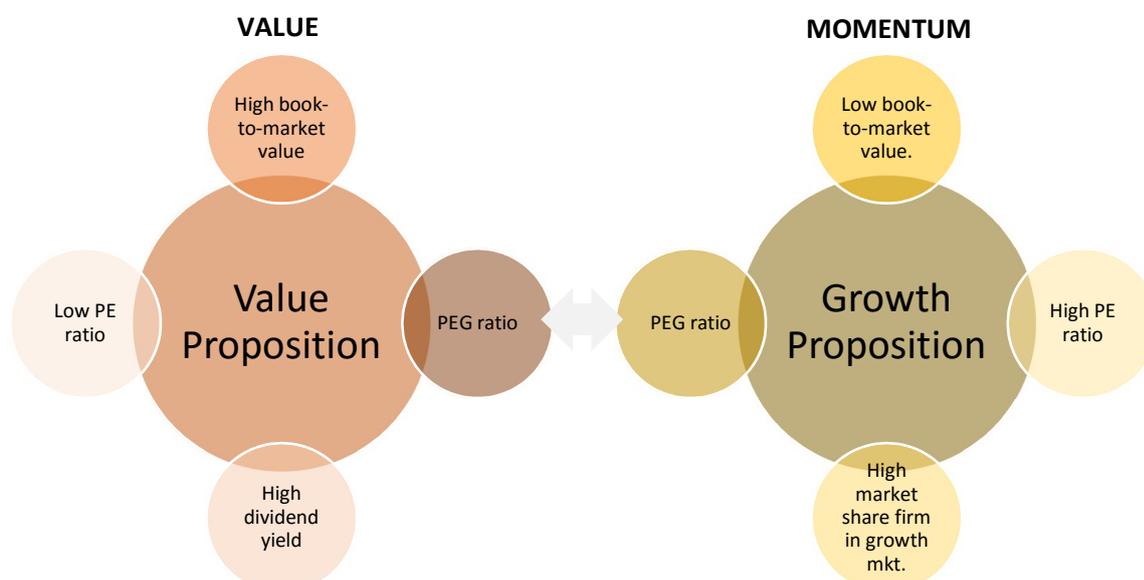
Conversely, a momentum strategy seeks to constitute the portfolio with high growth stocks whose share price is deemed to rise over time. The PE ratio is critical in identifying momentum stocks.

An active strategy seeks to time the market, to purchase or sell mispriced stocks, and ultimately beat the market. In investment circles this is referred to as generating alpha. By contrast, a passive strategy will seek to replicate the performance of the benchmark index by investing in the full array of the benchmark constituents or by replicating such performance via a sampling of the index.

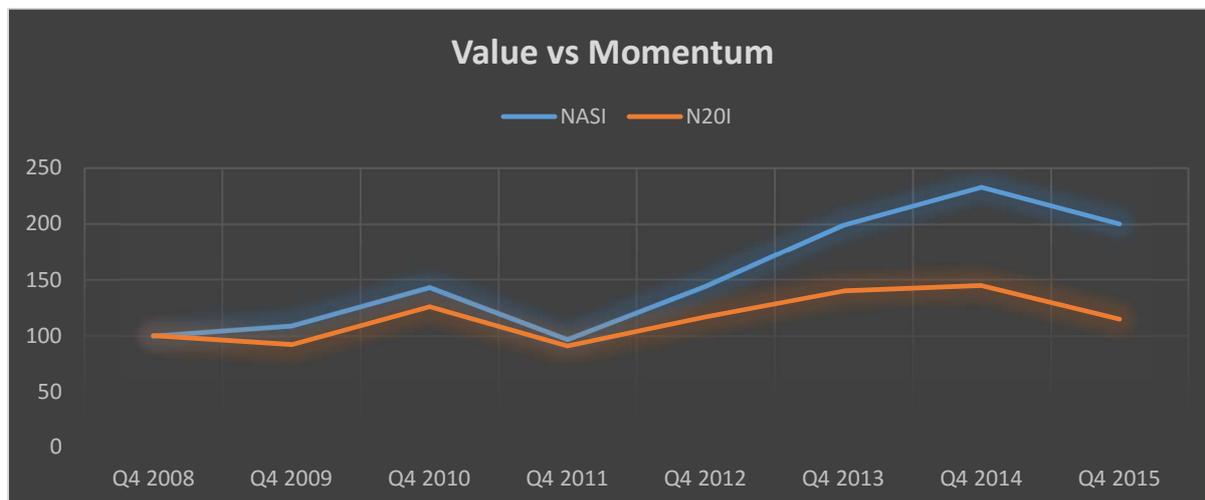
Here we combine these two sets of strategies to derive a hybrid strategy that both ensures a maximising of returns on the stock market but at a minimum cost.

Value vs Momentum

The NSE-All share index (NASI) has as its components all the stocks listed on the NSE Main Market, namely large-cap stocks e.g East Africa Breweries Ltd. (EABL) or Bamburi Cement Ltd. (BAMB), mid-cap stocks like ScanGroup Ltd. (SCAN) and small-cap stocks e.g Marshalls E.A Ltd. (MASH). By contrast the NSE-20 index (N20I) comprises merely the large-cap or largest companies on the NSE (typically blue chip companies).



We took the returns of the NASI and the N20I between the period 2009 and 2015 for comparison purposes. Since the NASI comprises all stocks- large, medium and small while the N20I comprises the large stocks it is safe to assume that the difference in performance between the NASI and N20I inadvertently reflects the performance of the small and mid-cap stocks, a typical value strategy. The performance of the N20I would reflect the performance of a typical momentum strategy represented by firms that hold significant market share in growth or mature industries.



Apart from 2011 when the performances of both the NASI and N20I were nearly exactly matched at +35% and +37% respectively (NSE, 2011) NASI has consistently outperformed N20I over the period under consideration signifying the superior performance of a value strategy.



Timing the market
(taking advantage of short-term mispricing)



The active investor
Stock-picking
(researching individual companies to identify value)



Beating the market
(out-predicting analyst consensus)

Active vs Passive

We further looked at the performance of an actively-managed fund by a leading fund manager in the country (name withheld) for the same period 2009 to 2015. This performance was taken as representative of an active investment strategy on the Kenyan bourse. We compared this performance to that of a passive strategy that 'naively' holds the benchmark index, in this case the NASI. The performances of the two strategies are shown in the graph below.

From the graph, the performance of an active strategy as reflected in that of the active manager appears to be similar to that of a 'naïve' buy-and-hold strategy or passive strategy. However, taking into account both higher transaction costs and commissions inherent in an active strategy seeking to deliver alpha, it is evident that this underperforms a strategy that merely holds or replicates the benchmark index i.e a passive strategy.

The outperformance of a passive strategy is especially evident in the period 2013-15- a period that saw the bull market reach its peak around March 2015.

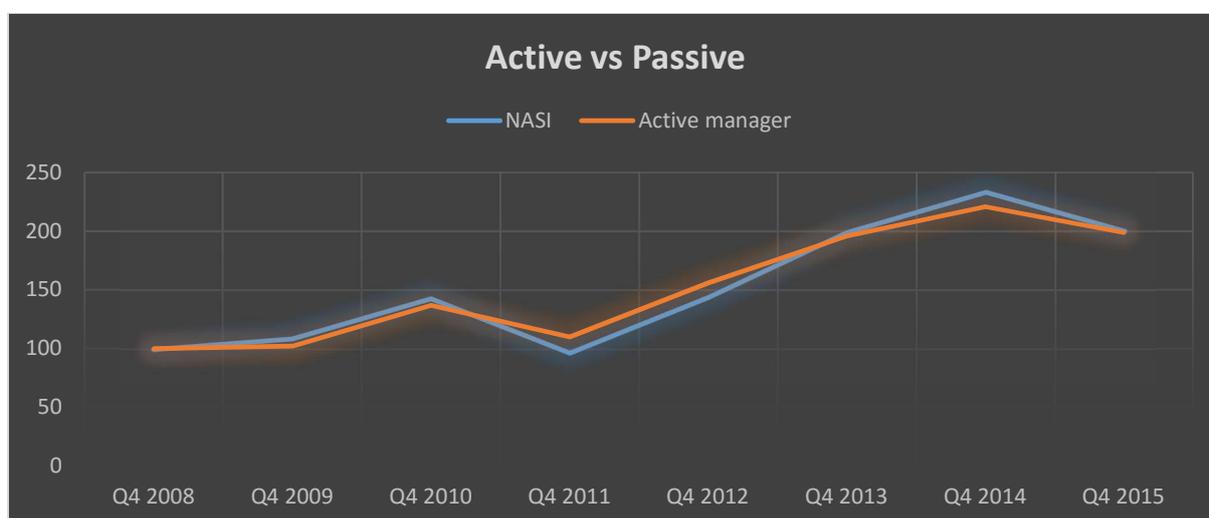


A 'naïve' buy-and-hold strategy

Time the market to identify the bottom

Buy basket of shares similar to the benchmark index

Sell when the market has peaked



Developing a hybrid investment strategy

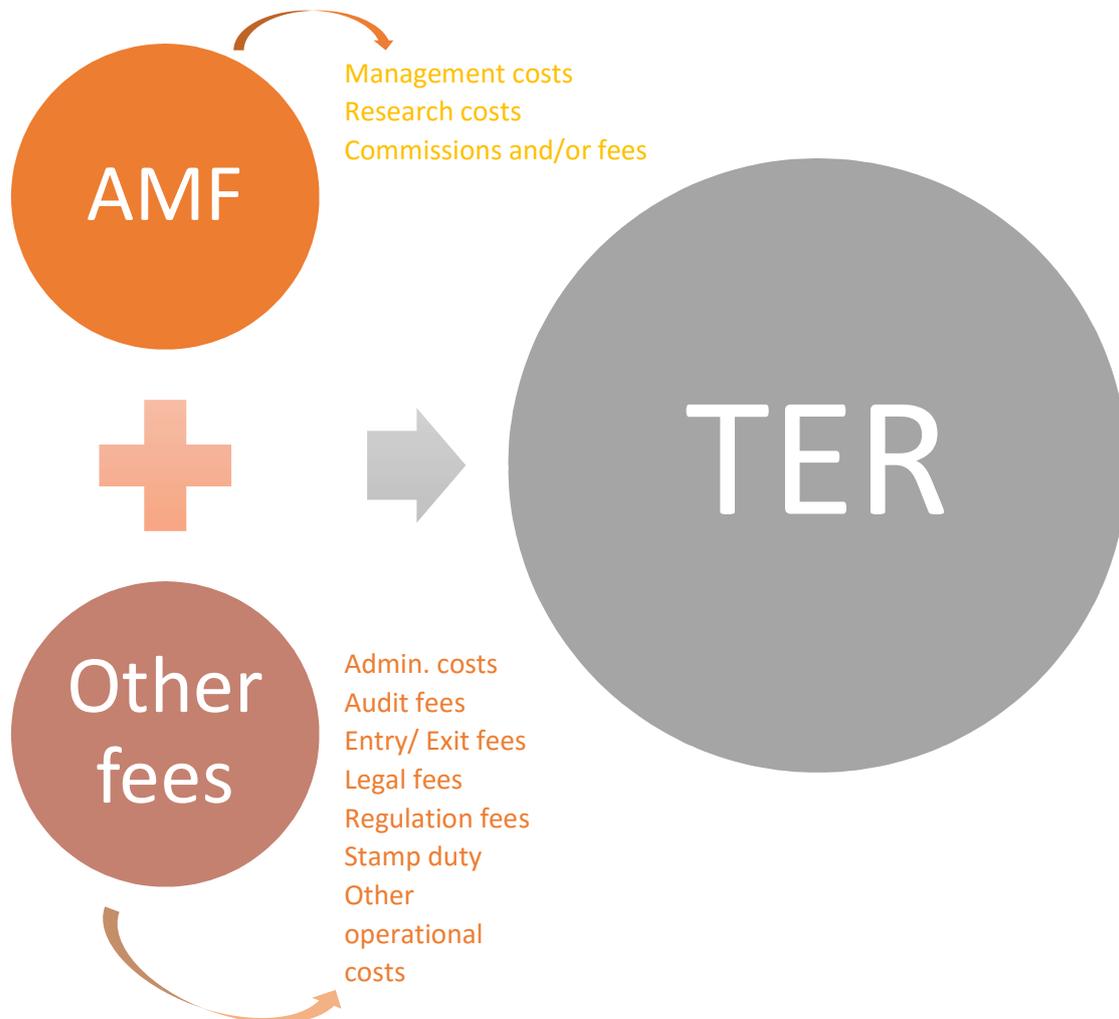
The performances of the two sets of strategies reveal the possibility of developing a hybrid strategy that encompasses the superior nature of both the value and passive investment styles. As an investor, rather than restrict yourself to blue-chip stocks as constituted in the N20I you are better off including the array of small and mid-cap stocks available on the exchange. Coupling this with a buy-and-hold investment style that seeks to identify the market bottom, investing the entire array (or a sample) of investable stocks on the exchange and selling off the same once the market has peaked represents the best way to maximising returns while keeping investment costs at a minimum.

Navigating the cost arena.

Whether investing via the services of a stock-broker or purchasing units in a mutual fund (otherwise referred to as a Collective Investment Scheme), transaction and other costs will eat into an investor's returns. In the case of a mutual fund, the fund will deduct most or all of its costs from overall return before making distributions to its investors (unit-holders). Thus in deciding on the success of an investment strategy and in choosing the most suitable mutual fund the investor will need to take a serious look at stockbroker or mutual fund costs.

Most mutual funds will quote the Annual Management Fee (AMF), which is but only a subset of the total costs the investor will need to factor into his investment decision. Of more and crucial relevance to the investor is the Total Expense Ratio (TER) which includes all fund costs as a proportion of total fund assets.

Unfortunately, fund companies (mutual funds) are not obliged to reveal their TER figures and many will publish only the AMF leaving investors with the mistaken impression that this is all they have to pay. In reality this is not the case.



For more information

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