The Active Fund Investor

Aiming to buy and exit at the optimum time.

ISACO

LET'S GROW WEALTH TOGETHER.

Contents

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Important Information

The value of a fund and the income from it can go down as well as up so you may get back less than you invested. If your fund invests in overseas markets, changes in currency exchange rates may affect the value of your investment. If your fund invests in small and emerging markets, these can be more volatile than other, more developed, markets. Past performance is not a guide to future returns. Due to the greater possibility of default, an investment in corporate bonds is generally less secure than an investment in Government bonds. Default risk is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may therefore vary between different government issuers as well as between different corporate issuers.

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Introduction

Stephen Sutherland.
ISACO's Chief Investment Strategist and author of *How to Make Money in ISAs and SIPPs*.

My name is Stephen Sutherland and my passion in life is investing. I was fortunate enough to have instant success when I first got serious about the stock market. That success early on in my trading career made my love and curiosity for the market strengthen. It's now in my blood and I live, eat and breathe the market 24/7. Some would say I'm obsessed and maybe they are right.

Since setting up our business in 2001, we've spoken to a huge number of DIY investors and what we've learned is that many felt reasonably comfortable selecting which funds to invest in but have problems knowing when to buy and when to exit. We've also found that most investors become uncertain about whether to hold on to their fund once they've bought it, especially if it drops in price just after they've purchased it.

They also tend to get very nervous as soon as it experiences its first major correction – which of course all funds will do. They think, is this normal? Should I sell it or should I hold? What if I sell it and it goes up? What if I keep it and it continues to go lower? You see, when a fund heads south, many private investors have no idea whether the behaviour is normal and healthy or abnormal and unhealthy.

Because of this lack of financial literacy, the uneducated investor will make a decision based on how they feel, which in most cases will unfortunately turn out to be a bad call. The good news is that I'm certain that the guidelines presented in this report will help you to start making better calls with your fund investing.

In case you are wondering, our clients are ISA and SIPP investors who buy funds for their portfolios and most of the people we work closely with have over £250,000 actively invested. If you are an ISA or SIPP investor with over £250,000 actively invested, this report was written especially for you.

Stephen Sutherland
Chief Investment Strategist and author of *How to Make Money in ISAs and SIPPs.*

Aiming to buy at the optimum time

Aiming to purchase at the optimum time starts with looking at the current market direction. Why? The majority of stocks (approximately 75%) tend to move in the same direction as the market. Funds own stocks and therefore funds also move in the same direction as the market. Therefore, even if you are fantastic at picking the best fund, if you are wrong about the trend of the market your portfolio is going to suffer.

Markets work in cycles and consist of a bull and a bear market. Bull markets are the upwards part of the cycle and last between two and four years. Bear markets head downwards and last approximately nine to eighteen months. Because bull markets last longer, the stock market over the long term forms an uptrend. Think of a staircase and think three stairs up (bull market), one stair down (bear market).

Find a fund that's suitable

Once you've completed your analysis of the market, if you believe that it's in a long-term uptrend (bull market), your focus can then move towards finding a fund that matches your risk profile and objectives. We like to focus on the past performance of the present fund manager and we also like to make sure that the manager has proved that they have beaten the market in the past and are beating it right now.

Check its chart pattern

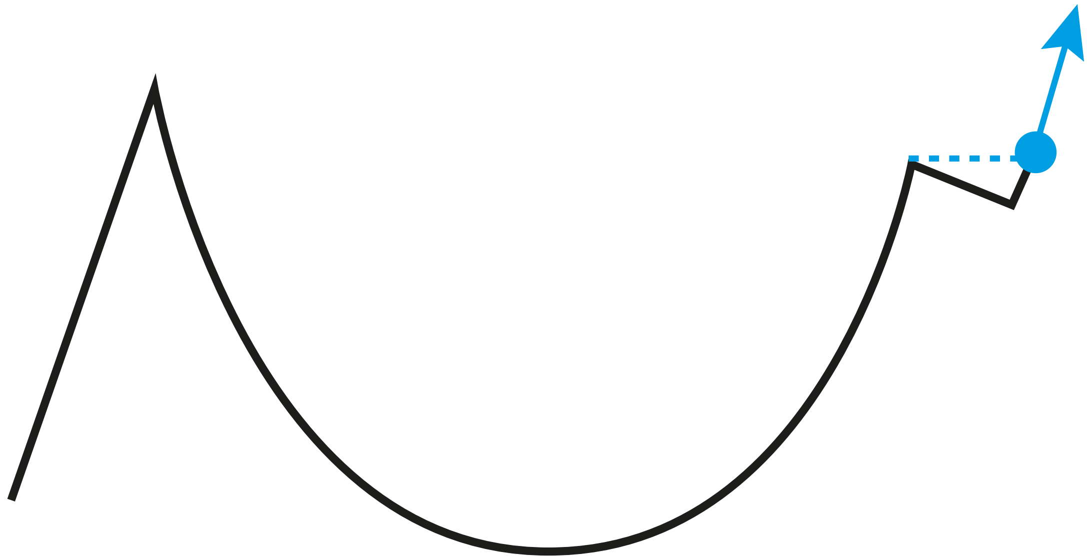
Once you're happy with market direction and you've identified a fund that you like and you feel is suitable, the last part of the jigsaw is aiming to buy at the optimum point. The key is being able to recognise two specific trading patterns as well as determining the proper buy points.Before a fund can launch a big price run up, it must have a solid base pattern to build upon. Base patterns occur when a fund's price falls and consolidates over a series of weeks or months or even years.

Most of them (80–90%) are created and formed as a result of corrections in the general market. Bases typically form after a fund has already experienced a nice increase in its price – also known as an uptrend – of at least 30%. That uptrend is important because it shows you the fund has built up a record of price growth already, and the stocks the fund owns have received support from some big professional investors. There are several kinds of bases that winning funds frequently form prior to a big price run-up.

Let's look at the two most popular:

Cup-with-handle base pattern

Learning to recognise the cup-with-handle pattern on a chart helps you aim to buy in before the fund begins its big run. The cup-with-handle base is one of the easiest patterns to spot – and probably the most powerful. On a chart it resembles a teacup as seen from its side view.



Courtesy of ISACO.co.uk.

During the final stage of the base – after the fund has climbed up the right side of the pattern – it may pull back, etching a downward-sloping handle on its chart. The key is to watch for the fund price 'breaking out' of the pattern, which is the best time to buy.

Three cup-with-handle examples

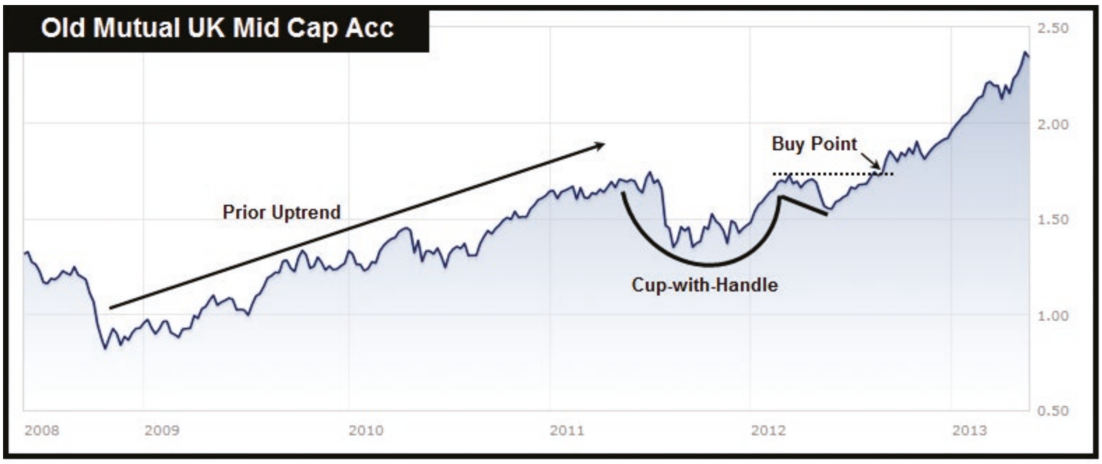


Chart courtesy of Morningstar.co.uk.

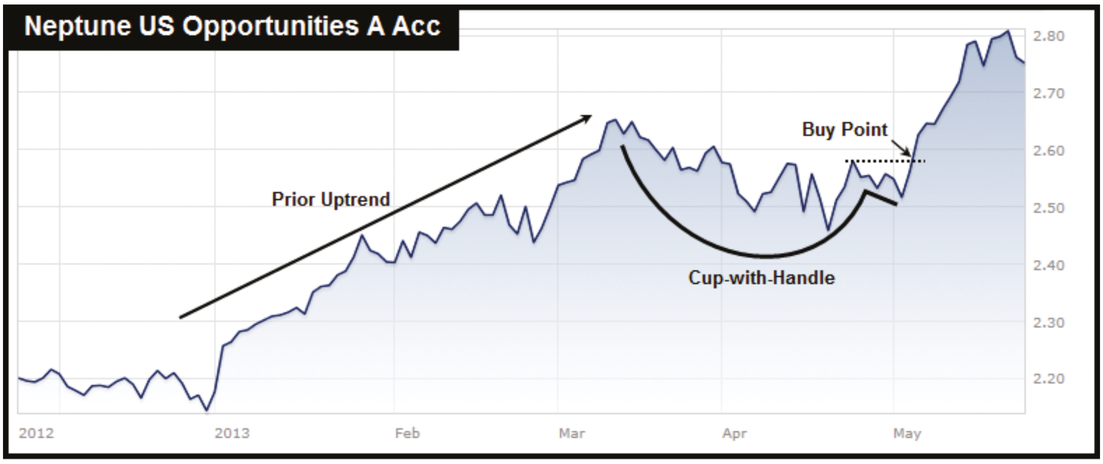


Chart courtesy of Morningstar.co.uk.

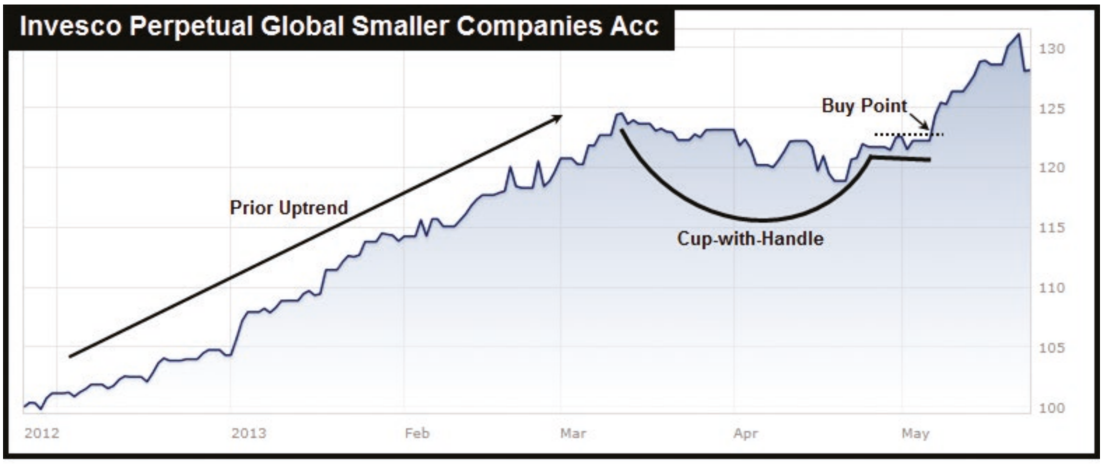


Chart courtesy of Morningstar.co.uk.

Buying at the wrong time

Some investors who learn about cup-with-handle formations ask the question, 'why not buy when the fund is at the bottom of its base at a lower price?' The reason we avoid buying at the bottom is simply because it's too risky. From our experience, we've found that buying at the bottom of the base results in a greater likelihood that the fund will head either lower or sideways (instead of upwards) after purchasing it.

Buying too early

Next, we want to show you two examples of funds we personally owned where we bought too early. The first is the Fidelity Funds - India Focus Fund A-GBP.

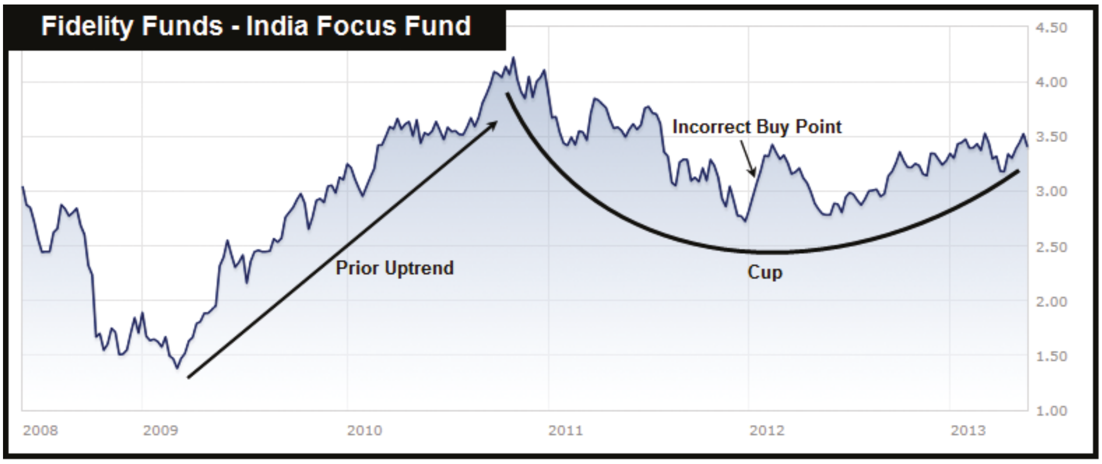


Chart courtesy of Morningstar.co.uk.

We bought this one on January 24th 2012 at a price of 3.12 and sold it on March 11th 2013 at 3.53. Even though we made a 13.1% gain in 14 months, we sold it because when we buy a fund our expectations are for it to outperform the market however, this one underperformed.

The second example of a fund we bought too early is one called the Neptune Russia & Greater Russia A. We bought and sold this fund on exactly the same day that we bought and sold the India fund.

Chart courtesy of Morningstar.co.uk.

This one performed even worse than the India fund and resulted in a 1.6% loss. A loss of less than 2% might not seem that bad but during the period we held it, the market was moving up and so were many funds. These two mistakes were sloppy of us. We very rarely deviate from our rule of aiming to buy funds when they are breaking out into new high ground however, after making the fatal mistake of trying to get in early, it reminded us that trying to buy low is a flawed strategy.

We've found that it's always best to buy when the fund has plenty of upwards momentum and is just about to emerge out of a consolidation pattern, such as a cup-with-handle or a flat base. Let's now take a look at two examples of buying a fund at the right time.

Buying at the right time

The first example is a fund called the Schroder UK Mid 250 A ACC.

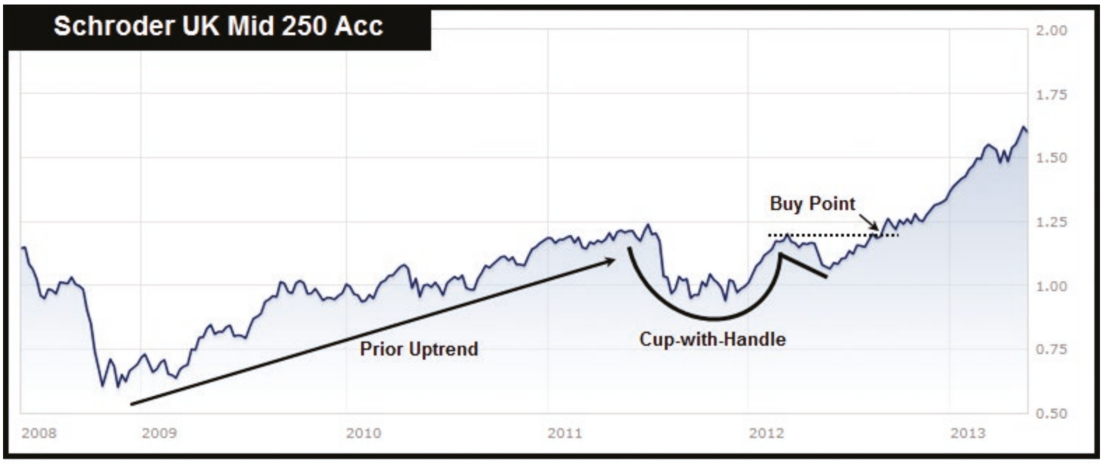


Chart courtesy of Morningstar.co.uk.

We purchased it on July 24th 2012 at a price of 1.31. Notice that we bought this after it had completed its cup-with-handle formation and just after buying, it took off like a rocket. In the first twelve months of owning it, this beauty surged 50.4%.

The Invesco Perpetual UK Growth ACC was purchased on the same day (July 24th 2012) as the Schroder fund, at a price of 3.41.

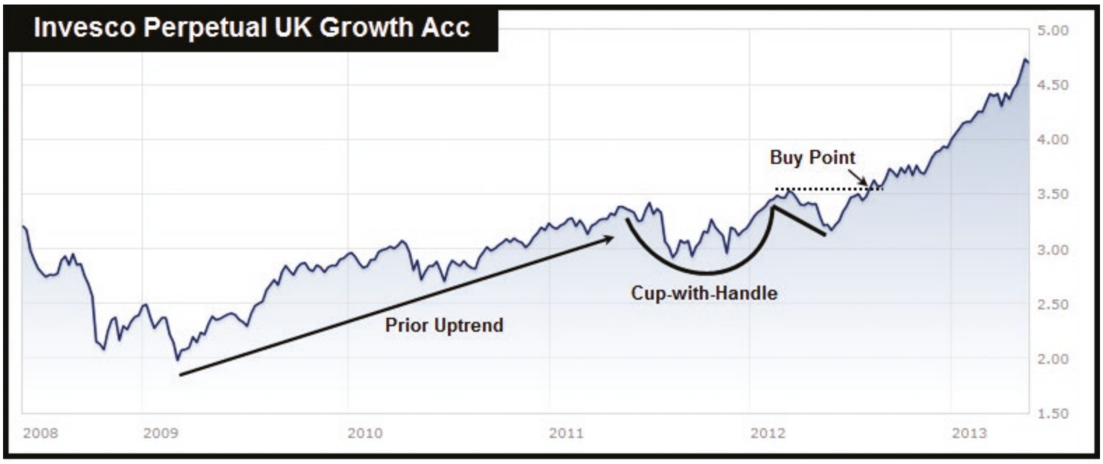
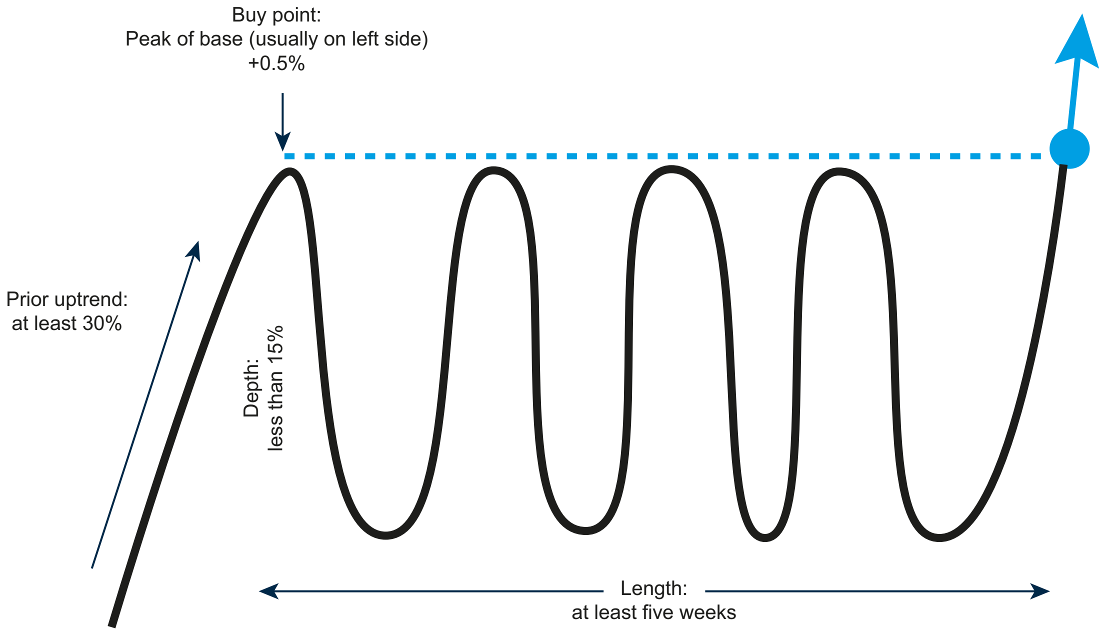


Chart courtesy of Morningstar.co.uk.

Notice once again that we bought it after it had completed its cup-with-handle formation. This darling also made a substantial move in the first twelve months that we owned it, vaulting 43.1%.

Flat base pattern

Though the cup-with-handle base is the most common pattern, there is another type of base to be on the lookout for, which is known as a flat base. Flat base patterns often form quietly, but the gains they launch can be explosive. These chart patterns frequently take shape when the broader market isn't making much upward progress.



Courtesy of ISACO.co.uk.

Flat bases tend to be shallow – no deeper than 15% from top to bottom. And they can form in as little as five weeks, rather than the usual seven weeks required for cup-with-handle bases. Flat bases sometimes occur after a fund rushes up from a previous base, then stalls. As its price moves in a narrow sideways range, its base looks rather flat on a chart. In many cases, the fund is simply taking a break as it consolidates its gains and prepares to head higher.

Think of it as a time when the fund is building up steam to propel its future take-off. To calculate the buy point of a flat base, add 0.5% to the peak, which is usually on the base's left side. That 0.5% is just added assurance that the fund has enough emerging strength to get above its earlier price high.

Three flat base examples

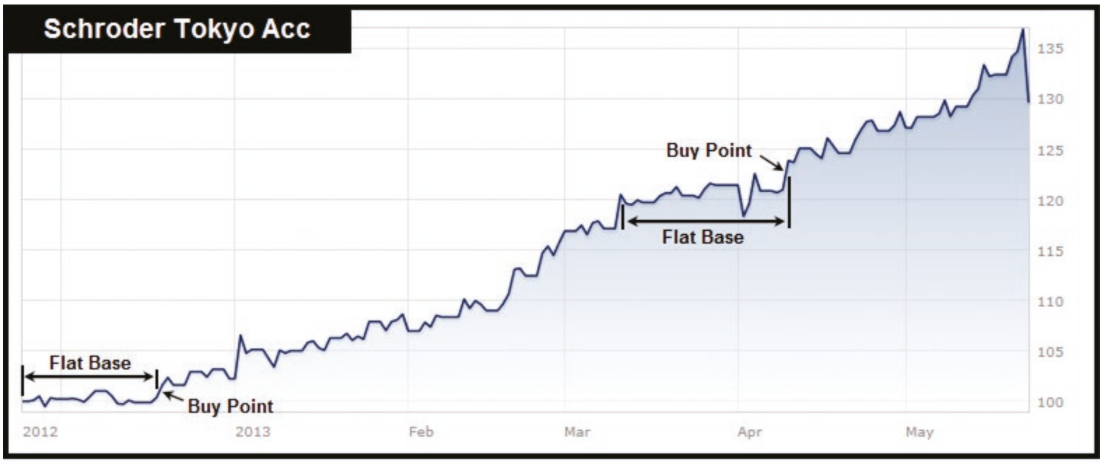


Chart courtesy of Morningstar.co.uk.

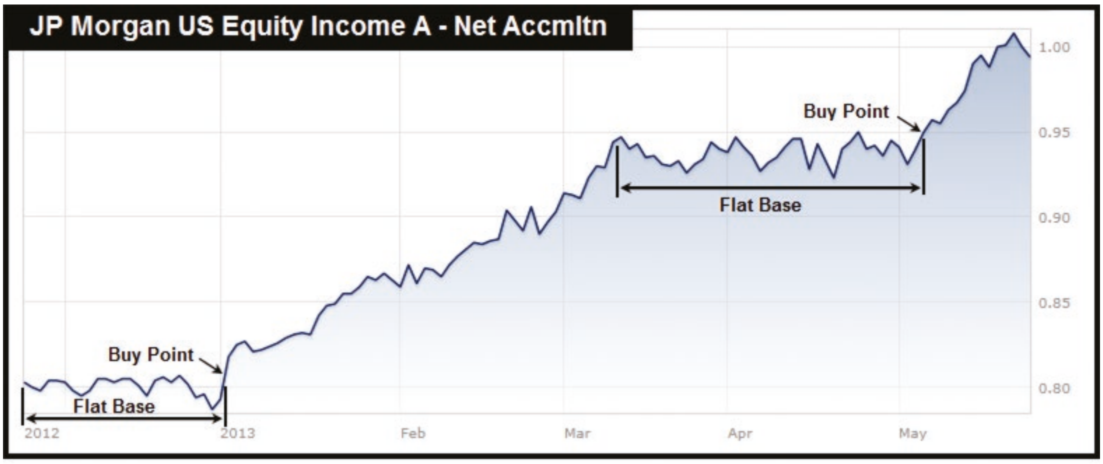


Chart courtesy of Morningstar.co.uk.

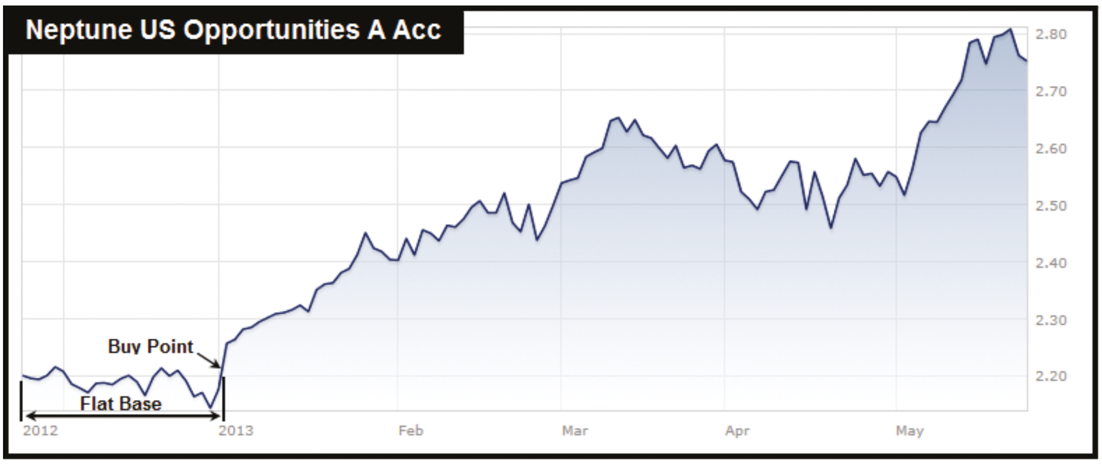


Chart courtesy of Morningstar.co.uk.

Breaking rules is never advisable, but sometimes necessary

Here is an example of when we broke the rules and bought a fund when it was low in price.

Chart courtesy of Morningstar.co.uk.

Buying this fund when it was low in price broke our buying criteria rules however there was a very good reason for doing this – and luckily it did pay off. I clearly remember deciding to purchase it during the 'sub-prime' crash of 2007-2009 and over that period I also recall that there were no funds making 'new highs'. I also remember that the reason we were struggling to find good investment opportunities was because the majority of funds were getting ravaged.

This was simply because the market was clearly in a major downtrend – what many financial commentators refer to as a 'bear market'. At the time, we were stuck with a dilemma because we could see from the price and volume data that institutional investors were aggressively buying into the market weakness. Our experience of previous bull/bear market cycles and how a bear market typically ends told us that it was just a matter of time before the indexes were going to turn around.

And because the data suggested that China was probably going to be one of the leading sectors in the new up-coming bull market, we wanted in. Fortunately by breaking one of our trading rules, we ended up with a significant gain of 64.9% over the ensuing 31-month period. For reference, we bought it December 16th 2008 at a price of 2.14 and sold it at a price of 3.53 July 27th 2011.

Aiming to sell at the optimum time

What is the best way to determine whether you should keep hold of a fund? What signals or signs should you look out for, telling you that all is okay or whether something is wrong? The amateur way is to go by how you feel. We prefer to base our decision on three things: market direction, recent fund performance and the fund chart pattern.

1) Market direction

Knowing if the market is healthy is an extremely useful tool because if the major indexes are in a bull phase, three out of four funds will be moving up in price. However, if they are in a bear phase, three out of four funds will be falling in price. This means that during bear markets it's much harder to find suitable equity based investment opportunities.

2) Recent fund performance

We keep a close eye on how the funds we own are acting on a daily basis and we are constantly measuring to see how our fund is performing versus the market. Ideally, when the indexes rise, our fund will outperform the general market for the day and when the market falls, it will outperform on the downside too.

However, in reality this rarely happens so you have to look at the fund's weekly performance versus the market, its fortnightly performance and its monthly performance too. But don't stop there – also look at its 3 month, 6 month and 12 month performance. We always pay particular attention to how our funds behave when the indexes are rallying and ideally, they'll be making a greater return than the general market.

In a perfect world, the fund should be beating the market and if it isn't, a red flag is raised. If it is doing better than the market, it tells us that it's probably best to hold onto it but if it isn't, and its underperformance is over a significant period of time such as 3–12 months, it usually means that it's time to sell.

Another thing that we do which is worth sharing is watch how the stocks the fund owns are performing on a daily basis. We do this by setting up watchlists on MarketSmith, which is a paid for subscription service and Investing.com, which is free.

Each day we look at how the stocks the fund owns are behaving and if they are beating the market, it tells us all is well, which gives us the green light to stay invested. However, if we see the stocks constantly underperforming, it tells us that it might be time to ditch the fund.

3) Chart pattern

Periodically, we like to check the fund's chart pattern. Why? We want to make sure it's acting right and ideally beating the market. For example, if the market is correcting, the fund might instead be moving sideways rather than carving out a big bowl shape – that's a sign of strength. On the flip side, if the market is advancing and we see that the chart of our fund shows it's been shuffling sideways, that's a sign that it might be time to exit.

It's also good to be aware of certain bearish chart patterns that funds carve out prior to them breaking down, such as climax tops and head and shoulder patterns. A climax top occurs when a fund rises very quickly and gets overextended. During a climax top, funds can make enormous gains in a very short period of time (usually less than two weeks). As an investor you certainly don't want to be one of the last passengers on the train and get quickly thrown off.

The head and shoulders pattern is generally regarded as a reversal pattern and it is most often seen in uptrends. We recommend you Google the term 'climax top' and 'head and shoulder pattern' to discover lots of examples of what these two bearish chart patterns look like.

Selling signals

We always want to know what stocks our fund owns so that we can monitor their activity closely. We ask questions such as, are the stocks the fund owns breaking down? Is the fund as a whole underperforming the market? A good question to ask is, would I buy this fund right now? If you wouldn't, it's probably time to get rid of it. Try to never fall in love with a fund and if it's been underperforming for some time, exit it and don't look back.

Selling an underperforming weak fund you own can be tough. You start to play mind games with yourself and worry that after you sell it, it's going to make a huge move to the upside. This by the way, rarely happens. Weak funds tend to get weaker and strong funds tend to get stronger. The psychological trick we use to get around this is to remind ourselves that we can always get back into a fund at a later date, should it come back to life in the future. This gives us the reassurance that we're not going to miss out if it makes a major move to the upside.

More tips on buying and selling funds

To achieve success, it's important to have clear objectives. For example, one of our goals is to buy a fund that will outperform the market and sell it when it's been underperforming over a significant amount of time. We always like to be aware what market cycle we are in and whether it's a bull or a bear cycle.

Try to adopt an attitude of constant learning and if you really want to get good at knowing when to buy and when to exit funds, read as many books as you can on technical analysis and investment psychology. We also suggest that you make a habit of analysing each and every trade you make and trying to learn from your mistakes.

The easy route

However, if you don't have the time or intention to learn how to improve the buying and selling of your funds, you could take the easy route and get some expert guidance from people who know what they are doing. Subscribe to services that will help you become a better trader and never delegate the investment process to a person or company – ever. Instead, we recommend you always keep full control of your investment decisions but seek out experts who can provide guidance rather than specific and personalised advice.

Aim to find a person or company that you can invest with side by side. We suggest you attend as many reputable investment seminars as you can and subscribe to the best investment blogs you can find. The key is to continue to keep upgrading your skills and knowledge throughout your life and always learn from investors with proven track records.

Final thoughts

I hope this report has provided you with the information you've been looking for.

If you would like some one-to-one help and guidance, feel free to get in touch. Our clients kindly say that my brother Paul and I are incredibly friendly, caring and highly responsive to their questions and requests for help, support and guidance. What's more, if you call or get in touch, I promise that you won't be charged a penny and you won't be passed on to a junior associate. Instead you will speak to me or my brother Paul, the founders of ISACO and two directors of the company.

Email me direct at Stephen@ISACO.co.uk

Or call me on my private line: 01457 831 642.

Your friend,

Stephen Sutherland

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