Tracking the FTSE – A Cautionary Tale

Over the 2013 calendar year the FTSE100 returned 14.4% and in a recent client review the performance of a cautious portfolio returning around 5% was compared against the index – "why can't we have that performance", well of course you can but at what cost?

Any investor with a good adviser and a medium to long term horizon should be well aware of the benefits of diversification – a non-correlated portfolio will have a far greater chance of performance in all weathers, diversification across asset classes (bonds & property etc not just equities) as well as across industrial or geographic sectors is the foundation of a well balanced portfolio. If an adviser were to present a cautious investor with a portfolio of 100 direct equities with 50% of the portfolio in just 13 stocks they would be well advised to question the advisers methods of risk assessment and walk away.

The FTSE100 index has just such a make-up and as an index weighted by market capital, 28% of the index is currently held in just 5 stocks (HSBC, Vodafone, BP, Royal Dutch Shell & GlaxoSmithKline), diversified? No.

As further evidence of the concentration of the index, 30% is comprised from the Oil & Gas and Banking Sectors alone but made up of just 12 stocks – almost a third of the portfolio reliant on performance of just two sectors.

If the index was less concentrated and diversified more equally between its constituents it would have returned annualised performance over 5 years more than a third higher than in its market cap weighting format. An equally weighted FTSE would have outperformed the actual index in 7 of the last 10 years – such is the benefit of diversification.

But if the UK economy is on the up the FTSE100 will reflect this and thus be a good place to invest? True to a point but currently 80% of earnings in the FTSE100 companies is from overseas and 53% of the shares in the constituent companies are held by foreign investors (source: Credit Suisse). The UK's primary stockmarket index is affected dramatically by events overseas and cannot be considered as truly the UK's index anymore.

The FTSE100 is the most prominent stockmarket index for UK investors and will always be seen as a benchmark but as a completely equity driven portfolio, volatility is high and will always be prone to sudden changes in direction – just over a month between 23rd May and 24th June 2013 saw a drop of almost 12% in the index in a good year– hardly a cautious approach.

Investors will always be conscious of the FTSE and its performance but should be more acutely aware of their own risk profile and the long term strategy for their holdings. Long term investment management is not about chasing 12 month returns if it means a portfolio positioned well outside a clients agreed comfort zone. A cautious investor should never have 100% equity exposure and shouldn't benchmark performance to a portfolio which does.

So how adventurous are you feeling?

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