NEW MINERVA REPORT

THE END OF A TREND

We believe that whenever an investment theory becomes universally accepted, the theory will be subsequently disproved. In the 1980's it became universally accepted that smaller companies' shares outperformed larger companies' shares. The academic theses, produced in the 1980's, went back over the past ten to twenty year periods to prove the argument. After the "big-bang" in 1986, and the crash in 1987, the "small company effect" started to crumble.

We have witnessed a number of investment fashions over the past ten years. The 'new' conventional wisdom permeating many investment styles is that of **indexation**. It is estimated that in the US, 30% of the market is index tracking, and in the UK 20% is index tracking. This is passive index tracking. A vast amount, yet to be quantified, in both markets, use the indices as their benchmarks, and vary from the percentages in the indices only marginally. In the UK, we have seen reports from the Financial Services Authority and the Government, which suggest that index tracking is the only cheap and real way to invest in a stockmarket. Due to competition and the regulatory authorities, everything has a benchmark. What easier way to benchmark than to an index. Most investors are interested in absolute returns, not relative returns. Anyone that wants absolute returns now, has to go to the unregulated hedge fund industry, and many of these funds are high risk.

We believe that the theory that indexation is the answer will be in tatters in a few years' time. Look at the performance tables over the past 12 months and you will find that the UK All Companies Sector average performance was up 13.03%, compared with the best tracker up 8.96%, (tracking the All Share not the FTSE 100). In the *Minerva Ratings tables,* the Index Trackers are all in the range between 4.7 to 6.0. (i.e. average.) That is where we would expect them to be. When we analysed prior to 1985, we found that the FT All Share was average. The FTSE trackers over the past 12 months were below average, with the returns from 3.1% to 6.63%.

The reasons why we believe that the end of the tracker phenomenon is nigh are threefold. Firstly, anyone who wants to track is there already, so the cash that has pushed up index stocks at the expense of others, is no longer greater than the rest of the market. It has been this imbalance that has been partly the cause of the trackers' success. Secondly, indices are becoming top heavy. Most indices have shares with the largest capitalisation with the greatest weighting in the index. So in the UK, eight stocks make up 50% of the FTSE 100 Index, with Vodafone AirTouch nearly 15%. When that stock falls, the index will find it hard to make headway.

Finally, and this is especially true of the narrower indices like the FTSE 100, the changes that happen at the bottom end, will adversely affect the index. In the past, the changes were beneficial because the odd duff stock dropped out of the index, like Polly Peck and British & Commonwealth. Now the 'flavour-of-the-month' stocks are being pushed up into the index. Stocks to be sold, will have to be bought by trackers!

UK ABSURDITY

At the beginning of March, the quarterly changes to the FTSE 100 Index were announced: nine new shares in, and nine out. Of the nine in, eight were "TMT" (Technology, Media and Communications) shares, four of which have yet to make a profit. In fact, in the last six months, the markets have been pushing up the share prices of companies who have little in the way of assets, make no profit, and pay no dividends. At the same time, the markets have been pushing down prices of companies with assets, profits and pay dividends. Some reality has been emerging during the last few weeks. We expect the 'real value' theme to become dominant for the rest of the year.

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