

Stock Market Perspective: Real Estate Fund Trading

Several times in past issues I have discussed the potential benefits from adding what are often called “alternative investments” to one’s holdings. A portfolio consisting of only a fund owning a broad selection of stocks, a bond fund, and a money market fund is all that is really needed for meeting longer term investment objectives. That is particularly so if one can avoid owning the stocks or bonds at times when they are suffering significant losses in value, which is a service I provide as I hope you all realize.

However, there are advantages to adding investments that are not highly correlated to broad market stocks and bonds. One is getting away from the feeling that you have “too many eggs in one basket” no matter how closely that basket is watched. In other words, all the types of investments you need may not be all the types you want.

I have traded sector funds as a managed account service from day one; at first only using the Fidelity Select funds and later using the Rydex sector funds. There are several methods with different trading characteristics and risk levels. To some extent sector fund trading is an alternative investment, but it is far from ideal for that purpose. The main reason is that sector fund trading tends to do best when stocks are rising.

A passive approach to adding alternatives such as precious metals, real estate, and overseas investments¹ is establishing a target percentage and

rebalancing periodically when a holding moves too far away from the target. That approach helps in controlling risk and improving returns to a small extent, but my preference is for active methods that identify the best times to own a type of investment. Over the years, I have been researching methods by others and developing some of my own. Not quite two years ago, I found a method for trading gold stock mutual funds that I considered worthy of implementing. I have applied it in some client accounts.

► **Real Estate:** Another type of investment that is considered desirable is real estate. There are a variety of ways for doing so ranging from direct ownership, which is obviously well beyond the scope of my services, to real estate investment trusts (REITs) with varying objectives, to mutual funds that own REITs and other real estate related firms.

I recently developed a trading method for the Fidelity Real Estate Investment fund (ticker symbol FRESX), which primarily owns REITs with several types of objectives. I chose that fund because it has the longest history of the funds I can buy for client accounts. That fund started in 1986, and I have high quality data for it starting in late 1988. The trading method I developed is based on fairly basic trend following. It may apply to real estate funds from other companies, but I have not yet done the analysis.

FRESX has performed quite well. Its compound annual return for the 18-year period 1989-2006 is 14.9%, and its largest drawdown, the percentage drop from a high to the subsequent low, has

¹ The Perspective a year ago discussed how correlations have been changing. In particular, stocks in developed countries’ markets are now highly correlated with the U.S. market.

been 28.2% in late 1999. That may be a bit on the high side for some, and soon we will see how it can be more than cut in half. In comparison to the broad market as represented by the Vanguard² Index 500 fund (ticker VFINX), FRESX has done quite well. For 1989-2006, the return of VFINX was 11.8% and its worst drawdown was a gut wrenching 47.5% in October 2002. Gold funds have been virtually uncorrelated with the S&P 500. The Fidelity Select Gold (FSAGX) fund's comparable values are a 7.8% annual return and a massive drawdown of 69.8% seen at the end of August 1998³. Those values show quite dramatically why that fund and other precious metals funds should not be just bought and held.

► **Trading FRESX:** Given the fine performance of the fund, a natural question is why not just put the fund in the portfolio and forget it. One answer is the old disclaimer that past performance is not necessarily indicative about future returns, so the fund may not do nearly as well in the future. A better answer is taking risk, and maximum drawdown is only one measure, into account and seeing if there is a way to substantially reduce risk without giving up much of the expected return.

² Fidelity's comparable fund, the Spartan 500 Index fund, began in 1990.

³ You likely have seen the math about recovering from losses. A fund would have to more than triple to recover from a drop of nearly 70%. FSAGX managed that with ease and recently has been more than six times as high as the low in 1998. That huge volatility illustrates the potential from a good way to trade that fund.

Adding a real estate fund can help diversify a portfolio, and trading it according to a good model will substantially reduce the risk.

The trend following model I developed meets those objectives quite well. The worst drawdown trading the fund was a quite tolerable 10.7% in March 2003; less than half of the worst one for the fund itself. The “price” for the substantial reduction in risk was reducing the compound annual return for 1989-2006 by less than two percent to 13.2%. The model does not trade frequently, an average of under two per year. Of the 28 trades completed, 17 or over 60% have been profitable. The worst one lost 5.3% while the best made 43.8%.

It is important to point out that the trading model performance shown here is hypothetical and was not done in a real account. Also, the model was developed with the benefit of hindsight. Factors that may have caused me not to follow the model could not have been taken into account. You should not assume that the model will produce the returns shown or will be profitable in the future.

Next we look at a table that compares the annual performance of the fund and the trading model. The Max DD (for drawdown) columns show the largest drops during the year. The overall worst ones cited previously are greater because they spanned more than one year.

FIDELITY REAL ESTATE INVESTMENT FUND				
	Buy and Hold		Trading Model	
	Return	Max DD	Return	Max DD
1989	13.8%	-6.0%	14.9%	-4.1%
1990	-8.7%	-16.9%	-2.3%	-5.7%
1991	39.2%	-3.8%	30.4%	-4.0%
1992	19.5%	-7.0%	15.2%	-7.5%
1993	12.5%	-9.9%	9.6%	-6.8%
1994	2.0%	-13.8%	4.1%	-6.3%
1995	10.9%	-4.8%	2.7%	-5.4%
1996	36.2%	-3.7%	32.6%	-3.7%
1997	21.4%	-8.3%	12.3%	-6.7%
1998	-18.6%	-26.3%	-2.3%	-5.3%
1999	-1.0%	-19.7%	-0.5%	-7.8%
2000	31.4%	-8.0%	28.0%	-7.0%
2001	9.5%	-11.1%	3.1%	-8.0%
2002	5.8%	-17.0%	7.7%	-7.5%
2003	33.8%	-6.9%	30.0%	-7.5%
2004	33.9%	-18.0%	35.1%	-7.7%
2005	14.9%	-11.4%	2.2%	-8.6%
2006	32.8%	-9.6%	27.2%	-7.8%

The table shows how the model significantly reduces risk in most years. The model and the fund had losses in the same three years, but in two of them the fund lost quite a bit more than the trading model. No model year showed a drop of as much as 10% within the year, but eight years saw the fund fall at least as much during the year with five of those worse than 15%.

►Current Status of Model: The model gave a buy signal effective for July 10 of last year and sold the last day of February. The trade made a profit of over 24.5%. Both its profit and length were greater than the average model trade. FRESX has fallen over 12% from its highs in January, and the last 5% was avoided by the model. It has recovered somewhat from its low in early March. If that recovery continues, there could be a new buy signal fairly soon. On the other hand, if the fund does not recover, the model will say to stay out of it. Given the model's history of generating at least one buy signal each year, there is a good

chance we will see one before the end of 2007.

In summary, I think that adding the Fidelity Real Estate Investment fund, particularly using the trading model, to one's portfolio is an effective way to add an "alternative" investment to one's portfolio. By itself the fund adds some genuine diversification since it is only modestly correlated with the S&P 500 index fund. Trading the fund according to the model reduces the correlation, and if the index is also traded by another one of my models, the Triple-40 described in the last issue's Perspective, the historical correlation gets quite low. The gold fund traded using the model I have applied to some accounts is essentially uncorrelated with either the broad stock market or with FRESX traded according to the model.

If you would like to know more or want to consider adding the Fidelity (or possibly another company's) real estate fund traded according to the model to an account I manage for you, please let me know.