Market Commentary

Is Buy and Hold Dead?

A Google search of "buy and hold investing" results in pages of articles detailing how investors cannot possibly hope to make money in stocks without correctly timing the proper entry and exit points of individual securities and/or entire markets. The fringe of the investment industry has launched a barrage of marketing pieces and media appearances touting the "death of buy and hold investing." On CNBC last November a trader named Jeff Macke proclaimed "2008 is the year that will go down in history as the year that long term investment died as a thesis." Another trader named Simon Maierhofer elaborates, "A down trend can be neutralized and even turned into a profit opportunity, by adding short or leveraged short ETFs. If the market decides to move up, extra returns can be squeezed out with leveraged ETFs." While it is clear how the brokerage and investment management industries benefit from advice like this, it is scary to think about small investors gambling with their life savings with these strategies. Larger investors are not spared the assault either. The hedge fund industry, reeling from record redemptions and drowning under high water marks (hedge funds cannot charge performance fees when the returns are merely making up previous losses), has seized upon investor anxiety to press again their solution of better returns through high fees. If one defines buy and hold investing as maintaining a long-term, strategic allocation to stocks, bonds, real estate and other assets and rebalancing around targets then there are really only two alternatives to it:

A) Market timing
B) Some very complex and probably highly leveraged hedge fund strategy

The problem with market timing is that, unlike buy and hold, everyone cannot do it successfully. The performance of a buy and hold strategy derives from the long term economic performance of the underlying assets and therefore is not a zero-sum game. Market timing, contrarily, depends on a patsy to buy stocks from you at the top and sell them to you at the bottom. Most market timing strategies use some combination of technical and macroeconomic analysis and they ignore the systemic implications of what happens when enough participants in the market use similar strategies. Economic research has shown that a large enough population of trend-followers in any market can cause radical disruptions (i.e. bubbles and crashes). More importantly, the financial markets exist primarily to allocate long term capital to businesses and a pervasive short-term casino mentality threatens the underlying stability of the overall economy.

The second problem with market timing is that it involves infrequent and large "bets". This is of course not a problem if the market timer has 100% accuracy in his predictions (but in that case why would he take your money?). Given the complexity of the capital markets, some small statistical edge would be the most one could hope for. Leaving aside the rather insurmountable issue of how one determines the skill of a market timer before the fact, let's assume that a given market timing strategy has a 60% success rate in predicting whether stocks will outperform cash in any calendar year. Suppose one invested in this strategy starting in 1999 and ending in 2008, a period when the S&P 500 delivered a cumulative 13% loss with four of the ten years negative. The strategy chooses either 100% stocks or 100% T-bills at the beginning of the year and holds the position until the beginning of the next year when it decides again what to invest in. Compared to cumulative returns of -13% in the S&P 500 or 11% in an annually rebalanced portfolio of 60% S&P 500 / 40% cash, a perfect market timer would have returned 355% (by the way, where are the Barron's articles on investment professionals or market timing services who achieved anything close to this?). Running simulations of a 60% success rate leads to results that beat the 60/40 portfolio about 2/3 of the time over a ten year period. Adding 1% to account for incremental management fees, taxes & trading costs reduces this number to slightly better than 55%, while deducting typical hedge fund fees of 2% and 20% against the performance reduces the odds of success to worse than a coin flip. The overall level of returns with this strategy is low, with only 30% of the outcomes above an annual gross return of 5%. Investor patience would likely not

last over the full ten years, as 35% of the time the strategy was a money loser during the first five years (assuming 1% in additional costs) whereas the 60/40 portfolio was up a cumulative 8% over the same period. While a 60% edge may sound slight, a stock picker who could choose 50 stocks per year that had a 60% chance of outperforming the market would outperform over a five year period with virtual certainty due to their ability to put larger numbers to work for them.

Is Diversification Dead Too?

Part of the criticism of buy and hold investing stems from a misunderstanding of the benefits of diversification. All risky assets lost value in 2008 and historical correlations were meaningless. However, the industry's obsession with statistics has obscured the fundamental reason for diversification, which is uncertainty. Uncertainty is different than risk. Risk is quantifiable and manageable, like the odds of getting black on a roulette table or what percentage of the population will die at a particular age. Uncertainty is unquantifiable. It is not possible to know what the average returns, correlations and standard deviations will be on various asset classes. It is likewise impossible know for sure whether stocks will outperform bonds, the future level of inflation or economic growth or which companies will survive or go out of business due to some new competitor. These risks cannot be quantified with any more than a "back of the napkin" degree of accuracy. The conceit of the investment industry and a prime cause of the credit bubble was the belief that somehow this fundamental uncertainty had been conquered by sophisticated quantitative tools. It would be a huge mistake to think that there is no need for diversification because of the failure of badly designed risk models when the real reason for diversification is the more fundamental uncertainty that we simply cannot know the future.

Profit Maximizing vs. Survival Maximization

The neoclassical economic model postulates that rational people pursue profit maximizing strategies. However, is it really rational to be "rational"? As Adam Smith noted 250 years ago in *The Theory of Moral Sentiments*:

> We suffer more … when we fall from a better to worse situation, than we ever enjoy when we rise from a worse to better. Security, therefore, is the first and principal object of prudence. It is averse to expose our health, our fortune, our rank, or reputation, to any sort of hazard.

Profit maximizing strategies often involve exposing oneself to unacceptable survival risks. For example, leveraging personal assets to invest in risky financial assets is a strategy that, over long periods of time, more often than not will result in high returns. However, there is a small, but real risk of financial ruin in a protracted downturn. Economist Roy Radner observed that successful businesses do not maximize profits; rather they focus on survival under conditions of uncertainty. A 2007 survey of endowment asset allocations by the Chronicle of Philanthropy revealed very few with combined allocations of fixed income and cash above 10%. It is likely that many of these endowments had unfunded private equity commitments equal to, or exceeding this amount. This profit-maximizing strategy led to several years of 20%+ returns for many large endowments that are now struggling with liquidity. Given the higher returns typically associated with risky assets relative to cash and high quality government bonds, it makes sense for a rational profit-maximizing investor to avoid these assets and perhaps even to leverage his investments through borrowing. However, an investor with liquidity needs maximizing his odds of survival will carry what appears to be an overly large allocation to low-yielding safe and liquid assets. An investor maximizing survival will limit exposure to investments that seem to be a sure thing to avoid even a slight risk of catastrophic loss. The obsession of the investment industry with beating benchmarks appears particularly absurd in regard to these dynamics. What does an investor do when beating a benchmark during a speculative period requires owning large concentrations of the most risky and overpriced securities within that benchmark? The experience over the past decade shows boards and individual investors firing managers who did not participate in the tech, commodity or credit bubbles and replacing them with the managers chosen from a database for having the best recent performance (i.e. those who had the most exposure to the overpriced assets). The aggregate effect of this behavior imposes a selection bias for riskier and riskier investments and penalizes or even threatens the survival of more conservative investment managers. One can recall stories of value managers going out of business during the tech bubble or unleveraged hedge funds folding when their performance could not keep up with their heavily leveraged competitors.

It is important to note that an investor's appetite for risk mainly derives from how well capitalized he is relative to perceived lifestyle requirements. People will take huge risks to preserve their current level of consumption rather than face a significant cutback in lifestyle or

status. Contrarily, investors who are adequately capitalized relative to consumption expenditures will tend to be conservative and risk-adverse. Those who are overcapitalized can afford to adopt either survival maximizing or profit-seeking strategies. These are all rational responses and any investment strategy needs to take these dynamics into account.

What can Investors be sure of?

A buy and hold strategy makes a few fundamental assumptions, namely that a liberal economic system will remain in place, property rights will be protected and owning a diversified portfolio of equity securities, real estate and other assets will enable one to directly participate in their respective underlying cash flows over a long period of time. An environment where these assumptions do not hold will likely mean that no asset is safe. It is foolish to believe that if capitalism and the rule of law collapse that some authority will not find any number of ways to expropriate the assets of those with wealth. Buy and hold does not assume that government policies will be ideal for economic growth, that there will not be major geopolitical disruptions or that economic cycles will not impair underlying cash flows and valuations for significant periods of time. Because of these uncertainties, a sufficient reserve of liquid, safe assets (5-7 years of cash flow requirements) is necessary to optimize the chances of survival.

Are Markets Efficient?

The traditional definitions of efficiency do not adequately reflect what has been learned about the dynamics of markets. The formal definition of efficiency is a top-down deduction from an improvable set of assumptions about human behavior. However, it is an absolute fact that markets are extremely efficient processors of information. The key factor is the notion of the "wisdom of crowds" which states that when there are many participants in a market and individual errors in the estimation of value are independently distributed, the errors cancel each other and the market price reflects true value. Empirical data in predictions markets, sports betting, horse-racing and controlled academic experiments overwhelmingly support this notion. However when the estimation errors of participants are not independent – perhaps because of widely held beliefs promulgated by the media, groupthink among institutional investors, or investment professionals following the career-based incentive of preferring to fail conventionally over succeeding unconventionally – inefficiencies will occur. They will not be easy to find or exploit, but will reward patient capital. This is also why a degree of contrarian thinking is essential to successful investing – in the financial markets the majority will always be wrong at some key point in time. The higher the degree of unanimity among market participants, the greater the likelihood that they are wrong. A diversified mix of core and opportunistic buy and hold strategies provides the best method to both protect capital and exploit undervalued securities.

Buy and Hold is the Worst Possible Investment Strategy … Except for all the Others

Despite the hype, holding a strategically allocated, diversified portfolio that matches liquidity needs remains the only serious investment strategy. While the prices of stocks, real estate and other risky assets are volatile, holding these assets provides exposure to the overall productive activity of the economy. The aftermath of a severe financial panic will likely limit economic growth for several years and public finances throughout the developed world face serious challenges by the recent explosion of deficit spending and the looming insolvency of entitlement programs due to aging populations. However productivity, enabled by technology and globalization, has continued to grow at 2.5% per year throughout this decade, unlike the 1970s where it increased at less than half that rate. Emerging technologies offer a clear path to continued, and likely accelerating, increases in output and per capita GDP. Max Planck, the founder of quantum mechanics and one of the most brilliant mathematicians who ever lived, once tried his hand at economics and quit because he said it was "too hard". The complexity of the global economy has grown exponentially since Planck made that quote and there is simply no way to reliably predict the performance of economies or financial markets in a way that can translate into excess profits. This is not to say that there is not a role for opportunistic managers that may increase or reduce their exposures based upon their fundamental views. However, it is imprudent to bet one's entire portfolio on their predictive skills. One should instead focus on a balanced allocation of quality assets with adequate liquidity and income to meet near term cash flow needs without having to sell stocks or other volatile assets at distressed prices.

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