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# “BUY AND HOLD” – IS IT DEAD?

by Cal Brown, CFP

***“Know when to hold ‘em, know when to fold ‘em, know when to walk away, know when to run.”***

written by Schlitz, performed by Kenny Rogers

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**T**oday’s investor has long been educated to buy investments and hold on to them during good times and bad. Financial books, magazines, radio programs and TV shows tout the conventional wisdom of “buy and hold.” Literature from vendors of investments such as mutual funds, retirement plan providers, and brokers drive home the message: do not sell equities just because the prices are down for the moment.

But is it still good advice? Is this what the pros REALLY do?

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## PUBLIC PROFESSING—PRIVATE DEALINGS

According to the Morningstar Principia™ for Mutual Funds database (12/31/02), the average turnover rate of the total 8,241 domestic equity funds is a whopping 111% annually. This figure is actually low because it includes index funds, whose turnover is very low. For example, the turnover rate of the Vanguard Index 500 fund is only 4%. If all index funds were removed, the statistics would

indicate the turnover of actively managed funds to be much greater. Thus, observing most active investment managers leads to the inescapable conclusion: “Don’t do as I do; do as I say.”

One question frequently posed to professional money managers in interviews is, “What is your sell discipline?” Most respond with a sophisticated analytical process of determining when a stock has reached its price target, or conversely, has disappointed below an acceptable threshold. Few managers answer like Warren Buffet: “...[I am] quite content to hold any security indefinitely...”<sup>1</sup> Why is this?

There exists an enduring hope that some expert or formula can beat the market. A recurring feature of magazine articles, and many radio and television programs is the topic: “Buy, Sell, or Hold?” Investors call or write to get professional advice with regards to certain securities. In addition, Investor’s Business Daily offers a free tape to teach investors its system of making these same trading decisions.

Why do these kinds of features continue to appear? In reality, frequent trading is simply

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<sup>1</sup> Robert G. Hagstrom, Jr., *The Warren Buffet Way*, (John Wiley & Sons, Inc.), 99

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entertainment for “investment junkies.” Inactivity is not exciting.

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### WHAT FITS THE PHILOSOPHY

So, is “buy and hold” really dead? The answer is based on your viewpoint. It depends on one’s philosophy of investing. There are essentially three options:

1. Stock Selection
2. Market Timing
3. Modern Portfolio Theory

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***Believe it or not, the answer is based on your viewpoint.***

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If an investor wants to beat the market by employing stock selection or by timing the market (or both), “buy and hold” is not consistent with either philosophy. This is obvious for market timing, because one would regularly be getting in and out of equities. And if the investor is seeking a higher return than the average market return by superior stock picking, as all actively managed mutual fund managers attempt, then buying and holding a diversified portfolio isn’t the answer. The result would simply be the market return over time. Remember, however, studies prove most mutual fund managers cannot, over time, beat the index.

While “superior stock selection” sounds good on paper, it’s problematic. If an investor owns individual stocks, it is very dangerous to simply hold. Why? Two reasons. First, it is possible to hold a stock until it becomes worthless. Second, the volatility (measured by standard deviation) on individual stocks is much, much greater than mutual funds that provide similar long-term returns. The average three-year standard deviation for the previously mentioned 8,241 equity funds in the

Morningstar universe is only 20.02 percent, and 16.43 percent for the Vanguard Index 500 fund. By contrast, it is 46.9 percent for IBM, 57.9 percent for Microsoft, and 57.6 percent for Cisco Systems. With smaller companies it is even greater. Furthermore, even if an investor is supposedly a great stock picker, unknown forces or events can cause a company’s stock price to go south, rapidly.

This means that if an investor is trying to beat the market by picking stocks and/or timing the market then “buy and hold” is simply antithetical. On the other hand, if a person can be content with the long-term rates of return provided by the various market segments (asset classes) and seeks to minimize risk, then an investment strategy using Modern Portfolio Theory (“MPT”)<sup>2</sup> is a good philosophical fit.

MPT is the investment philosophy by which large pension plans, charitable organizations, and other institutional investors in America manage the funds entrusted to them. Why do they use MPT? These fiduciaries must obtain an acceptable rate of return with a minimum of volatility. In addition, they are mandated to have adequate diversification across asset classes. Finally, their time horizon is suitably long. Interestingly, though, a blind “buy and hold” approach does not work with MPT, either!

Using MPT to invest is not very entertaining. The lyrics quoted in the beginning are from the song, “The Gambler.” Gambling entails high levels of risk, a good dose of entertainment, and the house usually wins. MPT is not gambling! The other two philosophies, however, are dangerously close.

So why isn’t “buy and hold” an essential part of MPT? Two aspects of MPT argue against a pure “buy and hold” strategy.

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<sup>2</sup> Harry Markowitz, “Portfolio Selection,” *The Journal of Finance*, March 1952, 77-91. Also, Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, “Determinants of Portfolio Performance II: An Update,” *Financial Analysts Journal*, July-August 1986, 39-44

First, re-balancing forces the sale of a portion of asset classes which have outperformed, with the simultaneous purchase of other asset classes which have underperformed. This may be done on some sort of rigid calendar basis, or it may be accomplished by means of a formula (for example, if an asset class is 5 percent above or below target allocation). As a result, securities are not held indefinitely.

Second, on a strategic level, the managers “hired” to manage the various asset classes may be “fired” at any time and replaced. This will depend on the due diligence process and/or screening mechanism used to identify managers based on costs, style consistency, measures of volatility, performance compared to a benchmark, etc. Thus, when a manager is “fired” or replaced by buying a new fund, securities are sold and different securities are purchased. This clearly is not “buy and hold.”

Nevertheless, the MPT strategy only works if there is a long-term commitment to the discipline. That is, the asset allocation must remain intact over long periods of time. Any effort to get completely out of equities during bear markets or chase returns during bull markets flies in the face of this portfolio management philosophy.

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## **WHAT GOES AROUND COMES AROUND**

“Those who cannot remember the past are condemned to repeat it.”

George Santayana

Having said all this about “buy and hold,” the current stock market decline has wreaked havoc in the equity portfolios of most investors. It is fair to say the recent experience is similar to the 42% decline during the bear market of 1973-74. It is the first three-year down market since 1939-41. What

should investors do? “Buy and Hold?” Well, as the commercial says, “not exactly.”

First, one must understand what “the market” is, and what it is not. The three most commonly quoted indices are the Dow Jones Industrial Average (30 large capitalization stocks), the S&P 500 Index (500 large cap stocks), and the NASDAQ. They are all proxies for large cap stocks, with a bias toward the growth category. The media, and consequently most people in general, frequently refer to one or more of these indices as “the market.” This is incorrect.

The U.S. stock market is actually comprised of over 9,000 publicly traded stocks. Most of these are considered small capitalization and/or medium capitalization stocks. Since its peak in March, 2000, the S&P 500 Index was down –45% through the end of July, 2002. However, according to data from T. Rowe Price, the average stock in the S&P 500 Index was only off –14% from its peak<sup>3</sup>. How is this possible? The index is capitalization-weighted, so the largest stocks impact the performance of the index much more than smaller stocks. Small cap stocks have fared much better than large company stocks over the past few years. Thus, the public perception of “the market” is very different from reality.

It frequently helps people to gain perspective on current events by looking at historical data. Several studies of “bear markets” have been examined by the author in order to reach important conclusions.

Three conclusions stand out:

1. Once an asset class has been adopted, stay fully invested, all the time because:
  - a. Up markets last longer than down markets, and
  - b. Up markets have higher returns than the losses during down markets.

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<sup>3</sup> M. David Testa, *Market Update and Perspective*, July 29, 2002

- c. No one can predict when up markets will begin, nor when down markets will end, so don't even try!
2. Down markets do end, and the subsequent upswings increase more rapidly than the decline. The only way to be positioned for that inevitable rise is to stay fully invested.
3. Re-balance to take advantage of small cap asset class performance, which has been historically superior to large cap asset classes.

Down markets do come to an end! Some last longer than others, and the one we presently find ourselves in has lasted 28 months through December 31, 2002. This is longer than the 21 months during the aforementioned bear market of January 1973 – September 1974, and also exceeds the 27 months from April 1930 – June 1932. Thus, history suggests this one will end soon; perhaps it already has.

One piece of good news is that when down markets finally do end, the subsequent up market is quite good. For example:

- The September 1929 – June 1932 period had a decline of –83.8% in the S&P 500 Index; the following three months experienced an upsurge of +115.4%. Notice in Chart 1 that the downturn in the S&P 500 Index from Jan. 1973 – Sep. 1974 was –42.5%; but the index rose +38.1% during the following twelve months;
- The drop in the Index from Dec. 1980 – Jul. 1982 was –16.9%; but the index rose +59.4% during the subsequent twelve months; Similar upswings over twelve months can be seen following all downturns since 1948;
- The average decline during these bear markets is –18.9%, while the average increase over the following twelve months is +35.7%.

Chart 1

Down Market	Length (Months)	Total Return (S&P 500)	Months to Breakeven From Start	Total Return First 12 Months After Down Market
Nov 48–May 49	7	(10.0)%	11	42.4%
Jan 53–Aug 53	8	(8.7)	13	35.0
Aug 57–Dec 57	5	(15.0)	12	43.4
Jan 60–Oct 60	10	(8.4)	12	32.6
Jan 62–Jun 62	6	(22.3)	16	31.2
Feb 66–Sep 66	8	(15.6)	14	30.6
Dec 68–Jun 70	19	(29.3)	28	41.9
Jan 73–Sep 74	21	(42.5)	42	38.1
Jan 77–Feb 78	14	(14.1)	19	16.6
Dec 80–Jul 82	20	(16.9)	23	59.4
Sep 87–Nov 87	3	(29.5)	21	23.2
Jun 90–Oct 90	5	(14.7)	9	33.5
<b>Average</b>	<b>10</b>	<b>(18.9)%</b>	<b>18</b>	<b>35.7%</b>

Source: Bloomberg, L.P.; Roger G. Ibbotson and Rex A. Sinquefeld, “Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns,” University of Chicago Press *Journal of Business* (January 1976), and Bernstein Investment Research and Management

To reap the inevitable benefits, investors must not bail out after a long period of negative returns. Those that do will quite probably miss a significant and sustained upsurge.

Chart 2 on the next page displays both Bull (“Percent Increase” column) and Bear (“Percent Decrease” column) markets since 1914, using the S&P Composite Return Index. Note that bull markets have larger percentage increases and last longer than bear markets. Also, the overall increase in equities more than compensates for the declines.

Due to the extended downturn since March, 2000, many investors’ portfolio values have shrunk back to 1997 levels. Now is an opportunity for those who were not invested in equities during the ‘90’s and think they “missed out,” to get in on the persistent upward movement of the American economy and the equity markets.

For those equity investors whose portfolios have dwindled to mid-90’s levels, hopefully they have learned their lessons about the futility of market timing and stock picking. Rather than gambling even harder to try to make back what they’ve lost, they should embrace the philosophy and discipline of Modern Portfolio Theory.

Is “Buy and Hold” dead? Perhaps, for the gamblers.

However, for most investors, MPT has proven its mettle in a very difficult market environment. Through the use of re-balancing, re-allocating, and changing managers when

appropriate, prudent MPT investors do not blindly “buy and hold.” Nevertheless, investors should stay fully invested at all times, because during the next upsurge they must be properly positioned!

Chart 2

**S&P Composite Return Index Bull and Bear Markets 1914-2002**

<b>Market Top</b>	<b>Index High</b>	<b>Percent Increase</b>	<b>Market Bottom</b>	<b>Index Low</b>	<b>Percent Decrease</b>
09/01/2000	2108.76	62.3%	07/23/2002?	1134.013	-46.2%
07/17/1998	1601.08	391.0%	10/08/1998	1299.44	-18.8%
07/16/1990	403.455	80.6%	10/17/1990	326.079	-19.2%
08/25/1987	332.957	305.3%	10/19/1987	223.450	-32.9%
11/28/1980	102.884	204.3%	08/12/1982	82.141	-20.2%
01/05/1973	61.53	89.2%	10/03/1974	33.810	-45.1%
11/29/1968	48.358	58.7%	05/26/1970	35.525	-32.7%
02/09/1966	37.778	98.4%	10/07/1966	30.477	-19.3%
12/12/1961	26.01	115.1%	06/26/1962	19.041	-26.8%
07/15/1957	15.075	517.3%	10/22/1957	12.094	-19.8%
05/29/1946	3.271	214%	05/17/1947	2.442	-25.3%
11/09/1938	1.576	66.8%	04/28/1942	1.042	-33.9%
03/10/1937	1.949	148.6%	03/31/1938	.9451	-51.5%
02/06/1934	1.102	120.9%	03/14/1935	.7840	-28.9%
09/07/1932	.8161	115.4%	02/27/1933	.4989	-38.9%
09/07/1929	2.3426	657.1%	06/01/1932	.3789	-83.8%
11/03/1919	.4198	79.9%	08/24/1921	.3094	-26.3%
11/18/1916	.3788	77.2%	12/19/1917	.2334	-38.4%
			October 1914	.2138	-26.7%