
The Principled Investor

Buy and Hold, Is it Dead?

By Cal Brown, CFP

Smart investment decisions are based upon principles, not predictions.

There is an interesting phenomenon regarding predictions: rarely does anyone go back and check on their accuracy. Two years ago I authored a white paper entitled “Buy and Hold—Is It Dead?” because we were in the third year of the longest bear market in sixty years and many people were questioning traditional wisdom. Predictions are one thing; principles are another. That paper was not a prediction, but contained several principles of successful investing.

Here are some market predictions appearing in the media during 2002 and 2003:

It's going to be a difficult environment for stock investors. Don't count on the market to move up.

David J. Winters, “Brainwork from the Experts,” Business Week, 12/30/02

I suspect that 2003 will end up being the fourth consecutive down year for the first time since 1932.

Jeremy Grantham, “Is the Bear Market Over?” Smart Money, January 2003

I do not believe a long-term investor will make money in this market because it is a secular bear market. Felix Zuelauf, “On the Money—Roundtable Part II,” Barron's, 1/27/03

The fear is that it could be a long war and we could have a sustained sell-off because of it.

Tim Heekin, “Fears of War with Iraq Send Blue Chips Below 8000,” Wall St. Journal, 2/26/03

If we see 8% this year, that will be good.

E. S. Browning, “Trading Ranges Keep the Bulls In,” Wall St. Journal, 4/21/03

Several important signals suggest that prices at best have topped out for the time being, and at worst are primed to move back down. Such signals “are classic signs of a market top,” says Charles Biderman, president of market research from Trimtaps.com. Jeff Opdyke, “Four Signs Stocks May Be Near a Peak,” Wall St. Journal, 6/26/03

Prediction Power: an Investment Illusion

For a short review, the major stock indexes bottomed in October 2002, rallied for a few months, then declined again as the war clouds gathered over Iraq. From early 2000 through the market bottom, most indexes were down 50 percent but many portfolios had declined even more.

Let's revisit the previous white paper's conclusions, which were based on research of historical bear markets and their aftermath:

1. Once an asset allocation has been adopted, stay fully invested, all the time, because:
 - a. Up markets last longer than down markets.
 - b. Up markets have higher rates of return than the losses during down markets.
 - c. No one has ever successfully predicted when up markets will start, nor when down markets will end, so don't even try.
2. Down markets inevitably come to an end and the subsequent up markets are usually substantially above the long-term average. The only way to be positioned for the substantial upward move is to stay fully invested in the chosen asset allocation.
3. Re-balance to take advantage of small cap asset class superior performance.

Investors who obeyed the principles mentioned in that white paper had spectacular results in 2003, despite the market decline in the first quarter of the year (the S&P 500 Index was down 4 percent from January through March of 2003). For the entire year, however, the S&P 500 Index was up 26 percent, the NASDAQ was up 50 percent, and the Russell 2000 Index of small cap stocks was up 48 percent. For the year-to-date

through November 30, 2004, those indices were up 6 percent, 5 percent, and 14 percent, respectively.

Even though these substantial market rebounds were expected and within the range of other upturns following protracted down markets, the "predictors" are at it again. Some are saying, "We've come too far too fast"¹ and "Valuations are getting ahead of themselves,"² indicating the market is due for a pullback. Others may forecast more good times ahead for equity markets due to the tax cuts, strong economic growth, and historically low interest rates. Do not confuse a writer's need to sell newsprint with the enduring, timeless principles of investing.

Investment Principles: No Illusion

Rather than getting embroiled in predictions, let's focus on these principles. First, **"determine an asset allocation for the portfolio and stick to it until the personal factors change."** An asset allocation, or portfolio design, should be based on "big picture" factors such as age, expected deposits or withdrawals, the amount of money in the portfolio, risk tolerance and, perhaps the most important, the time horizon. Conspicuously absent in this principle is whether someone thinks the market will go up or down in the near term—this has absolutely no bearing on what an investor's asset allocation should be. Those who stuck with this principle in 2003 may have suffered a bit more emotional distress in the first quarter but were paid handsomely in the following twenty months.

The sub-principle, "up markets last longer than down markets" is a historical fact, and is true in the vast majority of cases. Whether the positive performance since 2003 will extend beyond three years is a matter of speculation, but not a reason to make any changes to a portfolio. Here's the principle that's clear: the investor who remains invested

over their entire lifetime will experience more years when the market is going up than when it is going down. Being fully invested allows the investor to enjoy the next historically proven sub-principle, “up markets have higher returns than the losses during down markets.

“No one can predict when up markets will begin, nor when down markets will end, so don’t even try!” Even though people give lip service to this sub-principle, they love to hear what the next “expert” predicts the market is going to do in the future. Stock market predictions are the designer drug of the investing public. Those who get “hooked” end up often jumping on an investment just before it plummets. Accurately predicting the future simply cannot be done and those who kick that habit will have “healthier” portfolios.

Predictions are one thing; principles are another.

The equity markets in 2003 and 2004 once again proved the truth of the second principle: **“Down markets inevitably come to an end and the subsequent up markets are usually substantially above the long-term average.”** In 2002 and early 2003, many highly respected economists,³ financial advisors,⁴ and investment gurus talked about a “reduced equity premium” for the future. The equity premium is the difference between stock returns and bond returns. This group merely gave a higher “gloss” — a more academic appearance — to another bad prediction. It flew in the face of the historical data and was proved false by the dramatic upswing in the equity and smaller upturn in the bond markets almost immediately after some of the ink was dry on the newspaper. The “gloss” faded fast! Anyone who made portfolio allocation adjustments—increasing their holdings in fixed income and decreasing equities based on the (erroneous) reduced equity premium forecast—had sub-par portfolio returns.

The final principle, **“re-balance to take advantage of small cap asset class superior performance”** was on target in 2003 and 2004. Over the long run, small cap stocks have outperformed large cap stocks on average by approximately two percent annually. Both growth and value small cap asset classes had extraordinary returns in the past two years. Investors who increased their allocation to small cap stocks during the depths of the bear market experienced strong portfolio performance in 2003 and 2004.

At the same time it is wise to apply the corollary of that principle: investors should take a portion of their profits in the small cap asset classes and re-invest to their target asset allocations—in other words, rebalance. Principled investors pay no heed to predictions of either further gains in small cap stocks or pronouncements of the end of a small stock rally. Instead of trying to guess the future of these asset classes and either buy more or get out altogether, the principled investor will adjust the positions to the target percentages.

A final note regarding taxes: investors who harvested losses during the bear market, yet remained fully invested by buying a similar investment (and avoiding the “wash sale” rules), will have better after-tax returns than buy-and-hold investors. The capital loss carry-forward generated through a harvesting strategy will shelter gains caused by future re-allocations for years to come, as well as mutual funds’ capital gains distributions.

Investment Principle: Stick to Your Guns

In conclusion, through the use of re-balancing, re-allocating, and harvesting losses during bear markets, prudent investors do not blindly “buy and hold.” It is passé to buy and hold in the traditional sense of “set it and forget it.” The prudent and principled investor will actively buy and sell in order to re-balance and maintain the proper

allocations, or to take advantage of capital losses. This will not be a reaction to media assumptions or predictions of the future of the market. These principles may now dictate a reallocation from equities to fixed income investments, even though “everyone knows” interest rates will increase in the near future.

Smart investment decisions are not based on predictions of the stock or bond markets. Regardless of how impressive the prediction sounds or the credentials of the predictor, no one knows the future. We do know the past, however, and it holds the key to the future.⁵ Smart investment decisions are based on a solid understanding of historical data. Until there is some fundamental change in the nature of our economy, the cyclical nature of extended bull markets punctuated by brief bear markets will continue. Over the long haul, equities will outperform bonds, albeit with greater volatility, and small cap stocks will outperform large cap stocks. Unless an investor’s time horizon suddenly shifts and there is a short term need to liquidate the entire portfolio, the principled investor will remain fully invested according to the asset allocation plan determined in the absence of media hype.

Do not confuse a writer’s need to sell newsprint with the enduring, timeless principles of investing.

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ENDNOTES

¹ Jeff Bailey, “Shorting Stocks That Have Come Too Far and Too Fast” *Ask the Analyst*, 29 June 2003: <<http://www.OptionInvestor.com>>.

² Steven Goldberg, “Value Added: Opportunities Abound Abroad” *Kiplinger.com*, 20 April 2004: <<http://www.kiplinger.com/print.php>>.

³ Peter L. Bernstein, “Determining the Equity Risk Premium,” *AMIR Equity Research and Valuation Techniques*, (2002) or Robert D. Arnott and Peter L. Bernstein, “What Risk Premium is ‘Normal’?” *Financial Analysts Journal*, March/April 2002.

⁴ Harold Evensky, “Changing Equity Premium Implications for Wealth Management Portfolio Design and Implementation,” *Journal of Financial Planning*, article 9 (June 2000): <http://www.fpanet.org/journal/articles/2002_Issues/jfp0602-art9.cfm>

⁵ Joel Kotkin, “Global Cultural Islamic Cities: Can Past Be the Key to the Future?” *The Globalist*, 1 June 2003: <http://www.joelkotkin.com/Urban_Affairs/LAT%20Islamic%20Cities-Can%20the%20Past%20Be%20the%20Key%20to%20the%20Future.htm>.