CHLADEK
WEALTH MANAGEMENT

R.I.P. Buy and Hold

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“By changing nothing, nothing changes”
-Tony Robbins

Buy & Hold by definition

Buy and hold is often, questionably, referred to as an investment strategy. Most investment advisors that have managed money over the last 30 plus years have likely spent some time (if not their entire career) singing the praises of the non-strategy. Make no mistake, buy and hold served investors and the financial services industry fairly well until the year 2000. However, since 2000 investors have struggled, and since 2008 the financial services industry has joined the struggle. Although the financial services industry arrived late to the struggle, assets are flooding out of mutual funds and away from advisors that continue to hold their clients captive to a dated investment management approach.

In our opinion, to be useful an investment strategy must address four critical items. Those items are:

- when to buy
- how much to buy
- when to sell
- how much to sell

If you use the previous as the minimum standards to qualify as an investment strategy, then buy and hold fails the test since it only addresses the buying.

A little history

In the 1990’s, the financial services industry latched on to investment portfolio research from Harry Markowitz. While a PHD student in the 1950s, Mr. Markowitz pioneered research on investment portfolio risk, correlation and returns. In 1952, Markowitz published an article on his research, and then in 1955 published his book titled “Portfolio Selection.” From Markowitz’s book came Modern Portfolio Theory (MPT). In 1990, Markowitz won a share of a Nobel Prize in Economics for his research. According to the website Wikipedia.com MPT is:

“The fundamental concept behind MPT is that the assets in an investment portfolio should not be selected individually, each on their own merits. Rather, it is important to consider how each asset changes in price relative to how every other asset in the portfolio changes in price.”

We believe Markowitz’s work was ground breaking and important to opening the thought process for investment portfolio management, but not an end.

The Nobel Prize notoriety in 1990 created a burst of interest in Markowitz’s MPT. MPT subsequently became a marketing machine and asset retainer for the financial services industry. The industry took MPT and turned it into computer driven investment modeling supported by fancy charts and a great Nobel Prize story.

Let’s pause in our story and consider what many investment advisors were doing in the 90’s. Suppose broker/advisor Joe Smith worked for Big Box Brokerage Company. At Big Box, Joe’s primary job was to drum-up business through calling thousands of people a day attempting to set up meetings. So, if the overwhelming majority of Joe’s time was on the phone, on the golf course or at networking meetings, when did he have time to manage money? You are right; he did not have time. Once Joe signed on a new client, the administrative staff would get the new client set up, Joe would look for new clients, and

the current client money needed to be invested. What Joe needed was a simple, easy-to-explain, low time commitment way of investing money. Markowitz's work allowed the industry to create computer models (who could argue with anything computer generated) that showed how to build a "diverse" portfolio with "low risk" profiles. Now, broker Joe Smith could have a computer spit out an allocation (based on Nobel Prize winning research) and Joe could fill the allocation requirements from the stable of mutual funds that Big Box Brokerage had to offer. The new client portfolio was set and ready to forget as Joe resumed searching for new clients.

Wait a minute

Tragically, many investment advisors have never read Markowitz's "Portfolio Selection" book, yet will wax on about MPT and the Nobel Prize winning work that supports their portfolio recommendations. If an advisor took the time to read the book (or even parts of the book) they would realize that MPT was an imperfect beginning, not an end. Once someone took the time to read Markowitz's book, it became clear that Markowitz had to resort to using simpler data since he wasn't working with the computing power of today's digital watch. This limited computing power led Markowitz to use less than optimal risk measurements for his calculations. Using a less than optimal risk measure when the whole point of the research is risk-related should make an intelligent person wonder if there are better ways to address risk today.

Marketing buy and hold

With MPT's Nobel Prize story, computer-generated optimal portfolios, a busy society, and a friendly investment environment in the 1990's, what was not to love for both the investor and advisor? The best thing a mutual fund company or brokerage firm could do for themselves was to persuade investors not to sell their mutual funds or move their investments. The bottom line was that fund companies and advisors wanted "sticky money." This is still the case today; just look at the marketing material from almost every mutual fund company. On a more-than-regular basis, mutual fund investors are told about the potential impact of missing the best days in the market. Hence, investors must stay invested. As well, most mutual fund company reports and updates have been market cheerleaders or uber-optimists even in the face of economic destruction. Buy and hold was/is a win for advisors as it facilitated more time to add new clients, and a win for fund companies because investors were convinced they must stay invested or else they may miss the next up day.

The one study that every equity mutual fund manager (often advisors too) love to drag out is the chart that tells you what happens if you miss "x" of the good days in the market. Below is an example of one of these charts.

Returns for the S&P 500 for 25 years ending 12/31/08

If you missed the best "x" days	Average Annual Returns
10	4.10%
20	2.15%
30	0.54%
40	-0.93%

Below is the rest of the story.

Returns for the S&P 500 for 25 years ending 12/31/08

Days Missed	Missing Best	Missing Worst	Missing Best & Worst
10	4.10%	11.23%	8.15%
20	2.15%	13.80%	8.58%
30	0.54%	15.83%	8.61%
40	-0.93%	17.59%	8.82%

(Source: NAAIM, Inc. This data is for illustrative purposes only and is not indicative of the actual performance of any investment. S&P 500 Index returns do not reflect reinvested dividends.)

The results above, from the full story, reveal that missing the worst days is more important than getting the best days. Obviously, missing all the best or all the worst days is not possible, but is it possible to get close to missing both the best and worst?

As you can see, managing risk in one's portfolio is at least as important as seeking profits, if not more so. A critical part of risk management is minimizing the damage from major bear markets. If you cut bear market losses in half and capture just 80% of the upside in bull markets, you can significantly outperform a buy and hold strategy over the long-term.

Major downturns in the market can present dramatic setbacks to achieving long-term financial goals. Bear markets typically reclaim about half of the gain from the previous bull market, and a major bear like 2007-2009 can wipe out all of the bull market gain and more. Our goal is to limit such losses to less than half the market decline.

Limiting bear market losses means your portfolio doesn't have to gain as much to recover, which reduces the temptation to take excessive risk in the next bull market. Managing risk is inherently less volatile and you shouldn't ever have to suffer through the anguish of seeing your investments cut in half. By avoiding this pain, investors are more likely to be comfortable going back into the market early for the next bull market run when risk is lowest and the profit potential is highest.

We utilize a strategy that allocates assets to the market based on risk, which is fundamentally different from a buy and hold philosophy which stays fully invested at all times. We also view cash as an investment alternative which is used – at times along with a defensive hedge or bear fund – to reduce exposure when market risk is elevated. Allocation to the stock market must remain flexible.

Allocations should be adjusted to focus on changing market conditions. Used effectively, sector weightings can enhance returns and help reduce risk; sector adjustments are used to enhance returns in bull markets and reduce risks in bear markets. During the transition from a late bear market to an early bull market, cyclical sectors such as Financials, Technology and Consumer Discretionary historically outperform. The stock market generally leads an economic recovery, and as consumers and businesses start to feel better, they begin spending again in the discretionary areas where they may have delayed purchases.

In the mid to late bull market period when economic growth is more firmly established, Materials and Industrials historically outperform and are usually joined by Energy and Telecom stocks as the bull market matures.

Finally, as the bull market runs out of steam and a bear market takes hold, the non-discretionary sectors such as Health Care, Consumer Staples and Utilities are historically the most resilient. These companies provide products and services that people need regardless of how bad they feel about the economy or

the stock market.

The easiest way to implement the allocation and sector strategies referenced above is with sector ETFs. However, there are over 1,400 ETFs available on the major exchanges, and not all are created equal. We have specific due diligence in place when selecting the ETFs for our portfolios.

Take away

Remember, it's not how much you make in a bull market that counts, but what you have left after the bear market does its damage. We believe the active strategy outlined above using passive sector investments is superior to buy and hold.

- Lower volatility
- Higher cumulative returns
- Smaller drawdowns
- Miss more bad days than good days