GYC
Grow Your Capital

9 October 2011

The Fallacy of Buy and Hold

by William Cai, Vice President, Personal Financial Services

This article was featured in the Oct 2011 issue of Professional Adviser. Below is the original article by William Cai, for your reading pleasure.

Buy-and-hold investing has long been preached with evangelistic zeal as the ideal way for retail investors to manage their market exposure, but the last decade has shown that investors would have been better served by the old heresy of market-timing.

Advocates of buy-and-hold investing often like to display charts of the hypothetical results of investing in a market index over a period of time to support their theory. For instance, many have used the Standard & Poor's 500 Index from February 1966 through late October 2001 as reference points. During that period of almost 36 years, an investment of $1,000 in the index would have grown to $11,710 on a buy-and-hold basis.

But that return would not have been earned in steady manner. In fact, just missing the five best days in every calendar year of that period would have resulted in an investment of $1,000 shrinking to $150, based on a study done by investment firm, Birinyi & Associates!

That sounds like a strong case for buy-and-hold investing. Not being in the market during those crucial five days of every year would have cost you a bundle. Why lose $850 while you can gain $10,710?

What most investors don't realize is that Birinyi & Associates also found that a $1,000 investment in the S&P500 Index during that same period that missed only the five worst days each calendar year would have grown to $987,120. Clearly, a market timing system which can achieve that does not exist. But the huge contrast between $150 and $987,120 tells me that the opportunity to miss the worst days is greater than the risk of missing the best days.

In other words, it is probably better to wait for good opportunities to buy rather than simply plough money into the market whenever you have it. And trading is not a bad idea, especially in a long sideways moving market! Billionaire investor Warren Buffett would probably be accused by the buy-and-hold brigade of being a market timer if he weren't as successful as he has been.

Playing a sideways market

No doubt, the probability of losing money in the market is higher in the short term than in the long term. A popular study by Professor Roger Ibbotson concludes that from 1926 to 1999, the average compounded return from stocks was about 11.2% per year. If you hold a stock for more than 10 years, your investment performance will be much closer to these historical annual returns. But if you hold a stock for less than a year, the chance of you losing money in the stock market is very high, especially if you invest while the market is falling.

But what seems to be forgotten is that there have been significant periods of time when the only investors who managed to beat the return from holding cash were the ones who used market timing or portfolio allocation strategies. If you had invested $5,000 every year in the S&P 500 stock index over the 20 years from January 1956 to December 1975, your return would have been about $152,410. It seems a lot of money, but it hardly beat a timid saver who earned 4% per annum from a money market fund!

Moreover, if you were unfortunate enough to have invested a lump sum in February 1966, and spent your dividends like many other investors, you would have lost by 40% in December 1974. It was only after the end of 1982 that the index managed to break higher. That's a long wait of 16 years!

The buy-and-hold strategy then was reportedly scorned on Wall Street. Ironically, 25 years later, after a bull market from the late 1980s to 1990s, the strategy was back in vogue. But things have changed.

Applying the buy-and-hold strategy during the 3-year bear market from year 2000 to 2002, an investor would have lost as much as 40% of his investments. Even with the recovery in 2003 and 2004, investors would still be down about 11%. The index only broke even in 2007.

Now, from January 2000 to September 2011, after nearly 11 years, the index is still down 3% and 24.5% in Singapore dollar terms! And, that's before factoring in any fees. A few more volatile years like that and many investors might be forced to experiment with the heresy of market timing once more.

A misunderstood concept

Before I end, let me clear up some misconceptions about market timing. It is not about knowing the best time to buy and sell in order to make tons of money. We may get lucky occasionally, but nobody is always that lucky over a long period of time. Market timing is simply about raising cash when the adopted investment rules look bad but returning to the market when things look good again. This decision making process can be done using fundamental, economic and technical analysis.

Moreover, via investment platforms in Singapore, it is now possible for investors to switch among a stable of more than 200 unit trust funds at practically zero cost. In addition, capital gains taxes do not apply to stock and investment funds in Singapore. So, investors in Singapore have the means to practice market timing in a cost efficient way if they really want to.

My message to fund managers and distributors who blindly adhere to buy and hold investing is "Be careful what you are hoping for". The irony is that they are not aware that to really practice what they preach, many would lose their jobs. This is because all investors should buy and hold index funds, thus drastically reducing transaction and fund management fees. Active fund management still has its place if funds are truly actively managed and not merely using 'benchmark hugging' methods to track an index.

I believe that it is time for us to rethink the way we invest our money. There is a possibility that world equity markets will trend sideways for a long time. That represents a hostile environment for the buy-and-hold method, whatever its merits. Investors and advisers will have to learn a more active investment style if they are to keep their heads above water.

www.gyc.com.sg enquiries@gyc.com.sg +65 6349 1441

GYC is a licensed Financial Adviser, Registered Fund Management Company (RFMC) and Exempt Insurance Broker.

GYC Financial Advisory Pte Ltd | Co Reg No: 199806191-K | 1 Raffles Place #15-01 One Raffles Place, Singapore 048616