



November 2009

*t h e*  
F O C U S

A B r a n d e s P u b l i c a t i o n

Does “Buy and Hold” Still Work?

In the wake of market turmoil over the last two years, many investors may feel the need to change their approach and be more “nimble” or “opportunistic” in their pursuit of investment goals. For some investors, being nimble means abandoning fundamental tenets of traditional investment practices such as asset allocation, periodic rebalancing, and buying and holding individual securities. Some pundits claim that today’s “dynamic” market demands a dynamic approach. They advocate individuals adopt alternative methods that include market timing, short-term trading, absolute return strategies, and expanded use of derivatives.

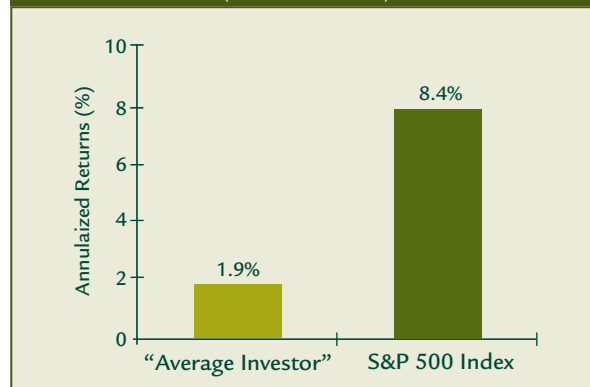
While such aggressive, non-traditional tactics may appear to have merit in the short run, the debate continues regarding their long-term effectiveness, investors’ ability to use these tools wisely, and the consequences associated with misusing alternative strategies. In this article, we address elements of traditional and alternative investment plans along with behavioral elements that may adversely affect decision making.

### **SOMETIMES, THE BEST COURSE OF ACTION MAY BE TO DO NOTHING**

Harvard University psychology professor Daniel Gilbert notes, “. . . in the long run, people of every age and in every walk of life seem to regret not having done things much more than they regret things they did. . . .”<sup>1</sup> People often feel better about doing something – regardless of whether it’s appropriate. When it comes to investing, doing something may lead to trouble. When markets fall, investors tend to sell holdings because it alleviates some of their fears. Investors also tend to buy at market tops because they believe recent gains will continue and they don’t want to feel foolish for missing out on a great opportunity. Often, such actions are completely at odds with the

premise of successful investing: buying low and selling high.

**Exhibit 1: Annualized Returns for the S&P 500 Index and the “Average” Equity Fund Investor (1989 to 2008)**



Source: Dalbar Quantitative Analysis of Investor Behavior, March 2009. Past performance is not a guarantee of future results. This example does not consider the effects of taxes or investment expenses. Actual results will vary.

Exhibit 1 illustrates returns for the “average” investor, based on fund flows, vs. the S&P 500 Index over the 22 years ending in 2008. While buying and holding the S&P 500 Index generated an 8.4% annualized gain over the period, the average investor earned just 1.9%. Morningstar publishes “investor returns” for individual funds that measure “. . . how the typical investor in that fund fared over time, incorporating the impact of cash inflows and outflows from purchases and sales.” Whether choosing active or passively managed funds, investor returns consistently are lower than funds’ total returns as a result of poorly timed purchases and sales. Investors’ long-term returns have been much worse than if, after making their initial investment, they had done nothing.

### **WHAT ARE INSTITUTIONAL INVESTORS DOING NOW?**

Individual investors aren’t the only ones weighing the benefits of abandoning investment plans developed years ago. Institutional plan sponsors (experts who manage billions of dollars on behalf of corporations,

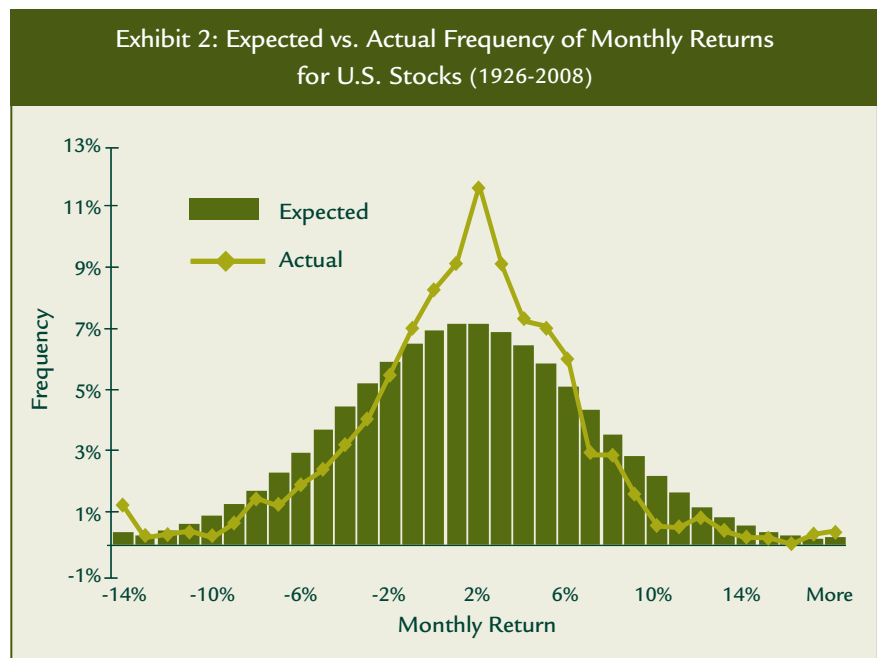
foundations, or endowments, for example) are also evaluating the pros and cons of becoming more nimble.

Robert Maynard, hired as Chief Investment Officer for the Public Employee Retirement System of Idaho (PERSI) in 1992, firmly believes in the benefits of keeping things simple.<sup>11</sup> When he was hired, PERSI ranked almost dead last (in the 99th percentile of public fund plans) for its 1-, 5-, and 10-year returns. Maynard made sweeping changes in how the plan's assets were managed by eliminating tactical asset allocation and opportunistic investing.

As of June 30, 2009, PERSI's performance over the 1-, 5-, and 10-year periods ranked it in the 33rd, 10th, and 18th percentiles, respectively. PERSI had about \$9 billion in assets on September 30, 2009. Given his plan's success, Maynard remains a strong proponent of investment approaches that are simple, transparent, and focused. And he criticizes increasingly popular tactics that emphasize intense active management, illiquid instruments and vehicles, often embrace leverage, and rely on many complex, opaque investment strategies. He calls the latter plans the "endowment" model.

Much of Maynard's conviction for a simple approach to investing stems from his belief that markets tend to be "wilder" and "milder" than most people think. The mild periods may provide confidence to take unnecessary risks or pursue exotic investment strategies. Such approaches may seem to work for lengthy periods. But as the old saying goes, such tactics "work right up until they don't." The consequences, when the market turns wild, can be devastating.

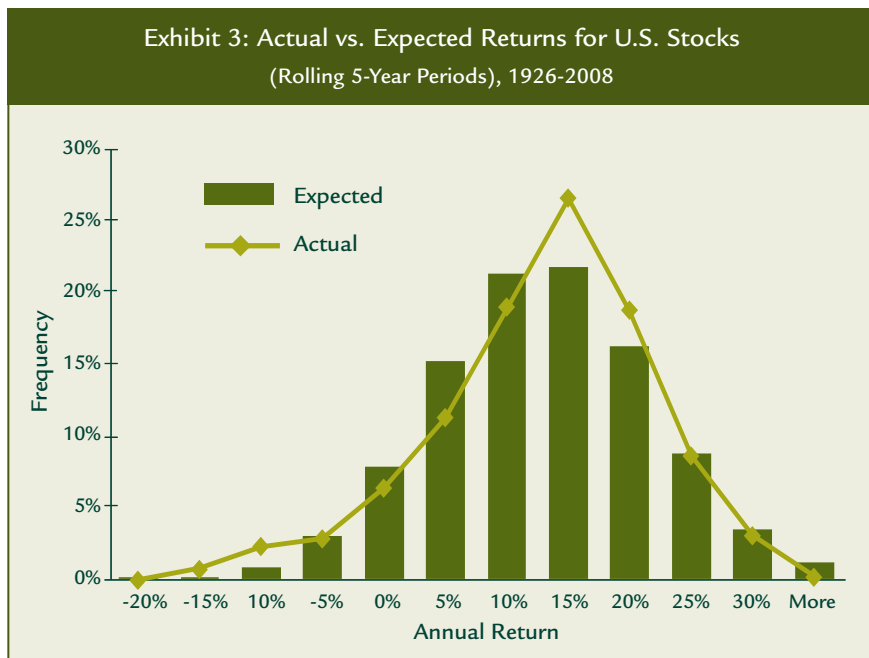
Many of the mathematical tools used to measure risk (such as standard deviation) are based on "normal" distributions. Exhibit 2 shows the differences between "expected" monthly returns for U.S. stocks between 1926 and 2008 based on normal distributions and actual returns. The "fat tails," when monthly returns were less than negative 14% or greater than 18%, have not been very numerous, but are responsible for much of the total market return. Over 10% of market movements came in only 1% of the months and over 40% of the market "action" (stock market movements of +/-10%) came in 13% of the market months.



Source: Actual returns from Ibbotson's *Stocks, Bonds, Bills and Inflation*, as of 12/31/08  
 Expected returns were generated under the assumptions of a normal distribution using Ibbotson data.  
 Past performance is not a guarantee of future results.

While historical returns on a monthly basis have been wilder and milder than one might expect, the wildness has tended to fade over time. Maynard believes that when managing portfolios for returns over 5-10 year periods, investors generally can use tools based on standard theories such as Modern Portfolio Theory ("MPT") that have been created over the past 40 years.

For example, annualized 5-year rolling stock market returns show a sharp reduction in “fat tails” as well as high peaks and are more consistent with the assumptions of normal randomness. See Exhibit 3.



Source: Actual returns from Ibbotson's *Stocks, Bonds, Bills and Inflation*, as of 12/31/08

Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. A hypothetical example is the 20-year time period from 12/31/82 through 12/31/02. This long-term period consists of 16 smaller five-year “rolling” segments. The first segment is the five-year period from 12/31/82 to 12/31/87. The next rolling segment is the five-year period from 12/31/83 to 12/31/88, and so on. Expected returns were generated under the assumptions of a normal distribution using Ibbotson data. Past performance is not a guarantee of future results.

Maynard sums it up, “So one can construct a portfolio with the basic goal of squeezing extra, marginal returns out of the mild periods or one can structure a portfolio with the basic goal of surviving shorter turbulent times in order to reach the calmer 10+ year time frames. It is difficult, if not impossible, to have both goals at once.” He contends that approaches relying on leverage, market timing, complex strategies, and exotic asset classes such as hedge funds seek to squeeze out extra marginal return at the risk of courting disaster in periods of high turbulence. “A conventional approach prefers the goal of simply staying in the game during calm times in return for much higher chances of survival and avoiding disasters during the wild and turbulent times,” he says.

## MARKET VOLATILITY

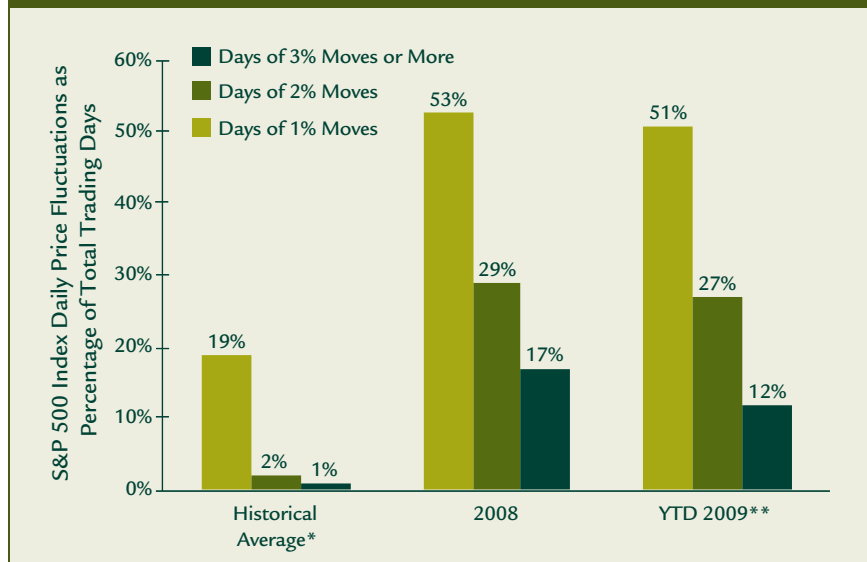
Stock price fluctuations in 2008 and 2009 have been more severe than historical averages. Exhibit 4 (next page) shows daily price moves of 1%, 2%, and 3% or more (up or down) for the S&P 500 Index. With prices climbing or falling sharply on a regular basis, investors might be tempted to alter their investment plans. But that can be dangerous. Long-term investors might want to ask themselves if they believe recent levels of volatility will continue or revert toward longer-term averages. If they truly believe the market will remain volatile, do they have proven strategies for capitalizing on its ups and downs?

Of course, investors who pulled money out of the stock market early in 2008 likely benefited as prices plummeted. However, how realistic is it to expect to replicate such effective market-timing decisions going forward? For those who raised cash in

2008, when did they get back in the market? On March 10 – just after the market fell to its lowest level in years? Later in 2009? Did they capture any of the nearly 60% gain (through 9/30/09) the S&P 500 Index posted since its March 9 low?

Having given up on long-term “buy and hold” strategies, many investors have turned to exchange traded funds (“ETFs”) as low-cost ways to accommodate market-timing moves. But John Bogle, founder of the Vanguard Group, a leader in index fund and ETF offerings, shared concerns recently about ETFs. Bogle participated in a live webinar on June 19, 2009 sponsored by IndexUniverse.com. “In many respects . . . that idea of using ETFs, exchange-traded

Exhibit 4: S&P 500 Index Daily Price Fluctuations  
(1948-2009)



Source: Leuthold Group, as of 9/30/09

Daily price movements measured using closing prices. Past performance is not a guarantee of future results.

\* Historical average between 1948 and 9/30/09. \*\* as of 9/30/09

funds, for speculation has come true, come *more* than true, come true in spades,” Bogle said. He said, “There are about 711 million shares outstanding of the SPDRS (Standard and Poor’s Depository Receipts) and they have 8 billion shares traded last year—8 billion shares of SPDRS traded.” And how have investors in SPDRS done? Similar to the Dalbar survey cited earlier, Bogle noted that “. . . the SPDR had a 5-year return of -1.9% a year—it’s been a difficult market—the average investor in SPDRs had a return of -8.2% a year. So you tell me whether all that trading is good for investors or is not good for investors.”

### THE NEED FOR LONG-TERM FOCUS

Market fluctuations – especially of the magnitude witnessed over the past two years – certainly can test investors’ long-term conviction. High levels of volatility may prompt investors to question the merit of their investment policy statements, asset allocations, investment managers, and financial advisors.

However, we do not believe a “buy and hold” strategy is dead. Nor do we believe that excessive trading, market timing, or exotic asset classes are wise, long-term approaches for creating wealth. In managing assets on behalf of our clients, we distance ourselves from many of the underpinnings of Modern Portfolio Theory. For example, we do not believe markets are rational in the short term. We believe short-term irrationality consistently creates opportunities for long-term, rational investors.

As legendary investor Warren Buffett explained, investors should think like business owners. According to BBC News, “He [Buffett] has always bought

shares for the long term and, as a shareholder, thought of himself as buying a part of a business. Focusing on share prices, he says, makes you a mere speculator, whereas a real investor ‘looks to the asset itself to produce the return.’”<sup>iii</sup>

In managing portfolios, Brandes Investment Partners® remains committed to the enduring principles that have guided our firm since its founding in 1974. We believe analyzing individual businesses and capitalizing on meaningful differences between the value of those businesses and their security prices represents the best way to build wealth. We invite clients to stay focused on the long term, to resist the temptation to act in the short term, and allow time and a well-conceived investment plan to bring them toward their goals.

---

<sup>i</sup> Gilbert, Daniel. *Stumbling on Happiness*. New York: Knopf, 2006. Page 179.

<sup>ii</sup> Robert Maynard is also a member of the Brandes Institute's Advisory Board.

<sup>iii</sup> Miller, Charles. "Warren Buffett: Crisis, What Crisis?" BBC News. Oct. 25, 2009. <http://news.bbc.co.uk/2/hi/business/8317072.stm>

The S&P 500 Index is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Investing in Exchange Traded Funds ("ETFs") involves specific considerations for investors, including expenses, liquidity risks, and the possibility that ETF shares may trade above or below their net asset value.

The information provided in this material should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any security transactions, holdings, or sectors discussed were or will be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance discussed herein. Strategies discussed herein are subject to change at any time by the investment manager in its discretion due to market conditions or opportunities. Please note that all indices are unmanaged and are not available for direct investment.

The foregoing reflects the thoughts and opinions of Brandes Investment Partners® exclusively and is subject to change without notice.

Brandes Investment Partners® is a registered trademark of Brandes Investment Partners, L.P. in the United States and Canada.