

The Nine Lives of the Buy-and-Hold Approach

By Fran Kinniry, CFA®

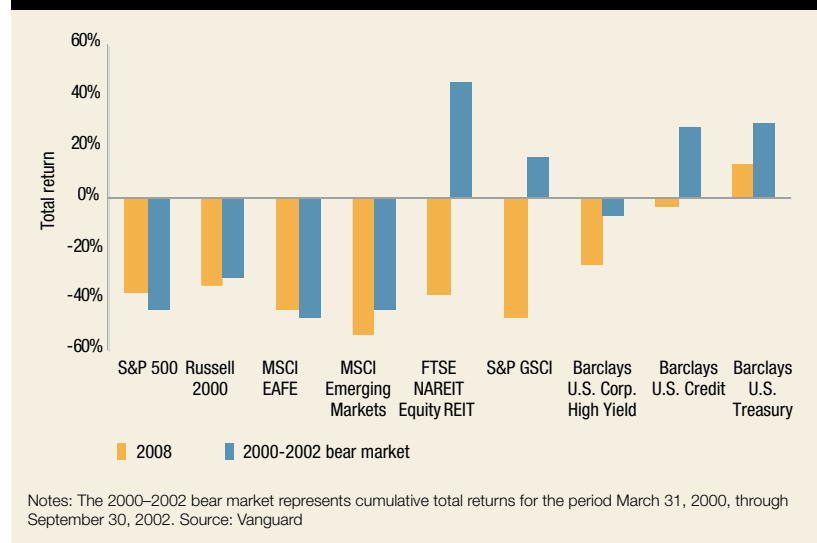
The death of the “buy-and-hold” investment strategy has been greatly exaggerated. For most of the year, media outlets have proclaimed the strategy *kaput*. Even the *Wall Street Journal* ran a story titled: “Advisers Ditch ‘Buy and Hold’ for New Tactics.”¹

Some pundits have seized on the market decline of 2008 and early 2009 as proof that investing for the long term in a portfolio of diversified securities is a sure-fire way to ride the market down while a more tactical approach enables a manager to bob-and-weave out of the way of oncoming market slides. Although the old Wall Street expression says, “An investment is simply a trade gone bad,” investing is not meant to be a game of chance; rather it’s a practice of patience and strategy.

Buy and hold is a strategy known by many definitions. Some investors interpret the approach as “set it and forget it.” That is, set an asset allocation based on risk tolerance and other factors, buy diversified investments in the appropriate percentages, and then let the portfolio run its course—all the while oblivious to market fluctuations. This strategy would have had an overweight in equities in the late 1990s, an underweight in equities in 2002–2003, and an overweight in equities again in 2007.

Contrary to this completely passive strategy, a buy-and-hold approach also can be thought of as “staying the course.” Once a strategic asset allocation is established, based on an investor’s goals, objectives, time horizon, risk tolerance, and other unique factors, the portfolio is rebalanced to that target allocation as the capital markets move. Right now, many investors find their asset allocation has changed, not due

FIGURE 1: MOST DIVERSIFIERS FROM THE 2000–2002 BEAR MARKET STUMBLING BADLY IN 2008



to any action of their own but simply because the current market has imposed changes. By rebalancing, an investor corrects this divergence from the original asset allocation and “buys and holds” in line with the original plan.

For strategic asset allocation—and a stay-the-course approach—to work, two significant tenets of investing must hold true: the benefits of diversification and the risk premium of stocks over bonds. Some pundits claim that these principles have faltered, but we disagree. We continue to believe that traditional risk/reward relationships still exist, that higher-risk assets should reasonably be expected to produce higher returns, and that diversification and staying the course will remain effective approaches regardless of future market gyrations. So, why have we seen such derision of time-tested investment strategies and is there any truth in the claims?

The Data are Deceiving

“There is terror in numbers,” wrote Darrell Huff in his bestselling book, *How to Lie with Statistics*.² More than 50 years ago, Huff illustrated how the misinterpretation of statistics can lead to inaccurate conclusions, and we see this today underlying the arguments against diversification and modern portfolio theory. For example, many people incorrectly believe that diversification let them down during the financial crisis.

During the 2008 financial crisis, many market sectors that had provided ample diversification in earlier bear markets failed to do so (see figure 1). The orange-colored bars would seem to indicate that diversification did not work in the latest bear market. However, figure 1 clearly demonstrates that diversification works, but only if investors had the *right* diversifiers. Unfortunately, many people gravitated away from traditional diversifiers such



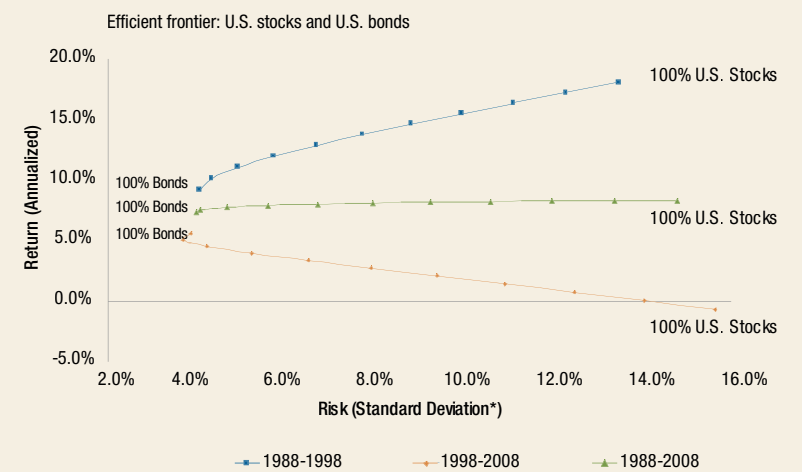
as Treasuries and investment-grade bonds and invested across other, riskier asset classes—real estate investment trusts, alternative investments, high-yield bonds. Those asset classes became more highly correlated with U.S. equities than in the past and in many cases underperformed the broad equity market. Most people who thought they were getting diversification of risk actually were getting amplification of risk.

Investors who held a more traditional mix of equities and Treasuries, high-grade municipal bonds, or corporate bonds, fared relatively well during the 2008 bear market. In fact, a portfolio split evenly between stocks and bonds lost 24.8 percent during the recent bear market then regained 23 percent during the recovery, for a total loss of only 6.8 percent. An all-equity portfolio lost 57 percent during the bear market and then recovered 62 percent over recent months, for a total loss of 27.6 percent.³ Diversification was never meant as a panacea, but it did successfully insulate investors from the full brunt of the market decline. It's impossible to know what the "right" diversifiers will be in the future, but owning a broadly diversified portfolio ensures that you will own some of the best and worst areas of a market and will not be entirely committed to the best or the worst.

The data also seem to indicate that the common assumptions about the risk/reward tradeoff between stocks and bonds are wrong. In figure 2, the blue line shows a normal-looking efficient frontier. As risk increases from 100-percent bonds to 100-percent stocks, reward increases. Over the past 10 or 20 years, however, as indicated by the green and orange lines, as investors moved further out on the risk spectrum, they were not compensated for that additional risk. It was clearly a bad time to invest in equities. However, past performance does not dictate the future.

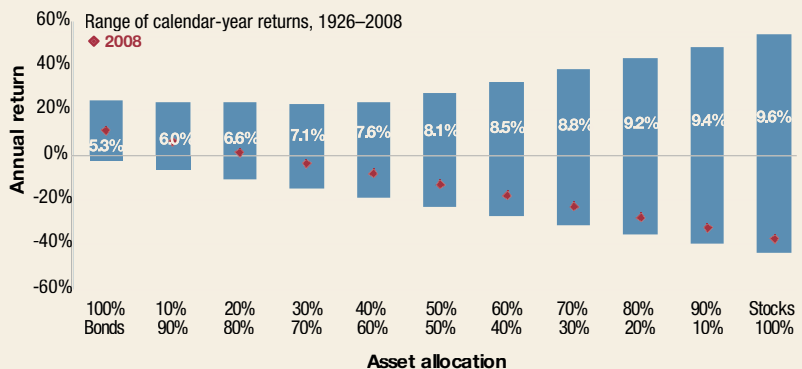
When we examine long-run performance, the equity market has a substantial return premium over bonds

FIGURE 2: TIME-SPECIFIC NATURE OF DATA CAN GIVE CONFUSING SIGNALS



*Standard deviation is a measure of the variability of a data set and measures how widely values are dispersed from the average value (the mean).
Data: "U.S. Stocks" is the returns from the Dow Jones Total U.S. Stock Market Index from December 31, 1987, through April 22, 2005, and the MSCI U.S. Broad Market Index thereafter. "U.S. Bonds" is the returns from the Barclays U.S. Aggregate Bond Index. Source: Barclays Capital and Vanguard

FIGURE 3: ASSET ALLOCATION MODERATES RISK—ASYMMETRIC PAYOFF



Stocks are represented by the S&P 500 Index through 1970; the Dow Jones Wilshire 5000 Index from 1971 through April 22, 2005; and the MSCI U.S. Broad Market Index thereafter. Bonds are represented by the Ibbotson Intermediate-Term Government Bond Index through 1972, and the Barclays Capital U.S. 1-5 Year Treasury Bond Index thereafter. Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Sources: Ibbotson Associates and Vanguard Investment Strategy Group. As of December 31, 2008.

and money markets. For example, when we look at 20-year periods in history, the stock market has outperformed the bond market in more than 90 percent of the observations. And if we move to 30-year horizons, we see the stock market outperforming the bond market 100 percent of the time. A long time-horizon doesn't erase the risks of stocks, but it may increase the probability of

realizing the expected risk premium. In fact, today's risk premium of equities relative to fixed income looks about as attractive as it did in the mid-1990s. Efficient frontiers change dramatically across time, and it's important to look beyond time-period dependent data.

If the tenets of diversification and risk/reward remain true, then so does a strategic asset allocation approach to



portfolio construction. We recommend that investors form portfolios beginning with a focus on the broad asset allocation, then the subasset allocation, and finally fund selection. Too many investors start by looking for the best funds and arrive haphazardly at broad allocation levels. The asset allocation decision is the most important factor in risk and return, as demonstrated in figure 3. As a portfolio increases from 100-percent bonds to 100-percent stocks, the portfolio's returns increase, as does the risk, as measured by the range of possible returns.

Human Bias as a Driver of Behavior

Time-period dependent data certainly plays a role in dissuading investors from holding to a tried-and-true approach, but our own human behaviors also play against us. Let's acknowledge that it is very emotional for investors to lose their hard-earned wealth; distraught clients naturally will look for concrete reasons for portfolio losses, and the buy-and-hold approach and modern portfolio theory are the scapegoats. This reaction is nothing new, and we've

“The chance of gain is by every man more or less overvalued, and the chance of loss is by most men undervalued.” —Adam Smith

seen similar responses during prior bear markets. That's in part because our brains are hardwired to react to risk in specific ways. One of the primary biases at work during last year's financial crisis was the bias of loss aversion.

Adam Smith in *Wealth of Nations* seemed to say it best: “The chance of gain is by every man more or less overvalued, and the chance of loss is by most men undervalued.”⁴ Loss aversion is the concept that the distress from loss is more negative than the sense of joy from gain is positive. In psychological terms, a \$1 loss is about two and half times more painful than a \$1 gain is pleasurable. In other words, a gain of \$2.50 or so is needed to offset a \$1 loss on a portfolio.⁵ Loss aversion appears to be at the root of many of the worst types of investment behavior, such as selling out of the market entirely, abandoning asset

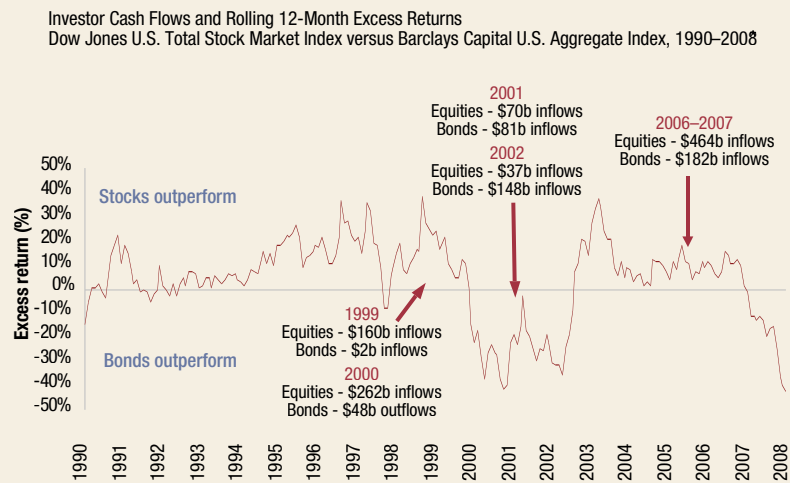
classes based on short-term returns, and focusing on specific losing investments rather than on overall portfolio performance. So, it is only natural that investors would be concerned and emotional as their assets decline in value. The extension of this is to lose faith in or blame the investment strategy, calling into question the value of asset allocation and diversification. This is where a financial advisor can act as a counterweight to clients' decision biases.

Moreover, humans are subject to herd mentality—the desire to move from what's not working to what is working. In fact, we see this quite clearly in figure 4, which shows cash flow data. Investors chase those areas of the financial market that have performed well in the past. In 2000, cash flow to stocks reached its highest level of relative outperformance over bonds, just before the stock market began its decline. Likewise, in 2002, bonds garnered the majority of cash flows, just as the equity markets began to recover. This year is no different: Cash flows to bond funds have topped \$220 billion through August,⁶ and many investors have missed the equity markets' strong recovery.

If history is any guide, it shows that, generally, humans are momentum investors rather than top-down investors, and we work to our own detriment. As a financial advisor, in periods of declining markets and loss aversion, it's critical to reframe investors' perceptions to the bigger picture, using appropriate data to explain current recommendations and putting portfolio losses in an historical context. It's not wise to give into biases by changing course altogether.

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FIGURE 4: ASSET ALLOCATION—AN EMOTIONAL ANCHOR TO CONTENT WITH TEMPTATION




As of December 31 for each year.
Sources: Vanguard Investment Strategy Group and Strategic Insight



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A financial advisor who provides proper asset allocation and oversight ensures that a client's portfolio follows investment policy and adds substantial value relative to an investor acting alone. Yet, market unpredictability can lead some investors—even financial advisors—to make abrupt changes in portfolios, which is likely a mistake. Despite hyperbole and headlines, everything we know about investment theory and practice suggests that staying the course and remaining diversified will continue to prove effective long after the din subsides. Advisors can keep clients on track by buffering emotion and biases, and by presenting an historical view of investment results that is grounded in long-term data. 

Fran Kinniry, CFA®, is a principal of Vanguard and a senior member of Vanguard's Investment Strategy Group, where he and his team are responsible for customized investment solutions, investment market commentary, and research. He earned BA and MBA degrees from Drexel University. Contact him at francis_m_kinniry_jr@vanguard.com.

Endnotes

- ¹ See Anne Tergesen and Jane J. Kim, Advisers Ditch 'Buy and Hold' for New Tactics, *Wall Street Journal* (April 29, 2009), available for subscribers at <http://online.wsj.com/article/SB124096109870565775.html>.
- ² Darrell Huff, *How to Lie with Statistics* (New York: W. W. Norton & Company, Inc., 1993).

- ³ Source: S&P 500 Index and Barclays Capital U.S. Aggregate Bond Index (rebalanced monthly). Data provided by Factset, Thomson Reuters Datastream, and Morningstar. Through October 19, 2009.
- ⁴ Adam Smith, *The Wealth of Nations* (1776), available at <http://www.adamsmith.org/smith/won-intro.htm>.
- ⁵ Amos Tversky and Daniel Kahneman, Judgment under Uncertainty: Heuristics and Biases, *Science* 185 (1947): 1,124–1,131.
- ⁶ Source: Investment Company Institute, http://www.ici.org/research/stats/trends/trends_08_09.