

Are You a Buy-and-Hold Investor or an Active Management Investor?

By Warren Wall
President, W. Wall & Company RIA

Most financial advice you read will advise you to buy a good stock or mutual fund and stick with it for the long-run. After all the writers maintain, no one knows what the future will bring, but we do know that historically the overall direction of the market has been up. A buy-and-hold position benefits from that long-term trend.

The problem is that very few investors really buy and hold. In fact, studies by Dalbar Inc. have consistently shown that the average mutual fund investor underperforms not only the market indices but also the performance of the funds in which they invest. What is happening? Does buy-and-hold investing work or should investors take an active approach to managing their investments?

At the risk of verbal abuse from both the buy-and-hold advocates and active managers, I would like to assure you that both strategies work. But there's a big IF. These strategies work IF they fit the investor's personality and risk tolerance.

The purpose of this article is to help you understand the advantages of both buy-and-hold investing and active investing, what it takes to make these strategies work for you and which investment approach fits your style.

Using a Buy-And-Hold Investment Approach

Many investors think they are buy-and-holders, but in fact they use a form of active management that one of my compatriots, Paul Merriman, calls the ICSIA or "I can't stand it anymore" timing system. Followers of the ICSIA approach jump into the market when they can no longer stand to sit on the sidelines watching other people making what looks like "easy money." Too often they buy right as the market is nearing a top. ICSIA investors then remain invested as the market declines until they can't stand the losses any more – and bail out often at the market's lows.

True buy-and-hold investing is the careful selection of an appropriate balance of assets for your portfolio, with the intent to hold those assets until either you need the money or your investment needs change. Based on the allocation of assets in the portfolio, this style of investing can be very conservative or very aggressive. The most

aggressive buy-and-hold approach is 100 percent in equities; the most conservative is 100 percent in fixed-income.

A true buy-and-hold approach does not sell securities to lock in gains or to cut losses. Instead, on a quarterly or annual basis, the portfolio is rebalanced to return to the established asset balance.

Rebalancing requires selling assets that have performed the best - and become an outsized proportion of the portfolio - and buying asset classes that have underperformed. It's the opposite of the old Wall Street adage, "Let your profits run and cut your losses short," but it does have the advantage of forcing you to "Buy low and sell high."

Buy-and-hold investing has four main advantages:

Once you have determined the right balance for your portfolio, managing your investments is easy. You don't have to worry about watching the market or the performance of your investments. There are no decisions to make. You can walk away from your portfolio with the exception of periodic rebalancing.

With a buy-and-hold portfolio, you should have minimal investment expenses. Other than rebalancing or adding additional funds, there will be little on-going trading costs and management fees are minimal.

Buy-and-hold investing offers greater tax efficiency. Gains on securities will tend to be capital gains, reducing tax liabilities. Unrealized capital gains that are passed on to your estate will do so on a stepped-up basis, eliminating taxes on that appreciation. You will still incur tax liabilities for mutual fund distributions and periodic rebalancing, but overall, assets will be held longer.

Your results will mirror market benchmarks. There's a certain comfort level in being just like everyone else. When your portfolio is down, you have the reassurance of knowing you are not alone. There's no one, including yourself, to blame for the performance of your investments. Performance is a result of the greater market trend.

Why Buy-and-Hold Investing Doesn't Work for Everyone

The number one reason many investors under perform when attempting to use a buy-and-hold investment approach is the emotional demand this approach makes. At one time or another, buy-and-hold investors will lose money. Possibly a lot of money. Peter Lynch and Warren Buffett have both warned that if investors aren't prepared to

lose 50% of their portfolio, they shouldn't be in the stock market on a buy-and-hold basis.

Even if you philosophically accept the risk of buy-and-hold investing, it's a different matter when your net worth begins to steadily erode with a downtrend in the market. Most investors find themselves unable to hold for the long term and inevitably sell at the worst time.

Do you have the emotional fortitude and the time to wait for a recovery that buy-and-hold investing requires?

Another issue is that a buy-and-hold portfolio, because of its diversification in different asset classes that tend to counterbalance highs and lows, will always be underperforming one of more segments of the market.

Can you tolerate that underperformance when the media coverage and the comments of others make it sound like everyone else is doing better than you?

There is no magic allocation. Determining the right allocation for your portfolio isn't that simple. The smaller the equity portion of your portfolio, the less the risk, but also the less the return potential. Too large of an equity position could result in losing more money than you can endure. Too little risk and you could fail to achieve the performance you need to meet your financial goals.

A bear market could hit the worst time. On average, a bear market - defined as at least a 20% drop in the broad market indices - occurs every five years. In the U.S., this has resulted in an average loss of 34% of the market's value (omitting the crash of 1929 when the market declined 87%). A bear market when you need to withdraw funds from your account could substantially change your retirement plans.

Your allocation could be wrong for current market conditions. The typical asset allocation for a buy-and-hold portfolio is based on historical returns and risk characteristics for individual asset classes. This data cannot predict what asset classes will do well in the future. For example, international funds have underperformed at a higher risk level than domestic funds over the past five years leading to a tendency to underweight the international class. If domestic funds falter while international funds surge ahead, a buy-and-hold portfolio has no ability to take on greater international exposure and opportunity.

[Using an Active Management Approach](#)

One of the difficulties of analyzing an active approach to the market is defining what constitutes “active.”

Active management is essentially adjusting an investment portfolio in reaction to changes in the value of a company, sector or overall market. In comparison to buy-and-hold investing, active management takes an opportunistic approach to the market. The active manager believes there are inefficiencies in the market that can be exploited to improve risk-adjusted returns.

Active management strategies that work tend to have three similar characteristics:

- They are a systematic, non-emotional commitment to make changes in the allocation of investment assets whenever the system indicates that an asset or asset class will perform better than another for the immediate future.
- They use *on-going* fundamental or technical analysis of investment options to make their investment decisions.
- They are applied consistently over time.

Active management ranges from 100% moves from a single asset class to cash and back in response to buy and sell signals to dynamically allocating a portfolio among asset classes or individual securities in response to perceived opportunities for gains or to protect the portfolio from losses. An active strategy could move from large-cap stocks to small-cap ones, from European bonds to Latin American bonds, from healthcare stocks to Internet stocks, from equities to bonds or from short-term bonds to long-term bonds.

Investors who participated in the market from 1965 to 1982 tend to have a bias toward active management. These are investors who experienced firsthand the market drops of 1960, 1968-1970, 1973-1974, and 1980-1982 and are aware that from 1965 to 1982, after inflation, the U.S. stock market as a whole went no where. The upward bias that buy-and-hold investors depend on was missing from the market for 17 years.

Although active management is often characterized as a “riskier” approach to investing by those who espouse buy-and-hold investing – more later about missing the best days of the market – in reality, it can be a very conservative approach, moving to the safety of a money market position when downturns appear to be underway.

ADVANTAGES OF ACTIVE MANAGEMENT

Active management has four main advantages:

Active management takes to desire for many investors to “do something” and channels it in a very deliberate strategy. For many people, the passive nature of buy-and-hold investing is counter to their basic nature. Faced with a growing loss or a missed opportunity, they want to take action, to change the results, limit the loss, explore the opportunity. Rather than working counter to these very natural human characteristics, active management provides a structure for making better investment decisions.

Active management reduces the risk of a major market drop decimating your portfolio. There’s no similar protection in buy-and-hold investing except having a substantial part of your portfolio devoted to fixed-income investments. And that reduces returns while it reduces risks.

Active management gives you at least the possibility to outperform flat or declining markets by avoiding the devastating losses of a bear market and opportunistically positioning your portfolio in sectors of the market that are doing well.

Active management gives you a tool with which to invest in more volatile aspects of the market, such as sector funds or leveraged funds. Without active management, these investment classes are much more risky.

DISADVANTAGES OF ACTIVE MANAGEMENT

There is no perfect system. There will be periods during which an active management strategy doesn’t do what it’s supposed to do. There is no way to know for sure that a strategy that’s been successful in the past will be successful in the future. Every time you make an investment decision, you face uncertainty.

When you fail, it’s your fault. When you do succeed, the market gets the credit. Active management requires making ongoing decisions. You can’t just walk away from your portfolio and its performance, unlike buy-and-hold investing. For many people, it is a much more stressful approach to the market than buy-and-hold investing.

Active management doesn’t work unless the investor has a high level of resolve, discipline and commitment, and the time follow your investments on a regular basis.

You have to be able to stay the distance and not continually look for the next sure thing, the better system, the smarter trade.

Active management often underperforms buy-and-hold strategies over the long term. According to a study tracking 10 years of mutual fund performance by Fulcrum Financial, a division of Fulcrum Financial Inquiry LLP in Los Angeles, 81% of actively managed value funds underperformed their benchmark indices, along with 72% of blend funds and 63% of growth funds. A primary factor is the additional costs created by active management, including management fees, sales load/redemption fees, brokerage fees and spread costs. The trends are similar when looking at individual money managers. With that said, there are clearly managers that excel, particularly in the growth investment arena.

Active management can lose money when the market is going up. Because many active strategies use trend following, buy and sell signals will lag actual market action. Leveraged funds can compound the pain of being on the wrong side of the market.

KEYS TO ACHIEVING INVESTMENT SUCCESS

Regardless of whether you choose buy-and-hold or active management, your success is going to require a disciplined approach. If you do not have the time, interest or emotional fortitude to be successful in your investment approach, hire an investment advisor. A good investment advisor who can help you formulate an investment approach that fits your personality and financial goals and keep you on track is well worth the annual expense.

Whether you opt to work with an investment advisor or manage your own money, the following are some lessons I have learned over the years to improve your probability of succeeding.

Tips for Achieving Buy-and-Hold Success

- (1) Use mutual funds or Exchange Traded Funds for your portfolio. Because these funds invest in multiple stocks, you reduce the risk of one company's misfortune torpedoing your entire portfolio.
- (2) Diversify your portfolio among the major asset classes. These include small- mid- and large-cap stock funds, value and growth stock funds, and international and emerging market funds. How you allocate your portfolio among these asset classes

will depend on your risk tolerance and return objectives. This is where professional help can be of great value.

(3) Know your risk tolerance and invest accordingly. Remember, for a buy-and-hold approach to be successful you have to commit to it for the long run. You are going to have some good years and some very bad years. If you haven't invested at a risk level you can accept, you are going to exit the strategy at the worst time.

(4) Work with an Investment Advisor. A good investment advisor can help you structure your portfolio correctly in the first place, manage the periodic rebalancing, provide you with a greater understanding of the market and where it is going, and help you stay committed to your investment approach.

Tips for Achieving Active Management Success

(1) To be successful, you need a trading system that is based on quantifiable factors and can be backtested over several market cycles. You want to know how the system has performed in up, down and trading range markets, what type of losses you could experience and how the system matches your risk tolerance. Predictions and intuition are not reliable investment tools.

(2) Use a system that limits losses. It is always harder to recover from losses than investors expect.

(3) Diversify. Just as with a buy-and-hold portfolio, one active management strategy should never have the capacity to wipe out your portfolio. You need to diversify your active management strategies to better protect your portfolio. For example, W. Wall & Company RIA uses multiple active management strategies to potentially capture higher investment returns with lower overall risk exposure.

(4) Make certain your investment strategy is implemented systematically on a disciplined basis. Here again, an investment manager can be indispensable. You don't have to worry about not having the time to follow your system, going on vacation or getting out of synch with the strategy.

(5) Work with an Investment Advisor. If you don't have the time, technical ability, and access to the information you need on a daily basis, or lack the inclination to methodically trade your investments, work with a professional investment advisor

whose system you understand and whose approach matches your investing inclinations.

Still unsure whether buy-and-hold or active investing best fits your style? Perhaps you should do both. In many ways, it's another form of diversification that may serve you well.

There is no easy way to invest. The very act of investing requires taking a risk. Your job is to choose the risk you accept carefully and to approach investing with discipline. Remember that there is also a risk if you fail to invest. Very few people can afford to retire on their savings alone. To keep up with inflation and the burden of taxes, your savings need to be growing, and that requires investing.

Warren Wall is president of W. Wall & Company RIA, a registered investment advisory firm based in Asheville, North Carolina. Wall has been involved in the financial industry for more than 22 years and utilizes active investment strategies in the management of client assets.