IS BUY AND HOLD DEAD? NOT SO FAST.

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The market events of the past 18 months have led even the most seasoned investors to question their investment process. Professionals and amateurs alike are refining their strategy and assessing it’s effectiveness in helping them achieve their goals. It is during volatile times that many wonder, is there a better way?

With the proliferation of a constant flow of business news and information that emphasizes “Fast Money”, “Mad Money”, and the quick, fast track to investing success, it’s no wonder so many individuals are taking their chances at becoming short-term market timers or traders. The hot trend, of course, has been to seek large profits by “playing” the current volatility in stocks. Benjamin Graham, the widely recognized father of Value Investing, referred to this as “speculation”, gambling if you will, in his book The Intelligent Investor. In truth, an individual investor with a long-term time horizon and a short-term trading focus is undertaking a highly counterproductive investment strategy. Two enduring facts support this conclusion: 1) A short-term focus only serves to amplify the very real costs of investing and 2) After these costs, the probability of outperforming the market by calling peaks and troughs year-after-year is very low.

THE COSTS OF INVESTING

When one thinks of investing costs, commissions and fees typically come to mind. While important, these costs are only part of the equation. Taxes and Opportunity Costs also play an important role in determining the true return on investment. Each of these costs is the result of a decision made during the implementation of a trade. As the number of decisions increases so do the costs, potentially leading to lower returns. Most individuals do not account for these costs when assessing their investment performance.

1) Commissions – technology has made commission costs negligible when making infrequent trades over a long time horizon. When dealing with frequent, short-term trades however, commissions can quickly erode an investment’s return. For illustration purposes, consider a purchase and sale of $1,000 worth of stock with a $12 commission and return on investment of 15%. After commissions, the return falls from 15% to 12.6%. These costs only increase as the trading activity required to achieve the 15% return increases. Buying and selling twice would reduce the return to 10.2%.

2) Taxes – Booking a quick profit on an investment feels great – it’s easy money. But taxes can erode an investment’s value even quicker than commissions. A recent article written by Stephen Mauzy, CFA appeared in the May/June issue of the CFA Institute Magazine and cited the following example: A buy-and-hold “investor” purchases $50,000 worth of stock and over the next five years it doubles. The investor sells and books a $50,000 profit which nets to $42,000 after-taxes. Now consider a scenario in which a “trader” captures the same gross $50,000 profit through short-term buying and selling in 10,000 increments. Over the same period the trader nets $9,500 less, or $32,500 by paying a 35% income tax rate on each $10,000.

3) Opportunity Costs – Perhaps the most overlooked costs are opportunity costs which are ever-present in investing. Consider a trader who purchases ABC stock for $20 a share (his buy target) and subsequently sells it two months later for $30 per share while a buy-and-hold investor would’ve booked the full profit at a lower tax rate.

Mathematical law is on the side of the investor who is willing to make an investment in his future, a strategy often called buy-and-hold. To answer the question posed in the title of this article, buy-and-hold is not dead. Warren Buffett says his “favorite holding period is forever”. While sage advice, one must also know when to sell an overvalued holding and book profits – perhaps the most difficult decision of all and especially important in volatile times. These are the decisions that ultimately lead to long-term wealth creation. It is in your best interest to maximize the likelihood of being correct more often than not.

CALLING THE PEAKS AND TROUGHS

Chart A represents the annual capital returns on the S&P 500 since 1950. As you can see, there is no pattern to annual equity returns. Calling the tops and bottoms year after year is not only difficult, it’s nearly impossible.

CHART A
The Speculator’s Task

The long-term investor who can see beyond annual returns stands to benefit from the fact that financial markets, over the long-term, tend to rise. Consider the same data shown as a 20 year simple moving average of returns (ie. Average of years 1950-1970, 1951-1971, and so on). The predictive nature in Chart B is much more evident.

CHART B
The Investors Good Fortune
S&P 500 20 Year Simple Moving Average (1950-2008)

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