

# Long Live Buy and Hold

Reports of the death of buy-and-hold investing are rampant, but greatly exaggerated.

- Investors apparently are worried about stock market returns after the “Lost Decade” but seem unaware of the fact that, on a total return basis, the U.S. stock market is at an all-time high.
- High-frequency trading and some of the “hiccups” in the stock market, including the failed BATS Global IPO, the 2010 “Flash Crash” and the recent \$440 million Knight Capital Group loss, have led investors to think the market is rigged against them. But *trading* is not *investing*.
- The Madoff scandal, the near collapse of the banking sector and the lack of accountability have broken confidence. Meanwhile, the press has done a poor job of countering these irrational fears—instead it has helped feed the sense that buy and hold is dead and equities are a lousy investment.

To put it bluntly, it’s hard to think of a time when so much inanity about the stock market and investing was given this much serious coverage on air, in print and online, especially from some normally reputable sources. We have to wonder if the same people who are promoting the notion that stocks are dead are simply reflecting on their own stock market losses, having been mauled during the last bear market because they failed to follow the well-worn (and old school) advice of staying diversified, buying low and selling high, investing in things you understand, or, in Adviser Investments’ case, investing with managers you know and respect.

## Who Says Investors Can’t Win?

Where is all of this anti-stock negativity coming from?

First there’s the issue of investors’ unrequited expectations of returns of 10% per year (not 10% annualized over many years), which was unrealistic to start with. This false sense of safety was fostered by a very, very benign yet bullish 1990s stock market, coupled with the popular “set it and forget it” indexing mantra. In simple terms, indexing adherents promoted the idea that *being* the market—rather than trying to *beat* the market—was the smartest investment strategy on earth.

Note that in the following analysis we’ll use Vanguard and its flagship S&P 500 index fund to illustrate some of the points we think bear consideration. As a proponent of both buy-and-hold investing and indexing, Vanguard should shoulder some blame for investors’ current confusion.

Unfortunately, the 1990s were followed by the so-called Lost Decade, which ran from the end of 1999 through the end of 2009. Vanguard 500 Index, the mutual fund industry’s poster child for the Lost Decade, generated an annualized loss of 1.0%. If that wasn’t bad enough, during the course of those 10 years, investors suffered through not one, but two major bear markets.

Talk about bursting the expectations bubble.

And let’s not ignore the 30-plus-year bond bull market, which has created an entirely new set of unrealistic expectations about the “safety” and profitability of bonds. Most of today’s investors—and probably a good number of today’s bond fund managers—have never experienced a bear market in bonds.

In addition, the rise of the internet age has spawned a proliferation of blogs for which accountability is nonexistent, while a 24-hour news cycle farming ratings with hyperbole have both added to the uncertainty and sense of doom that pervades investors’ thinking today.

Finally, the aforementioned technical glitches, including the 2010 “Flash Crash,” the computer-botched IPOs of both BATS Global Markets (cancelled) and Facebook (a disaster), the most recent fiasco that lost Knight Capital a cool \$440 million in some 45 minutes of computers-run-amok trading, plus the Madoff Ponzi scheme, the banking sector meltdown and the fact that none of the main actors in that banking debacle have gone to jail have certainly rattled investors’ nerves and battered their confidence.

Of course, not all investors have abandoned stocks. Someone is buying and making prices go higher in the face of all of the shrill, anti-equity silliness. And those buyers have been making some nice coin. On a total return basis, counting dividends, the Dow Jones Industrial Average has hit two-dozen all-time highs this year—most recently in mid-August.

But many investors seem ignorant of the gains they’ve made (or could have made)—possibly because they’ve missed out in their risk-off flight to bonds.

Let’s explore some of these thoughts in a bit more detail.

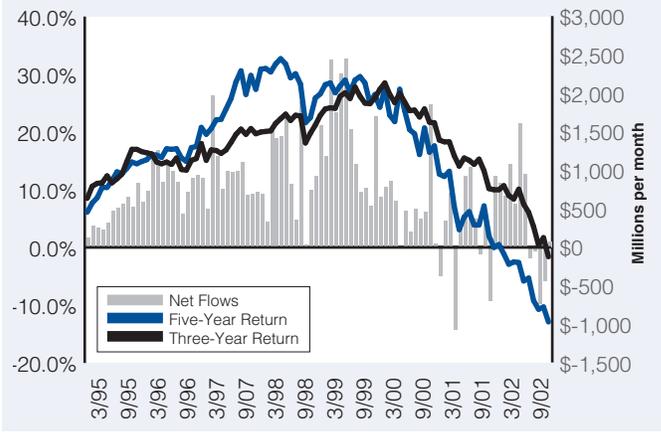
## Buy the Manager, Not the Market

For all the good of its low-cost ethos, Vanguard must take a good chunk of the fault for current investor dismay. Their incessant marketing of the notion that simply indexing the entire stock market was the path to investment success rose to a fevered pitch during the 1990s, as stock market returns reached heretofore unheard-of heights. Then-chairman Jack Bogle and Vanguard CIO Gus Sauter were the preachers par excellence for buying the market and being the market. It was hard for the casual investor to resist their arguments and, as the drumbeat for indexing grew louder, investors loaded up.

Consider 500 Index, Vanguard’s massive, low-cost S&P 500 index tracker. During the mid-1990s, the fund sported both three-year and five-year annualized returns in the mid-teens, which, based on the historical record, was pretty darned good given stocks’ long-term average annual returns of around 10%.

But as growth stocks marched higher in the latter half of the decade, 500 Index, with its market-capitalization-weighted strategy of owning more of the most expensive stocks and fewer of the cheapest stocks, rang up enormous gains. By the middle of 1997, the fund’s five-year returns were running over 20% per annum and its three-year returns were over 30% per year. Investors salivated at the notion that a simple index fund could, at 30%, more than double their money in under three years.

## As Returns Rose, So Did Inflows



Note: Chart shows Vanguard 500 Index’s rolling three-year and five-year annualized returns alongside monthly fund flows.  
Source: Adviser Investments.

Super returns and pro-index marketing attracted lots of attention. Cash flowed to 500 Index, exceeding \$2 billion in new money per month in early 1999. By mid-1999, the more than \$125 billion invested in 500 Index represented over 25% of all the assets (including bond and money market funds) that Vanguard had under management—not too far from four times the level just five years earlier. Add in the \$20 billion or so in the newer Total Stock Market Index and the two funds accounted for almost one-third of all of Vanguard’s assets as the stock market was peaking in 2000.

We all know what happened next.

As you can see in the chart above, just as assets and asset flows were hitting their crescendo, returns suffered mightily and the Lost Decade kicked off. Or, at least the “losing” began for those who’d drunk the indexing Kool-Aid.

Not everyone lost money, though. If you’d been following a diversified strategy, owning funds in various asset classes, run by top-tier institutional managers—as we do at Adviser Investments—you probably had a “winning” decade.

## Low, Low Risk

Another reason investors loaded up on domestic, large-cap stocks in the late 1990s: The prior decade had been one of low, low risks. In fact, with losses muted during the 1990s, investors began to believe the stock market was easy money.

Say all you will about the Greek alphabet soup of risk measures like alpha, beta, relative volatility, standard deviations and the like. The real measure of risk for most

investors is how much money they've lost. And they simply didn't lose much for long during the 1990s.

As you can see in the chart below showing Vanguard 500 Index's drawdowns, the 1990s were a period of rather muted stock losses. While investors in an S&P 500 index fund like Vanguard's were subject to a 33.1% drawdown during the 1980s, there really weren't that many investors in the fund at the time. At the end of Dec. 1989, 500 Index had just \$1.8 billion in assets. The fund gained size and followers during the next decade, during which the worst loss suffered was a mild 19.2% decline that was over almost before it began. Again, big profits with small losses led investors to believe in the holy grail of buying the market to be the market.

The decade of the aughts was another story entirely; big losses followed by long drawn-out recoveries is the Cliffs Notes version. As we all know too well, we've seen two massive drawdowns during the most recent decade, with a 47.5% loss from Sept. 4, 2000 through Aug. 5, 2003, recovered by Oct. 2006, only to be followed by a 55.3% drop from Oct. 9, 2007 through Mar. 9, 2009. Remarkably, we've almost recovered from the 2009 bear market—though most investors are completely unaware of this. And almost as remarkable, over the full period shown in the chart, the stock market has generated an annualized total return of 10.1%.

## Accentuated Misperceptions

Let's revisit an earlier point: The press has done a disservice to investors by equating trading with investing.

A recent column in *The Wall Street Journal*, following on the Knight Capital fiasco, asks rhetorically, "When Will

Retail Investors Call It Quits?" (Aug. 2, 2012). Rather than debunk the notion that investors would or should quit the stock market, the author instead quotes a couple of individual investors whose reasons for dismay with stocks make no sense at all.

One attorney, who professes to speak for small investors, intones that the negativity around stocks stems from a sense that the little guy will always be "late to the game and probably wrong." We won't speak for the abilities of the "little guy" to make smart investment picks, but being late to the game smacks of both market timing and trading. Long-term investors aren't late to the game—they are already in it.

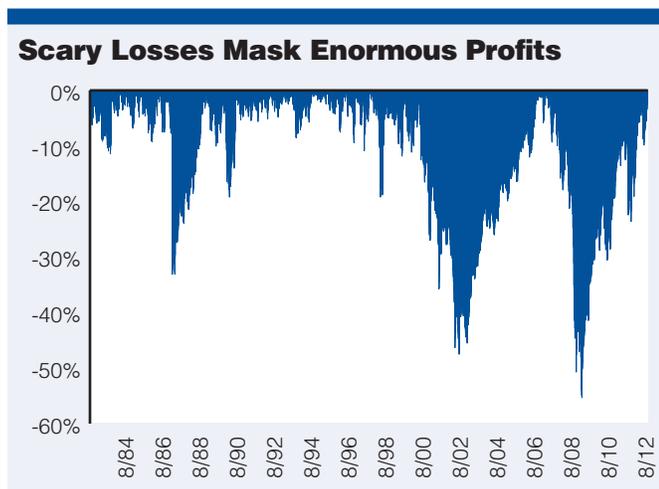
Another investor, a professor, bemoans that after years of hard work and building towards a financial goal, you can "then lose everything in five minutes." When? Where? Unless the professor is checking his portfolio every five minutes AND was planning to sell everything just as the market was going through one of its computer-induced hiccups, his logic gets an "F."

Why is it that investors, or those who once thought they might be investors but now simply hoard cash, find it so hard to believe that stocks and the stock market might actually be worthy options? GMO's Ben Inker put it pretty succinctly in a recent paper, "Reports of the Death of Equities Have Been Greatly Exaggerated" (Aug. 2012). He writes, "At those times when you were most at risk of losing your job, your bank account, your house, or your life, you could rely on equities to be piling on the misery." His point: Stocks tend to fall when times are bad, such as during recessions and depressions, oil shocks, global financial crises or even wars.

Given the fact that we've just come through a miserable economic contraction that was so bad it was labeled "The Great Recession," it's no wonder that would-be investors, former investors and even some current investors feel as though the black cloud they are living under emanates from Wall Street. Let's not forget that during these periods of crises, it's bonds that do well, seemingly validating the gains earned during the 30-year bond bull market and driving the current mania for bonds over stocks, despite record low yields on benchmarks like the 10-year Treasury.

## Put Fear into Perspective

Today's pessimism may find high-frequency trading, a slow-growth economy and problems in Europe as symptoms, but what's really spooking investors is a fear that their financial futures and the futures of the next generation are in jeopardy.



Note: Chart shows cumulative losses of Vanguard 500 Index fund.  
Source: Adviser Investments.

What is startling is that despite evidence of real gains, there continues to be mistrust about those gains—many simply don't believe they're there, and those who acknowledge them feel as if the rug could easily be pulled out from under them.

It's not just that the investment "game" may or may not be rigged, it's that the whole question of how to ensure a secure retirement—both getting there and once there holding onto it—feels more uncertain than in decades past.

Of course this can feed a self-fulfilling trajectory: If more and more people don't feel like investing in stocks and cause the market to fall, then greater numbers of those who are relying on stocks for their retirement will suffer. The fear of that scenario snowballing into an avalanche of selling is fodder for many soap box soothsayers.

Focusing on what we know rather than what we don't has worked well over the time Adviser Investments has been in the business of building diversified, risk-adjusted portfolios for long-term investors. We've just been through the most emotionally trying decade since the Great Depression. But the belief that no one can beat the markets or should even try to engage in stock market investing because, well, the game is rigged, is simply wrong-headed.

Today, the U.S. economy is larger than it has ever been. While the labor markets remain in recovery mode, and housing appears to be bumping a bottom no one thought we'd ever see, the U.S. economy is producing goods and services worth nearly \$16 trillion a year and growing.

Last year, the U.S. became a net exporter of petroleum products and that trend is accelerating. After decades of near-fealty to questionable allies with large oil reserves, this sea change could be the catalyst for tectonic shifts in the economic world order, and may create a few more jobs here as well. Our manufacturers have become so competitive that not only are U.S. companies bringing more work back home from overseas, but others who wish to tap our markets and our productive prowess are building plants here, rather than at home.

The world is not coming to an end, the U.S. is not coming to an end, nor is the stock market about to lay waste to those of us who continue to see it as a route to a profitable end.

If past is prologue, at just the moment when stock market gains have had their best days, the herd will stampede back. That's when we'll get nervous. But until then, Adviser Investments is sticking with an allocation to the stock market that is appropriate for our clients' objectives and risk tolerance.

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