

Buy And Hold is Dead (Again) The Case for Active Management in Dangerous Markets

*Why tactical and active portfolio management is
required in secular bear markets*

THE SUMMARY IN BRIEF

Institutional investors have relied on Modern Portfolio Theory (MPT) for more than fifty years as the basis for constructing portfolios. Based on the Nobel Prize winning work of Harry Markowitz, published in 1952 in a paper called, *Portfolio Selection*¹, the industry has relied on Markowitz's insight that portfolios can be built in an efficient manner that maximizes return for each incremental increase in the level of risk. Unfortunately the implementation of this theory in the real and practical world of investing has resulted in a methodology for building portfolios that is based on questionable assumptions and science. The result is poor performance in bear markets.

After a full decade of less than expected returns, buy and hold investors, called strategic asset allocators, are left to hope that the historical risk premiums for owning common stocks will soon reappear. Unfortunately, based on today's market valuations and the structural headwinds facing the global economy, it is a high risk strategy for investors to rely on the archaic assumptions of buy and hold investing. It is time for investors to consider a new portfolio strategy called *tactical asset allocation*. Tactical asset allocators search for value-based investment opportunities and invest them within the context of a diversified portfolio. The result can be higher returns with less risk if implemented successfully.

IN THIS SUMMARY, YOU WILL LEARN:

- What is tactical asset allocation.
- The secret behind long-term or secular stock market returns.
- The basics of Modern Portfolio Theory and the many theoretical problems it creates.
- The case for a new theoretical approach to pricing theory called Rational Beliefs and why it makes so much sense in today's volatile markets.
- How active managers can outperform passive benchmarks.
- What you need to know about active management and making investment mistakes.
- What is the author's forecast for the investment industry and active portfolio management.

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BUY *and* HOLD *is* DEAD (AGAIN)

THE CASE FOR ACTIVE
PORTFOLIO MANAGEMENT
IN DANGEROUS MARKETS

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We Are All Investment Geniuses in Bull Markets

Many financial advisors learned their craft in the great secular bull market that began in 1982 and ended in 2000. In long-term bull markets stocks dramatically outperform bonds as P/E multiples expand over many years. Buy and hold investing or strategic asset allocation, is the perfect strategy in lengthy bull markets because the greater risk is to be out of the market and miss out on the outsized investment gains that are available to all as long as the bull is intact. While there are bear markets within secular bull markets, they tend to be shorter and less severe while the stock market continues its inexorable climb higher. The rule is to buy the dips, or if you are a strategic investor, the rule is to rebalance the portfolio; both strategies allow investors to fully participate in a continuing bull market. In addition to learning their craft in a historic bull market, advisors rely on a Nobel Prize winning body of research called Modern Portfolio Theory (MPT) that also encourages the buy and hold strategy. The language of MPT is mysterious and complex, the perfect sales tool for advisors who must be seen as investment experts by their clients. The combination of an 18-year secular bull market, a Nobel Prize winning theoretical justification for the strategy, and a wonderful marketing strategy and business model combined to make buy and hold investing the status quo for virtually all institutional investors.

Today the story is different. The stock market has delivered negative returns on average for more than a decade. Investors who have patiently waited for historical average returns to appear in their portfolios have seen their retirement plans destroyed. Patience and the dependence on the past to repeat itself in the future are unsuccessful tactics in

long-term or secular bear markets where P/E multiples do not expand and stocks do not outperform competing asset classes for years at a time. So what's an investor to do now? The answer lies in building portfolios with two rules of portfolio construction: 1) Diversify the portfolio, and 2) Don't buy overvalued assets. The problem with the first rule is that diversification only works as a risk reduction strategy when the underlying assets in the portfolio exhibit low correlations to each other – they zig and zag at different times. The problem with the second rule – don't buy overvalued assets, is that investors will disagree about what constitutes an overvalued asset. As we will see, value is only found in the eyes of the investor and different opinions about valuation can lead to investment mistakes. The answer to utilizing both rules of investing lies in an investment strategy called tactical asset allocation.

Tactical asset allocation allows portfolio managers to change the asset allocation mix of the portfolio on an incremental basis based on their changing views of current and future investment opportunities. Instead of owning a "fixed mix" of asset classes that is presumed to be the most efficient mix of assets for any level of risk, the investor owns a changing mix of asset classes that presumes that markets are inefficient and that value opportunities can be exploited in order to earn excess returns. As long as the tactical changes in the portfolio occur within a diversified portfolio, then the highest level of risk management is being achieved. The problem for strategic, buy and hold investors, is that the concept of value is presumed to be non-existent, or by some, impossible to achieve.

Because value investing is completely ignored by strategic buy and hold investors it can be a **v e r y** high risk strategy in expensive, volatile markets.

The Secret to Long-term Stock Market Returns

Most investors assume that stocks will outperform bonds over long periods of time usually measured in decades. The risk premium, or the amount that stocks earn in excess of cash, is presumed to be a given, available to patient investors who are smart enough to buy and hold the market long enough for the premium to be earned. The risk is to be out of the market, and the bear markets that occur in the meantime are assumed to be unavoidable. Today's investors must understand the secret about why stocks do not always earn the expected risk premium. The answer to the riddle is found in the P/E multiple (price to earning ratio) that investors pay to own the stock market.

Stock market value is often determined by assessing how much investors are willing to pay for future stock market earnings. The main ingredients to the calculation are how fast earnings will grow in the future, and what multiple or P/E ratio investors will pay for future earnings. Interestingly, the rate of earnings growth has remained fairly stable over the years and is about equal to the growth rate of the economy. However, the P/E multiple can vary widely. The data clearly shows that when investors buy stocks when the P/E multiple is high (stocks are expensive) and hold stocks while the multiple is falling (investors are becoming more pessimistic about future earnings) then the resulting long-term 20-year returns for owning stocks are, without exception, lower than the historical average. Conversely, when investors buy stocks when the multiple is low and likely to expand over time, the resulting long-term 20-year returns are well above average, without exception. It appears that the data confirms that buying low and selling high is actually a profitable strategy!

What drives P/E multiples higher and lower? The data shows that the main driver of P/E multiples is inflation. As inflation moves higher it has the positive impact of increasing the nominal rate of earnings growth. This would have a bullish impact on future stock market value. However, inflation tends to drive the P/E multiple assigned to future earnings lower, which makes sense since future earnings are worth less when money is inflating. While analysts continue to study the reasons why

P/E multiples expand and contract, investors must begin with the realization that they do. Buying and holding stocks from high valuations cannot lead to historical average stock market returns in the future.

This revelation, that you should buy low and sell high, has serious implications for individuals concerned about their retirement. The latest financial planning research shows that portfolio returns in the first decade of retirement are critically important. Although a portfolio may earn average expected returns over the life expectancy of the retiree following retirement, it is the *order* of how the returns are earned that matter the most. All of the sudden the very long-term averages of past asset class returns don't matter as much as they used to. Instead, investors must focus on what returns might be in the first decade of their retirement as they consider their ability to retire and live off of portfolio withdrawals, assuming that they have no other sources of retirement income. In this context, asset class valuation means everything. Retirees cannot assume that they will earn historical risk premiums from owning stocks when they buy them at high valuations. The idea that diversification is the only methodology needed to manage risk has been debunked. Diversification without concern for valuation turns out to be high risk strategy in expensive markets. 🍷

Hogs, Cobwebs, and Other Imperfect Assumptions

Economists have been trying to apply the mathematics of the physical sciences for years in order to prove their economic theories. For example, Lois Bachelier, an options trader and economist in the early 1900s, made the assumption that the movement of options prices on a daily basis was the same as tossing a coin, where the results are perfectly random. Based on this assumption he could use the mathematics of his day to show that price distributions are normal as illustrated by the classic bell curve. The mathematics of measuring risk based on normal distributions is based on standard deviation, a measure of risk that was first discovered in the 1700s. He also assumed that prices move at a constant rate and so he used the mathematics of Brownian motion, a then recently discovered mathematical formula used to explain how pollen

grains move when dropped in water. The combination of all three assumptions, that prices move randomly, that the distribution of prices is normal and can be measured by standard deviation, and that prices move evenly over time, are still being used today.² In fact, much of Bachelier's math is used in the well known Black-Scholes option pricing model.

Unfortunately, we now know that price movements are not random, but are instead often distorted by the behavior of market participants. We also know that financial markets are notoriously not normal, but instead have the disturbing propensity to stop working altogether. The resulting extreme price movements cannot be measured or predicted by using standard deviation in pricing formulas. Finally, today we can easily observe that stock prices are subject to momentum effects and do not move evenly over time.

Perhaps the most pervasive assumption about pricing is known to investors as the Efficient Markets Hypothesis (EMH) first published by Eugene Fama at the University of Chicago Booth School of Business as his Ph.D. thesis in the early 1960s. Fama believed that the financial markets were so efficient in digesting all available information that it was impossible for any individual investor to "beat the market" except by luck. Many believe that his work is derived from Robert Lucas's Nobel Prize winning work in macro-economics called the Rational Expectations Pricing Theory. The application of the Efficient Markets Hypothesis in economic models results in other poor assumptions about the financial markets.

False Assumptions

- There are no transaction costs in buying and selling securities. (false)
- Liquidity is infinite. (false)
- Investors are indifferent to taxes. (false)
- Investors have the same time horizon. (false)
- Investors measure risk in the same way. (false)
- Investors can lend or borrow at the risk-free rate. (false)
- Investor psychology has no impact on the financial markets. (false)

For practical investors who don't care to submerge themselves in arcane academic theory, perhaps the most important question to be answered is: does the theory accurately forecast real world market behavior? Unfortunately the answer is a resounding no. Investors who cling to the buy and hold theory of investing because it is based on a Nobel Prize winning body of economic work should realize that the assumptions of the theory are under attack in the academic community, and the theory itself is not robust in terms of having any predictive value in financial markets. ●

The Theoretical Case for Active Management

There are competing theories about how markets work that make infinitely more sense than Rational Expectations or the Efficient Markets Hypothesis. Mordecai Kurz at Stanford University has published an important new theory called the *Rational Beliefs Equilibrium Theory*.³ The assumptions in the Rational Beliefs Theory actually make sense to today's investors. The economy is assumed to change over long periods of time. Each era is divided into a different regime where data is viewed differently based on changes in the economy. Instead of investors having the ability to perfectly forecast price changes based on the news, investors are presumed to make mistakes in their forecasts. These mistakes constitute a new risk, called endogenous risk, that is the result of investor misbehavior. Kurz tells us that more than 60% of market volatility is due to endogenous risk, a far cry from the perfectly rational markets envisioned in the EMH.

Woody Brock, the founder and director of Strategic Economic Decisions, and a brilliant academic in his own right, in his paper, "The Ability to Outperform the Market-Logical Foundations Based on the Theory of Rational Beliefs⁴," proposes three strategies that allow investors to beat the market. The first is to exploit structural change in the economy. Since these changes cannot be predicted by past data, investors who invest the time and energy to better forecast structural change can outperform. The second strategy suggested by Brock is to exploit endogenous risk. The misbehavior of

markets based on investor created bubbles and panics allows active investors to buy or sell securities at favorable prices leading to outperforming the markets. The third strategy is to exploit logical errors of inference. Here Brock says that the consensus often misunderstands or misinterprets how the economy actually works. Once again, this allows active managers to take advantage in order to earn excess returns.

Brock also gives us the concept of optimal asset allocation. He emphasizes that strategic investors using Modern Portfolio Theory often use data incorrectly when optimizing their portfolios. By using the averages of the past data as inputs, instead of using the data in a dynamic manner, they get one fixed portfolio asset allocation that will only be the most efficient portfolio asset allocation if nothing ever changes in the economy in the future. By using past data in a more dynamic manner (using stochastic dynamic programming), the portfolio asset allocation will change. These allocation changes are not based on the subjective views of the investor but are instead based on using the same data in a more dynamic fashion.

Finally, Brock allows that the most efficient, or optimal portfolios, are constructed based on the subjective beliefs of investors. These portfolios are based on forecasts of structural change and can't be proved by past data, no matter how it is used in pricing models. When investors use their knowledge, judgment, and experience to make better forecasts than the consensus, in essence allowing them to be less wrong than the rest of the market participants, they can then outperform the financial markets and earn excess returns. ●

Compelling Evidence That Active Management Really Works

Over the years there have been several studies proving that active fund managers, on average, can't beat their relevant equity benchmarks. Without exception these studies focused on "tracking error," or the performance of the managed portfolios compared to the benchmark. Recently two brilliant professors at Yale University, Martijn Cremers and Antti Petajisto, completed a study of active management

called, *How Active Is Your Fund Manager, A New Measure That Predicts Performance*⁵, that added a second dimension to the comparison between active managers and their benchmarks. In addition to tracking error, they analyzed how the portfolio holdings for active managers differed from the benchmark holdings. The variation in actual holdings is called, Active Share. When considering both dimensions of comparison they found conclusive evidence that the managed portfolios with the highest active shares consistently delivered better than benchmark returns.

Specifically they found that during the 1990's there was a significant shift from active to passive management in managed funds as mutual fund managers bought more of the benchmark securities for their portfolios. Cremers and Petajisto call fund managers who own 40% or more of their funds in index securities "closet indexers." It makes sense that when fund managers own the index securities but also have higher expenses than the index portfolios they would trail the benchmark returns. The study found that funds with the highest active share actually outperformed by 1.49% to 1.59% per year – after considering all expenses. The highest performing group of active funds was the group with the highest active share, smallest assets, and the best prior one-year performance. This group outperformed their benchmarks by a staggering 6% each year, an amount that should surprise the typical investor who believes that active managers can't outperform.

I believe that the performance of any one fund manager investing in one style-constrained methodology in order to outperform a specific asset class benchmark has little to do with whether portfolio managers can find value opportunities across a broad spectrum of asset classes. Tactical asset allocators, as opposed to the typical style-constrained money manager, presumably have the discretion to find value across the entire global palette of asset classes. However, if this study helps to prove that active managers can outperform, then it should be of great interest to buy and hold investors who believe that markets are perfectly efficient. ●

Becoming an Investment Expert

If investors are going to use their skill, judgment, and experience, to make tactical changes to investment portfolios, then the question becomes how much skill is required to succeed? While the financial industry wants the public to believe that earning professional designations like Certified Financial Planner Practitioner (CFP®), Chartered Financial Analyst (CFA®) and MBA mean that the designee is a financial expert; the fact is that these programs still exclusively teach Modern Portfolio Theory as the only academically accepted method of portfolio construction. While these practitioners may know the arcane language of MPT, in fact they know very little about how financial markets actually work. After all, the theory suggests that security valuation has no impact on making money in the stock market, an absurd proposition that should be rejected by today's sophisticated investors.

The knowledge base needed to truly become an expert is available to all through independent research and on the Internet. Investors should assume that consensus market views are reflected in the popular media. Reading the Wall Street Journal, Investors Business Daily, the Financial Times, Business Week, and then watching financial news on CNBC or Bloomberg television, provides a basic level of understanding about financial markets that is valuable to investors. However, they then need to dig deeper in order to formulate non-consensus views of the markets. I recommend that investors purchase the best independent buy-side institutional quality research that they can afford.

Unfortunately, investors who would like to read the most knowledgeable institutional analysts and then simply follow their recommendations will be disappointed. The best institutional analysts disagree with each other most of the time. It is up to the individual consumer of all of these views to develop their own point of view about the markets and then invest that viewpoint in a way that earns excess returns.

To my knowledge there is no shortcut to doing this work. No quantitative model or reliance on a single newsletter writer can provide the lowest risk approach to active money management.

That assurance can only be provided by the amount of sweat equity spent by the investor in becoming a true expert at his or her craft. No investor, regardless of their expertise, can avoid making investment mistakes. However, investors only need to be less wrong than the consensus to earn excess returns. ☼

Developing a Point of View: Top-Down Analysis

Over time the economy tends to move in a cycle that goes from contraction to expansion and back again. Different sectors of the stock market tend to do better than others as the economy moves through the cycle. The defensive sectors of the stock market include consumer staples, health care, and utilities. The early cyclicals include financials, consumer discretionary, and technology, and the late cyclicals include materials, industrials, energy, and telecom services. Investors who can properly forecast where they are in the economic cycle have a decided advantage in generating excess returns versus investors who buy and hold the equity markets. In order to forecast the economic cycle, investors can look to several different types of data that are reported each month. Investors can utilize information about consumer spending, (70% of the U.S. economy), the corporate bond market (insights into the health of corporate America in general), the Federal Reserve, (inflation and interest rates), and Leading Economic Indices, in order to make an informed forecast. Each category has many data points to consider and can give investors an advantage in developing their point of view about the U.S. and international economy. For example, to assess the current state of U.S. consumer spending investors can analyze dozens of data points, including:

- Personal Consumption Expenditures
- Real Wages
- National Association of Home Builders Index
- New Home Sales
- Building Permits
- The Federal Funds Rate

Over time different investors will reach different conclusions about the economy from the data that are reported each month. Each will develop their own

preferences as to which data is most important to them in developing their forecast.

Investors next have to decide how to use data in order to craft their investment outlook. They can make their decisions qualitatively, meaning that they use skill and judgment to make their forecast. They can also make decisions quantitatively, meaning that they use the data in mathematical models in order to make their forecast. I recommend that investors use both methods to analyze their data and create a top-down outlook or point of view about the global economy. ●

The Psychology of Being Wrong

One of the biggest concerns for buy and hold investors who are considering a more active management approach is the problem of making investment mistakes. Strategic, buy and hold investors assume that markets are efficient and therefore it's impossible to outperform the market. In this world of perfectly rational investors, diversifying the portfolio is the only risk management tool available for investors. The only mistake that buy and hold investors can make is to sell an asset class and miss the historical average returns that are presumed to be inevitable. On the other hand, active management is based on the idea that ALL investors make mistakes. This is because investors can't know what the future is with certainty. Risk management in portfolio construction is all about dealing with this lack of certainty. According to Brock, investors can outperform the market by BEING LESS WRONG than the consensus.

Behavioral finance has given us a Nobel Prize winning body of work that helps us to understand the nature of investor mistakes. Humans cannot avoid certain biases and heuristics (behaviors) that are part of our genetic make-up. Unfortunately, when these biases become part of the decision making process for portfolio construction they lead to investment mistakes. While there are many acknowledged biases, two of the most important for investors to consider are loss aversion and decision regret. Loss aversion means that investors do not consider gains and losses equally. In decision making they hate losing more than they hate

uncertainty. This bias results in investors focusing on investment losses even though they may have occurred in the proper implementation of a variety of risk reducing strategies. Decision regret is popularly known as 20-20 hindsight. It is the mistaken notion that investors could have made better investment decisions with knowledge that could only be available to them after the fact. Decision regret often results in investors reaching the conclusion that active management leads to avoidable mistakes when, in fact, that is not the case. The best active and tactical investors learn how to deal with investment mistakes. The first and most important lesson is to avoid BIG mistakes.

Insisting that portfolios remain diversified is one important methodology for tactical investors to avoid large mistakes.

Tactics for Dealing With Investment Mistakes

- Keep retesting your base case.
- Encourage dissenting opinions about your investment thesis.
- Do not be dogmatic in your point of view.
- Learn from your mistakes.
- Think longer-term – evaluate your performance over the proper time horizon
- Turn off the TV and get away from the drumbeat of daily opinion.
- Don't dwell on investment losses.
- Take credit for you victories – if you've done the work then the result is due to skill and not luck.
- Take a break and get away from portfolio management for awhile.

There is no alternative to active and tactical management for investors who want to build the most risk averse portfolios in secular bear markets. The only way to succeed is to understand that investment mistakes are part of the active management process and then to use them to your advantage over time. ●

Active Management - A Forecast for the Investment Industry

I believe that the investment industry is going to be forced to move away from strategic, buy and hold investing and begin to embrace active, tactical asset allocation strategies. The data is so clear that value is an important component to long-term returns that portfolio construction without the consideration of valuation will be considered a high risk approach to managing wealth. This change will first become apparent in the curriculum of the elite organizations that teach financial advisors how to manage money.

Today's CFPs and CFAs are taught MPT to the exclusion of any other portfolio management techniques. In the future the curriculum will include subjects covered in this book, including the basics of market valuation, secular and cyclical business and economic cycles, investor psychology, technical market analysis, etc. The industry will have to be prepared for a sea-change in the expectations of investors. While the status quo for investors for the past 40 years has been to buy and hold, soon investors will want to know the justification for buying and holding when investment markets refuse to deliver expected returns. Investors and investment advisors must be held accountable; they must refine their approach to valuation, accept a systematic and repeatable approach, and recognize the consequences of an inaccurate investment time horizon, and most importantly be prepared to explain their methodology.

Finally the industry will have to create new tactical and actively managed investment choices for small investors. These solutions will probably take the form of a whole new category of mutual funds that will be available as 401(k) choices and for investors who are investing their taxable funds. As the average investor considers the true art of learning the craft of active management, many more will come to rely on investment professionals to help them manage their portfolios in a volatile and dangerous investment environment. 🌐

Decisions, Decisions, Decisions

Investors who wish to actively manage their portfolios must answer six important questions:

- What types of securities will you use to invest the portfolio?
- Will you use alternative investments?
- How will you choose your benchmark?
- How far will you deviate from your benchmark? (Absolute versus relative return investing)
- What is your investment time horizon?
- Will you use passive or active managers to invest each asset class?

Investors looking to actively manage their portfolio must focus on building a diversified, multi-asset-class portfolio to meet their specific financial goals and objectives.

Source List:

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4. Horace W. Brock, Ph.D., *The Ability to Outperform the Market – Logical Foundations Based on the Theory of Rational Beliefs*, Revista Internazionale di Science, 2007, n.3, 365-402
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