# Buy-and-hold investing: Inherent risks

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**Out of the countless strategies that exist in the investing world, the most widespread and widely accepted approach is known as buy-and-hold investing. The buy-and-hold strategy is quite simple: financial instruments, usually stocks, are purchased and then held for a long period of time, with the investor seeking profits through upward price movement.**

Buy-and-hold investing certainly has its merits. It's a strategy that most people use successfully in many aspects of their financial life: We buy our homes — often our largest investment — and live in them for years or decades as they, quite often, appreciate in value. We commit to an occupation by training in a specific area, working at it throughout our career and commanding higher compensation over time. We hold onto antiques and family heirlooms for years, quite possibly generations. And most of us practice buy-and-hold with a sizeable portion of our investment portfolios.

## An in-depth look at buy-and-hold investing: Passive versus active

Investors who use the buy-and-hold strategy assume that over the long run, stocks are very likely to rise in value. These investors are divided into two groups: passive and active.

### Passive buy-and-hold investing

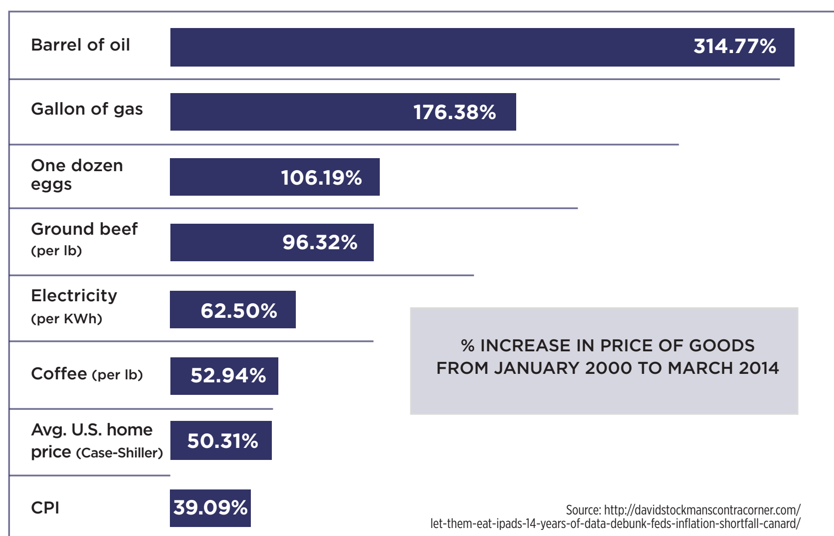
Investors who choose the passive buy-and-hold strategy typically purchase financial instruments that mirror returns of benchmark indexes, such as the Dow Jones Industrial Average (DJIA) or the S&P 500, and hold them for an extended period of time. They believe that this approach produces strong returns over the long run, with minimal risk. However, research shows that returns achieved by passive buy-and-hold investors have been mediocre at best, with investors exposing themselves to risks that are more significant than often acknowledged.

Buy-and-hold investment strategies are often promoted by showcasing the strong annual returns of a major stock index, such as the DJIA, over an extended period of time. For example, the DJIA had an annual rate of return of 5.5% over the past 100 years, 6.2% over the past 50 years and an impressive 9.56% over the past 30 years. These are returns that most investors would be pleased with. However, a passive buy-and-hold investor in a fund mirroring the DJIA would not actually be earning those same returns. There are several reasons for this.

First, the returns of the index are nominal, not real, and do not take into account the negative effect of inflation on the purchasing power of an investor's capital. Over the past 50 years, the core Consumer Price Index (CPI) — the statistic that the U.S. Federal Reserve Bank uses to determine whether or not to adjust interest rates — has increased by approximately 4% per year in the U.S.[1] That means the nominal rates of return for indexes such as the DJIA must be discounted by at least 4% to estimate real annual returns over the past 50 years.

While core CPI in the U.S. has increased by about 4% per year since 1964, this measure of inflation does not appropriately reflect the impact that rising prices have had on the average consumer. Core CPI does not track some of the most volatile goods, including energy and some food items, several of which

have increased in price by almost 100% or more in the past 14 years alone. If these items were factored into inflation, it would be much higher than 4% and real investment returns would be much lower.




Another factor that significantly improves the performance of buy-and-hold portfolios is the assumption that dividends are regularly reinvested. But the fact is that most people fail to reinvest the dividends from their investments. Rather, investors commonly use dividends as a form of cash flow and periodically withdraw funds from their accounts to pay for one-off expenses such as trips or home improvements. U.S. trader and author Michael Dever calculated the returns of a buy-and-hold strategy under the assumption that the dividends were reinvested, and then under the assumption that the dividends were not reinvested. This is what he found.

> *"Since 1900, U.S. equities produced a real average annualized return of 1.82% if dividends were spent, rather than reinvested; and a 6.27% real annualized returns with the dividends reinvested... If we were to look at the "nominal" return, the amount stocks earned before adjusting for inflation, the returns jumped 4.92% if dividends were spent and 9.51% with dividends reinvested.*[2]

If a more realistic approach to calculating buy-and-hold returns is adopted, one that takes into account the impact of inflation and the failure to reinvest dividends, the returns from a buy-and-hold strategy are not nearly as attractive. As the passage from Dever reveals, the annual real returns since 1900 for those who did not reinvest their dividends was a mere 1.82% — and this does not even take into account the impact of fees or taxes.

Another key risk for buy-and-hold investors is that bear markets, when they occur, can wreak havoc on investment portfolios in a short period of time. Since 1900, North America has experienced several significant bear markets, during which buy-and-hold investors have suffered greatly. The following table shows the major bear markets in North America, as reflected by the S&P 500, from 1945 to 2014.

| Market Peak | Market Low | Market Decline (%) |
|---|---|---|
| May 29, 1946 | May 19, 1947 | -28.60 |
| July 15, 1957 | Oct. 22, 1957 | -20.70 |
| Dec. 12, 1961 | June 26, 1962 | -28.00 |
| Feb. 9, 1966 | Oct. 7, 1966 | -22.20 |
| Nov. 29, 1968 | May 26, 1970 | -36.10 |
| Jan. 5, 1973 | Oct. 3, 1974 | -48.40 |
| Nov. 28, 1980 | Aug. 12, 1982 | -27.10 |
| Aug. 25, 1987 | Dec. 4, 1987 | -33.50 |
| March 24, 2000 | Oct. 9, 2002 | -49.10 |
| Oct. 9, 2007 | March 9, 2009 | -56.80 |

Source: www.businessinsider.com/bull-bear-markets-2012-10

Psychology studies have shown that people are loss averse. This means that they strongly prefer to avoid losses, more so than acquiring gains. Given this loss aversion, it has always been a challenge for investors to maintain discipline and not withdraw their money during a market crash. If they stay the course, they risk losing 20% to almost 60% of their investments — which can be devastating at the beginning or the end of a person's investing career. However, if they pull their investments from the market at a loss, they compound the problem by chasing a better investing approach — which they're often unable to achieve.

### Active buy-and-hold investing

The mediocre returns achieved through a passive buy-and-hold strategy have led some to champion the active buy-and-hold approach as a better option. This approach involves portfolio managers using their knowledge to pick individual stocks that they predict will appreciate in value over time, rather than purchasing financial instruments that mirror the returns of an entire benchmark index. In theory, it's a sound approach. But in practice, finding an active buy-and-hold investor with a talent for picking the right stocks, time and time again, is no easy task.

In fact, a number of recent studies have revealed that most active buy-and-hold investors lack the ability to obtain returns in excess of a benchmark index — known as obtaining alpha — and that most even fail to match the returns of major indexes. Conclusions from two such studies are highlighted below.

> ❝ ***According to a 2009 study by State Street Global Advisors, more than 70 percent of large-cap blend funds run by a portfolio manager [active investor] failed to outperform their relative benchmark.... In 2004, only 28.8 percent of large-cap blend managers beat their benchmark. Tracking those successful managers out for five years to 2009 shows that only 0.1 percent of them still beat their benchmark.***[3]

> ❝ ***Barras, Scaillet, and Wermers tracked 2,076 actively managed US domestic equity mutual funds between 1976 and 2006. They found that after fees, three-quarters of the funds exhibited zero alpha, a fund's excess return over a benchmark index, and 24% of the funds were run by unskilled managers (who had negative alpha, or value subtraction).... Only 0.6% — you read that right, 0.6% — showed any true skill at beating the market consistently, "statistically indistinguishable from zero," the three researchers concluded.***[4]

The rarity of these skilled active buy-and-hold investors makes it extremely difficult to actually find one. The method that most people would assume most promising for choosing a successful portfolio manager — that is, choosing one who has recently achieved superior returns — does not work. Past returns, studies show, are not a good indicator of future performance of an active investor.

**BETWEEN 1976 AND 2006, ONLY 0.6% OF TRACKED PORTFOLIO MANAGERS BEAT THE MARKET CONSISTENTLY.**

> *Data from institutional funds show that large numbers of new accounts go to managers who have produced superior recent results. Of course, this occurs after these managers' best performance years. And assets move away from underperforming managers after their worst performance years. In a recent study of the experience of more than 1,000 institutional funds, the managers hired had achieved — over the three years before their hiring — significantly higher returns than the managers who were fired… However, for the three years after the new managers were hired, the fired managers actually achieved slightly higher returns than the new managers.*[5]

So, when it comes to active buy-and-hold investing, a lucky few might strike gold by investing their money with the next Warren Buffett, but most will not. Rather, most people will find that active portfolio managers rarely achieve the alpha that they promise. This inability of the overwhelming majority of active buy-and-hold investors to beat the indexes proves that active buy-and-hold investing is not a superior alternative to the passive approach.

As we have seen upon closer inspection, buy-and-hold investment strategies leave something to be desired. The failure to account for the impact of inflation, the incorrect assumption that dividends are regularly reinvested and the damage inflicted by bear markets all serve to highlight the shortcomings of a passive buy-and-hold approach. And the fact that most active buy-and-hold investment managers fail to meet, let alone beat, their respective benchmark indices is a telling repudiation of that approach as well. Is there a better way?

**To discuss further, or for more information, please contact Christopher Keeley, CFA, lead portfolio manager at ICM, at 647-748-4651.**

**End notes**

[1] Consumer Price Index for All Urban Consumers: All Items Less Food & Energy. (n.d.) Retrieved August 8, 2014, from http://research.stlouisfed.org/fred2/series/CPILFESL#

[2] Dever, M. (2011). Jackass Investing: Don't do it, Profit from it (p. 21). Thornton, PA: Ignite.

[3] Why Active Equity Management Stinks – US News. (2011, January 14). Retrieved June 8, 2014, from http://money.usnews.com/money/blogs/the-smarter-mutal-fund-investor/2011/01/14/why-active-equity-management-stinks

[4] Case Closed: Almost No One Can Beat the Market. (2013, October 24). Retrieved June 8, 2014, from http://www.moneyshow.com/articles.asp?aid=No-Nonsense-32901

[5] Why 'active' investment is a losing bet. (2012, March 23). Retrieved May 10, 2014, from http://www.cbsnews.com/news/why-active-investment-is-a-losing-bet/