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'Buy and Hold' Can Result in 'Hold On to Your Hat!'

In response to Burton G. Malkiel's op-ed "'Buy and Hold' Is Still A Winner," op-ed, Nov. 18:

I respectfully disagree. Buy and hold does not work and never has. Yes, it made money every year from 1982-1999, but so would have any strategy that invested in stocks, including monkeys throwing darts. Mr. Malkiel is right—nobody can time the market, and those who try usually end up buying during tops and selling during bottoms. However, a strategy as simple as buying the S&P 500 when it is above its 10-month moving average, and selling it when it is below, would have avoided the losses in 2008 and because of that would have crushed buy and hold. Diversification also works in an up market, but in a down market, if I have six different asset classes I just have six different ways to lose money. The key to making money in the market is not to do better than the market when it rises, it is avoiding the large long-term loss.

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Investors are being advised by Prof. Malkiel to hang in there, even when the market drops 60% of its value, as it did during 2008-2009. But he has little understanding of active investment management, a valid alternative to "buy and hold" investing, which he equates to market timing.

Active investment managers use technical and fundamental research, and pay attention to draw downs, to drive their decision making. We also use proven techniques such as hedging and stop-loss orders, as well as some of the techniques he advocates in his column—diversification, dollar-cost averaging and rebalancing.

The big difference is that active managers sell off when they see trouble coming. Advising my clients to sell in the summer of 2008 saved them a great deal of money that they would have lost if they followed the "buy and hold" strategy. (See The Wall Street Journal, Feb. 12, 2009, for an example.)

Prof. Malkiel advises individual investors to keep their money in index funds and ignore the ups and downs of the market. He cites respected investors Warren Buffett and Yale's David Swensen, who give the same advice.

But if investing in index funds is such a great idea, why don't Messrs. Buffett and Swensen follow their own advice? Active investment managers believe individual investors should benefit from many of the same techniques that these investment experts use. If we've learned anything from the past decade, we should have learned that investing in index funds is too risky.

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It seems to me that Mr. Malkiel may be afflicted with the problem of "selective amnesia," or perhaps using a rear view mirror to develop an investment strategy based on historical returns. Trying to support buy and hold based on the asset allocation strategy he suggests seems far-fetched to me. First of all, an investor with a 67/33 split between stocks and bonds would at best be considered a "moderately aggressive" investor from a risk management standpoint. Realistically, how many advisers would have recommended that a moderately aggressive investor put 14% and 12% of their portfolio into emerging market stocks and REITs respectively in 2000 or for that matter now? I will grant to him that those two asset classes were certainly where the bulk of the returns were generated during the past 10 years, but is he really suggesting that these asset classes will be the best performers going forward?

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One of Prof. Malkiel's assertions is that passively managed mutual funds are always superior investments to actively-managed funds. In most time periods 25%-30% of actively managed mutual funds beat the S&P 500; of the 20,000-plus funds available in the U.S., 4,000 to 6,000 outperform the index.

In 2008, index funds followed the 38% decline in the market. Yet, during that crash year, 28% of actively managed funds outperformed the market. Why would that be? A plausible explanation is that active management enabled the moderation of losses through informed decision-making on a day-to-day basis.

The key to success in mutual fund investing is to find those funds that are most likely (but not guaranteed!) to produce higher average returns than the market while taking on lower risk. Generalities don't help in this search. It requires new performance measures which focus on identifying funds that persistently outperform.

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