Stock Market Perspective: Importance of Active Management

An alternative title could be "why conventional wisdom will not protect you during a secular bear market." Of course, that would be a bit long for a headline. What you usually see and hear from Wall Street and the talking-head experts on cable networks usually is something like "buy good stocks and mutual funds and hold on to them." The good ones in their opinion are almost always the ones they are trying to get you to buy, often because they have taken large positions themselves or, particularly in the case of mutual funds, they will benefit directly from increased public purchases.

Is Warren Buffett an undeclared market timer? His latest shareholder letter implies that the answer is yes.

Sometimes these "experts" will urge you to periodically add to your investments, often by dollar cost averaging, and to rebalance your accounts at least once a year. Both of these are reasonable. Regularly saving is a good idea for most investors, but dollar cost averaging—buying the same dollar amount of a mutual fund at fixed intervals such as every month or every quarter—is not a particularly good way to do that. Rebalancing your asset allocations to bring them back to your targets if they vary from them too much is a good practice although by itself it won't be enough to prevent large drawdowns during major market declines.

The conventional wisdom promoters usually give one or both of two reasons why you should "buy and hold" and eschew active management of your accounts. One is the Efficient Market Hypothesis that says all the relevant knowable information is already in the prices, so there is no way an investor can benefit from any sort of analysis to determine when to buy or sell stocks or mutual funds. The other reason is that "market timing" is impossible and they don't know of anyone who has ever been able to do it successfully.

▶**Efficient Market Hypothesis (EMH):** I wrote about it a year ago and concluded that while it the markets eventually converge on the "correct" price in the absence of meaningful new developments, they usually overshoot both on the high side and the low side in the process. My main argument is that prices are not set by knowledge, but by dollars. EMH essentially assumes that those with the most money to take positions in a stock or market have more relevant knowledge than the other participants. My doubt is based on a lot of history.

Andrew Lo, a professor at the MIT Sloan School of Management, has written a paper "The Adaptive Markets Hypothesis: Market Efficiency from an Evolutionary Perspective" that discusses EMH in a new and interesting way. The paper, which is well written and quite readable, can be downloaded from his web site, "http://web.mit.edu/alo/www". He argues that how investors behave, which is often considered to be "irrational" can be explained by an "evolutionary model" of "adapting to a changing environment via simple heuristics." One consequence is that the market provides opportunities with favorable reward-to-risk characteristics contrary to the EMH and its implication that the only way to increase expected returns is to accept higher risk levels.

Lo makes the point that the existence of many actively traded, highly liquid, financial markets means EMH is *not* generally accepted. If it were, there would be little point in either trading or perhaps, more importantly, devoting the time and other resources to decide what and how to trade. If the markets were truly efficient, one could just buy anything with an appropriate risk level when funds were available for investment and sell when funds were needed for other purposes.

▶**"Timing is impossible":** The fact that one is not aware that someone has a particular skill hardly means that nobody has that skill. I immediately discount any pundit who says that something can't be done because he or she does not know anyone who does it.

The more common argument against market timing is computing the decrease in returns over some period if an investor missed some number, usually ten, of the best days, weeks, or months. Not surprisingly, there is quite a decrease. It is sort of like asking what a team's record would have been if it had won ten fewer games. Usually these "experts" do not present the opposite calculation of the increase if one had missed the same number of the worst periods. A more balanced calculation would be the effect of missing both the best and the worst. (Since stock markets tend to go down faster than the go up, that calculation would show higher returns.)

Can you think of a goal-oriented activity where a passive approach or solution is preferred to an active one?

All of that is entirely irrelevant and ignores the virtual impossibility that any investor or trader could manage to miss just certain periods and be in the market for all the others. Worse, it makes a serious investment approach seem like a game and obscures the main purpose of timing, which is controlling risk levels. In the aftermath of the Spitzer investigations, the term market timing has been used, mainly inappropriately, with another meaning, so I now describe the models I use as "risk reduction" or "tactical asset allocation." Whatever the name, they are an important part of active management of investments.

▶**Is Warren Buffett a market timer?** The most famous and likely most successful investor over the long term is certainly Warren Buffett, the head of Berkshire Hathaway Inc. and often called the "Oracle of Omaha." He is held out as the epitome of a buy-and-hold investor, and he has said his favorite holding period is "forever." His annual letters to shareholders are always interesting and often contain goodly amounts of investment wisdom. (You can download them from "http://www.berkshirehathaway.com/letters/letters.html")

The most recent letter might well give one the idea that Buffett is an undeclared timer. (Incidentally, his whole approach demonstrates a strong disbelief in the EMH.) In it he says "I found very few attractive securities to buy. Berkshire therefore ended the year with $43 billion of cash equivalents, not a happy position." In other words, he believes there are times when one should not be buying stocks. To be fair, his problem is quite a bit different from what we face. With that much cash around, buying a few hundred or a few thousand shares of a stock is not going to do much for his portfolio. In recent years, he has more often than not bought whole companies. Even so, he buys asset classes, such as silver, treasury bonds, and now foreign currency contracts, when he thinks they are good values *and sells* them when that is no longer so. Note that there is nothing that prevents him from taking meaningful positions in stock market indices if he thinks stocks are undervalued.

Later in the letter he says that investors should have earned "juicy returns" from the growth of American business over the past 35 years. One reason they have not has been "a start-and-stop approach to the market marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline)." Also, "if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful." To me, he is saying that while most can't do it well because they do it emotionally, timing is certainly possible and quite possibly advisable. Moreover, his actions over many years and his

willingness to sit on a large amount of cash show that is how he behaves.

As far as holding stocks "forever," Buffett may say that, but deep down it seems that he has doubts. Later in the letter he writes "since our original purchases, valuation gains have somewhat exceeded earnings growth because price/earnings ratios have increased. On a year-to-year basis, however, the business and market performances have often diverged, sometimes to an extraordinary degree. During The Great Bubble, market-value gains far outstripped the performance of the businesses. … I can properly be criticized for merely clucking about nose-bleed valuations during the Bubble rather than acting on my views. Though I said at the time that certain of the stocks we held were priced ahead of themselves, I underestimated just how severe the overvaluation was. I talked when I should have walked."

▶ **Investing "pros" are active managers:** The old saw says to look at what they do rather than to believe what they say. It is clear that the large majority of those who appear on TV investment programs do not "buy and hold" for their own accounts. A typical show will put up the recommendations the guest made during his or her last appearance and report how much each stock has gained or lost since then. I haven't taken what would be an unscientific sample, but my impression is that if the stock has made a large move up or down, the pundit has either sold some or all to "take some profits" in the case of a rise or completely sold to "cut losses" if the stock has fallen sharply. It is only those that have shown relatively little movement that they still own and recommend. Again, it sounds like they are trying to time their recommendations.

What I find even more interesting is the difference between what mutual fund managers typically say and do. They routinely advocate buying and holding mutual funds, especially the one(s) they run. Yet the average holding period for the stocks owned by most mutual funds is around one year. That means the portfolio is essentially completely turned over from year to year. That is hardly buying and holding. In effect, the fund managers are saying to their investors "trust me" because I can time stock purchases and sales better than you can. However, the long-term record of just about all fund managers shows that they are not particularly adept or effective at what they do.

▶**Active vs. passive:** Can you think of a goal-oriented activity where one should or would choose a passive approach over an active one? Raising children? Advancing your career? Trying to improve performance in athletic, artistic, or other endeavors? Why should investing to achieve financial goals such as funding for retirement or to pay tuition be different? So why should we accept the advice to be passive and buy and hold? We should not. What's more, the passive approach is riskier because stock price movements are quite volatile. The passive approach of trying to ride out the declines and hope the markets will be higher when the money is needed is fraught with risk and uncertainties.

That leads to the question of how one should actively manage one's investments. Many books have been written on the subject, and while I have not written any, I have been far from silent on the matter. I discussed my most general approach in the 2003 Fourth Quarter newsletter. I'll be happy to send you a copy upon request. A similar presentation with some updated data can be found on my web site at: "www.pankin.com/retire/". It also illustrates the dangers of a secular bear market and how the risk reduction models I use can enable investors to meet financial goals.