Is Buy and Hold dead?

With the rocky markets we have endured over the past few years, many investors have been asking themselves if there is a "better" way of investing. The financial services industry has responded to these inquiries by launching ever increasing numbers of strategies all touted to provide superior returns without the discomfort of the downside risk. Basically assuring their clients they could have their cake and eat it too.

One of the popular strategies that seems to be getting a fair amount of traction is "Tactical Allocation." Definitions for tactical allocation vary depending on the strategist, but hinge around the idea that timing the market is an effective method for managing risk. While it is true that correctly timing the market can decrease risk while increasing returns, the unfortunate reality is that correctly timing the market is rarely done over an extended time period. According to Warren Buffet, ***"The market-timer hall of fame is an empty room."***

If you're like most investors, its hard not to get lost in the noise and chatter in the media. So, this quarter we are going to evaluate tactical strategies.

One of the reasons that tactical strategies seem so compelling is because of one of the psychological processes with which we are hardwired: Hindsight Bias. This trick our brain plays on us tells us that events that have happened in the past were "obvious." With the benefit of hindsight, the market seems down right predictable. And why are we paying our financial advisor if they can't predict the future?

First, let's do a quick recap of some of the studies that underpin the strategies that we are following in your portfolio. The number one, most important point to remember: ***Control what you can and ignore the rest.*** What is the most important element you can control? If you've been listening to and reading what I preach, you guessed it - Asset Allocation! According to studies, asset allocation explains 92% of the variation in a portfolio's performance.[1]

[1] Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, *Determinants of Portfolio Performance*, The Financial Analysts Journal, July/August 1986. Gary P. Brinson, Brian D Singer and Gilbert L. Beebower.*"Determinants of Portfolio Performance II: An Update,* Financial Analysts Journal, May/June 1991

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Another important element you can control is Active Manager Error. The best way to avoid this risk is to not get sucked into the hype. Active management is based on the idea that the active manager, because that person has a fancy degree from Harvard, wears a Brooks Brothers suit, has access to a boatload of information and analysis tools, is able to predict the future and position your portfolio to sidestep the down markets and be invested when the market is going up. Again, unfortunately, the evidence is contrary to what Wall Street wants to sell you. According to a groundbreaking study by Treynor and Mazuy[2], only 1 out of the 57 funds they studied showed significant market timing ability! Subsequent studies have supported this conclusion that the vast majority of portfolio managers have been unable to make successful market timing decisions.[3]

So, with these studies under our belt, let's take a look at Tactical Allocation. Morningstar conducted an analysis of 163 tactical portfolio strategies comparing results to the Vanguard Balanced Index. Not surprisingly, 2 out of 3 of the strategies underperformed that benchmark when comparing since inception annualized returns.[4]

Well, some tactical strategists admit they aren't "all weather" strategies, but rather have touted themselves as being "insurance" against the down market. Again, unfortunately the hype was better than the reality. Compared to the benchmark, 68% of the portfolios studied experienced **larger** downturns than the index. Being **more** exposed to the downturn doesn't sound like very good insurance to me!

Other complicating factors in identifying successful tactical strategies include (1) the newness of the strategies (2) the mortality of existing portfolios and (3) portfolios that are really the "living dead." Of the 163 portfolios that Morningstar reviewed, half were under three years old with very little evidence to support projected claims. Additionally, approximately 25% of the portfolios were shut down due to poor performance. And then, even worse, the living dead

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[2] J. Treynor and K. Mazuy, *Can Mutual Funds Outguess the Market?*, Harvard Business Review, July/August 1966

[3] G. Connor and R. Korajczyk, *The Attributes, Behavior and Performance of U.S. Mutual Funds*, Review of Quantitative Finance and Accounting, 1991; M. Grinblatt and S. Titman, *The Evaluation of Mutual Fund Performance: An Analysis of Monthly Returns,* Working Paper, University of California, Los Angeles, 1988; Roy D. Henriksson, *Market Timing and Mutual Fund Performance: An Imperical Investigation*, The Journal of Business, January 1984

[4] Jeffrey Ptak, *In Practice: Tactical Strategies Miss Their Mark,* Morningstar Advisor, October 25, 2010

portfolios include portfolios that were shut down for poor performance and then resurrected under a different banner so as to avoid reporting the historic futility of their strategies prior to the 2008-09 market fallout. In short, these "living dead" portfolios report an incomplete and rosy picture of the underlying strategy's effectiveness.

Tactical strategists and many media pundits have proclaimed that "Buy and Hold is Dead!" Financial service firms assure you that by buying their programs, they can help you predict the future. Is that really true? The data doesn't support their claims.

To answer the question posed above: "Why are we paying our financial advisor if they can't predict the future?" Hopefully you're not paying your financial advisor to predict the future; because if you are, you probably aren't getting what you're paying for! On the other hand, what we are doing in your portfolio is attempting to control what we can (asset allocation, rebalancing, internal fees and costs, taxes, active manager error) and letting the rest of the noise fade into the background.

When it is not in our power to determine what is true,
we ought to follow what is most probable.
~ Rene Descartes

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At a Glance

- ✓ **U.S. Stocks:** strongest quarter in years
- ✓ **Unemployment reports down**: weak but positive job growth
- ✓ **Interest rates:** mortgage rates at historic lows
- ✓ **Chinese real estate:** takes a hit
- ✓ **Top two** performers by asset class: US REIT and Small-Cap
- ✓ **Bottom two** performers by asset class: International REIT and Small-Cap

After a brutal summer of stock market declines followed by a rollercoaster ride of rebounds and declines, the fourth quarter of 2011 caught many investors off guard as equity markets rebounded strongly at the end of the year. Domestic U.S. stocks had one of their strongest quarters in years as investors moved away from bonds.[5]

Some good news on the jobs front came in the form of unemployment reports indicating that the first-time unemployment claims are dissipating with the markets responding to weak but positive job growth.[6] As stocks rallied, many investors began moving out of precious metals, driving gold and silver prices down.[7]

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[5] BlackRock, Interactive Data Corp. and Lipper
[6] Bureau of Labor Statistics, *Employment Situation Summary*, Economic News Release, January 6, 2012
[7] BlackRock, Interactive Data Corp. and Lipper

Interest rates continued to decline with mortgage rates dropping below 4%.[8] Investors continued to worry over the growing financial crisis and political maneuvering in Europe. Fears were driven higher as some credit agencies hinted at downgrading credit ratings for several of the European Union countries.[9]

China also saw price declines in the intense real estate market as many investors questioned the sustainability of China's economic growth policies.[10]

The fourth quarter closed surprisingly well for investors, giving a much needed break from the market gyrations we've endured as of late.

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[8] Prashant Gopal, *U.S. 30-Year Mortgage Rate Falls Below 4% for First Time*, BusinessWeek, October 6, 2011
[9] Walter Brandimarte, *S&P may downgrade European Union, Large Euro-Zone Banks*, Reuters, December 7, 2011
[10] Adam Minter, *Real Estate Prices Fall in China, Inciting Anger and Applause,* Bloomberg, December 2, 2011

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Assets in Your Portfolio

Going back to the question "Is Buy and Hold Dead," while we don't pursue the often disastrous strategy of market timing, your portfolio is definitely not static. If you take a look at your statements, you will see a fair amount of activity that encompasses the receipt of dividend and interest payments that are reinvested, as well as our systematic quarterly rebalancing proces.

As a review, the disciplined rebalancing process we use in your portfolio attempts to mechanically take advantage of market movement by moving money out of asset classes that have been performing well and repositioning into asset classes that have been undervalued. That may seem counterintuitive at first. But, we strategically sell assets that have done well (prices have risen, we're tending to sell higher here) and we are buying assets that have not done as well (prices typically have fallen, we're likely buying lower here). Simply put, we are trying to "Buy Low, Sell High."

We must embrace the fact that the future is unknowable. But, I believe that if we consistently look to buy into assets when everybody else is selling, and we sell down assets when everyone else is buying, we may be able to mitigate the downfalls of the fear and greed cycle that plague many investors.

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Asset Class	Index	Q4 Return[11]
Small Cap	**S&P Small Cap Index**	**17.17%**
Domestic REITs	**Dow Jones U.S. Real Estate Index**	**13.78%**
Large Cap Value	Russell 1000 Value Index	13.12%
Mid Cap	Russell Mid Cap Index	12.31%
Large Cap Growth	Russell 1000 Growth Index	10.61%
Commodities	S&P GSCI Total Return Index	8.96%
High Yield Bonds	iBoxx High Yield Index	7.98%
Emerging Markets	MSCI Emerging Markets Index	4.42%
Developed International	MSCI EAFE Index	3.33%
TIPS	Barclays TIPS Index	2.69%
Municipal Bonds	S&P National Municipal Bond Index	2.10%
Aggregate Bonds	Barclays Aggregate Bond Index	1.12%
Short Term Municipals	S&P Short Term Municipal Index	0.40%
Short Term Treasury	Barclays Short Term Treasury Index	0.04%
International REIT	**S&P Developed ex US Property Index**	**-0.04%**
International Small Cap	**FTSE Developed Small Cap ex-North America Index**	**-0.21%**

[11] BlackRock, Interactive Data Corp. and Lipper, 9/30 – 12/31/2011

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