For those who maintain at least two classes of holdings, one to trade and one to invest, buy-and-hold's demise presents a problem. For many, active investment in exchange-traded funds and even futures are replacing these passively held stock and mutual fund holdings. Here's one strategy to help fill the void.

Buy and hold, R.I.P.: 1900-2007

BY MURRAY A. RUGGIERO JR.

Classic financial planning says that investments in both the stock market and real estate are the keys to building long-term wealth. The implication is that both these assets outperform inflation and should be invested in steadily over time. The popularization of this concept among the American middle class, and the common method for applying it that involved investing a certain amount ($50, $100, $1,000, etc.) month in and month out, fueled the rapid growth of no-load mutual funds. The "trading" restrictions on these investment vehicles only further bolstered buy-and-hold's popularity.

Now, however, with stocks and real estate in turmoil and most investors convinced that buy-and-hold is a fool's game, investment companies are loosening their restrictions. Many fund families, such as Rydex, have no redemption fee. This means they can be used for market timing because they don't have any penalties for active trading. Exchange-traded funds (ETFs) have made "active investing" even more accessible. If you're so inclined, there are now ETFs that are both positively and negatively correlated with the S&P 500, Treasury bonds and even sectors such as currencies, precious metals and energies.

In 2008, seven years of stock market gains were lost. Century-old financial monoliths went bankrupt. Terms such as "dollar cost average" have become anathema. Following this historic shift, a review of the previously unassailable buy-and-hold approach is in order, along with some suggestions of what should come in its wake.

A HUMBLE BEGINNING…

The popularity of buy-and-hold increased in earnest in the mid-1960s, perhaps culminating with the landmark paper "Efficient Capital Markets: A Review of Theory and Empirical Work" by Eugene Fama Sr. in 1970 and the book "A Random Walk Down Wall Street" by Burton Malkiel in 1973. However, the roots of the concept were hardly new.

French mathematician Louis Bachelier, who later gained notoriety for his work in Brownian motion, published papers in the early 1900s and concluded that "past returns have no predictive value on future returns. Both were statistically independent." The concept of Wall Street stepping to the beat of a "random walk" was born.

Half a century later, British statistician Maurice Kendall (1953), the University of Chicago's Harry Roberts (1959), along with Fama, showed evidence of "statistical independence" in stock returns and the "nil predictive power" of various techniques of "chartists."

Paul Samuelson and Benoit Mandelbrot demonstrated a decade later that such randomness could co-exist with a link between fundamentals and stock price, explaining that such randomness in returns is expected from a well-functioning stock market: "Investment in stocks is a fair game." The "fair game" concept is that today's stock price (with all available information) reflects the expectations of investors. Therefore, tomorrow's price should change only if investors' expectations change, which should be randomly positive/negative as long as investors are unbiased. This is the core of the Efficient Market Theory (EMT).

EMT was not universally accepted, however.

In 1980, Sanford Grossman and Joseph Stiglitz argued that an extremely high level of market efficiency is internally incompatible as it disallows the profitable opportunities that motivate security analysis to produce information. In addition, market "frictions," they said, limited market efficiency and the level of efficiency differed across markets, depending on costs of analysis and trading.

Further, by the late 1970s and early 1980s, inconsistencies such as seasonal tendencies became apparent. For example, one involved the likelihood that small-capitalization stocks accelerated in value in January. Arguments against these tendencies included one that this "January effect" was a premium necessary to compensate investors in small stocks, which tended to be illiquid at the turn of the year.

Research on long-term returns further challenged EMT. In 1981, Robert Shiller pointed out that stock index returns were over volatile relative to aggregate dividends, and in 1985 Werner DeBondt and Richard Thaler showed that over the long term, stocks tended to overreact. The following year, Lawrence Summers showed that prices could take long, slow swings away from fundamentals, which would be undetectable with short-horizon returns.

For the most part, these arguments rarely escaped the Ivory Towers in which they were conceived. Perhaps it has been the market itself, without the aid of academia, that has made the best argument against buy-and-hold. Few would agree that such extreme "six-sigma events" as the 1987 stock market crash, the Internet bubble and the most recent stock market slide, occurring within the relatively short period of two decades, are consistent with the random-walk theory. Even if these events can be rationalized, the truth is today's investors are not comfortable with buy-and-hold. They are looking for a different way.

ENTER THE ETF

Thankfully, the demise of the passive

It's the Boomers' fault

One contributing factor to the long-term positive stock-market performance that made the passive buy-and-hold argument so easy to accept was the Baby Boom that followed the Great Depression and World War II (see "When it rains, it pours," page 52). This same phenomenon might also lend credence to the prospect that passive positive stock returns are about to end.

As families grew following WWII, so did consumption. Better education and employment resulted in even higher corporate revenues. Markets also grew as per the needs and expectations of the new generation. By the 1960s, Baby Boomers had come of age, bringing the era of post-materialism. Birth rates dropped as more women entered the work force. Spending increased, reducing public investment, which affected prosperity. By the 1970s, the economy slowed down drastically as compared to the 1950s and 1960s. Nevertheless, asset accumulation was highest among this generation.

It's no secret that Baby Boomers and subsequent generations had fewer children than the generation before them, resulting in a relatively older population nearing retirement age straining the economy in terms of pensions and social security. This requires more relative funding from the younger generation, which in turn must lower its economic living standards to support the larger, retired population.

One suspicion is this lowering of consumption will lead to a long period of slow economic growth. Indeed, it now seems unlikely that the 5% U.S. gross domestic product growth since 1947 will continue. The analog is Japan, which has found itself in a similar situation. A decade or more of effectively flat stock market returns could be in our future.

Over time, the proponents of buy-and-hold were not above adjusting the fundamental approach. For example, one change was to support spreading funds across different sectors, which smoothed out the performance over the economic cycle. However, depending on how you adjust the allocations, diversification smells a lot like market timing. After all, "buy and hold the right mix of markets" is quite far from "buy and hold."

Ironically enough, the final nail in buy-and-hold's coffin might be rooted in the market's inherent unpredictability. One argument for buy-and-hold is that you don't know when big returns will occur, and if you miss the biggest two to three up days for the year, then you have missed the returns for that year. This makes sense until you realize that there are bigger down days than up days.

Since 1901, there have been about 10% more 2%-3% daily down moves than daily up moves for the Dow Jones Industrial Average. This edge for down days increases as we look at larger moves. Thus, the reverse of the argument about missing the biggest few up days per year is more likely: "If you miss the largest two to three down days each year, you would more than double your returns."

stock investment strategy has been accompanied by the growth of an investment vehicle that lends itself perfectly to active investment: ETFs.

An ETF is traded on a stock exchange much like a stock. It holds the underlying assets over the course of the trading day to equal the dollar value for the number of outstanding shares. Most ETFs track some underlying index/instrument. They are taxed like stocks and if held long term are taxed as capital gains.

An ETF combines the valuation feature of a mutual fund with the tradability of a stock. You can enter and exit on stops, limits and trade them intraday. ETFs have been available since the early 1990s, and in the past few years, their number has increased dramatically. While ETFs have long been based on indexes, in 2008 the U.S. Securities and Exchange Commission allowed the creation of "actively managed ETFs."

Although ETFs require you to spend money on commissions to buy and sell, they have a lower expense ratio than most mutual funds. Moreover, you can hold ETFs for any period you want without any penalty. This is unlike mutual funds, where you get penalized if you liquidate before a specific time period.

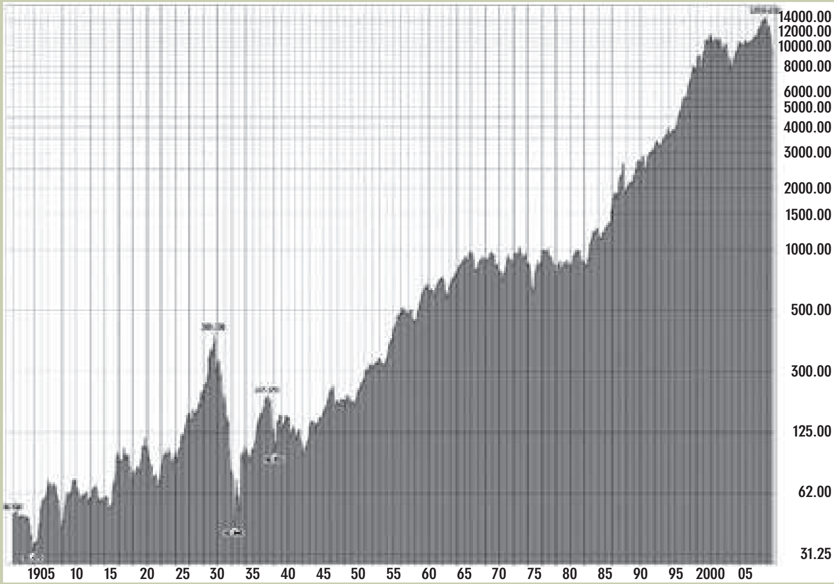
There are positively correlated ETFs, negatively correlated ETFs (which are particularly beneficial since you can't short stocks in an IRA) and leveraged ETFs. There is an ETF for almost every sector, such as currencies, metals, energies and livestock.

In addition to providing an excellent vehicle for self-directed active investing, ETFs have opened up an evolution in managed investments. These managed accounts, run by registered investment advisors, charge only a management fee (typically 2% or less) and trade your account for you. Many of these investment advisors used to buy managed mutual funds for the clients. The new breed is instead using well-tested strategies to trade baskets of ETFs.

One example is Tuttle Wealth Management of Stamford, Conn. According to Matthew Tuttle, the problem with mutual fund managers was their strategies were not transparent. ETFs are transparent by design and lend themselves perfectly to what he describes as tactical asset management. Another firm in this same vein is Select

WHEN IT RAINS, IT POURS

This logarithmic chart of the Dow Jones Industrial Average shows why buy-and-hold was so popular during the 1950s-60s and 1980s-90s. Simply put, it made a lot of money. However, other periods offered flat returns at best and required a more active approach to managing a portfolio.



Source: StockCharts.com

BUY AND SELL

There are better ways to manage a portfolio in volatile times. A simple intermarket switching system, easily executed using long and short ETFs, can significantly outperform a passive investment approach.

Performance summary: All trades (points)

Total net profit: 16.52 **Gross profit: 179.68**	**Open position P/L: -0.6** **Gross loss: -163.16**
Total # of trades: 103 **Number winning trades: 65**	**Percent profitable: 63.11%** **Number losing trades: 38**
Largest winning trade: 11.2 **Average winning trade: 2.76** **Ratio avg. win/avg. loss: 0.64**	**Largest losing trade: -16.35** **Average losing trade: -4.29** **Avg. trade: 0.16**
Max consecutive winners: 9 **Avg. no. bars in winners: 11**	**Max consecutive losers: 4** **Avg. no. bars in losers: 20**
Max intraday drawdown: -44.57 **Profit factor: 1.10** **Account size required: 44.57**	

Source: TradersStudio

Advisors in Exton, Pa. It is a clearinghouse that licenses trading strategies from third-party developers and trades your accounts with those strategies for a management fee.

STRATEGIC INVESTING

We can develop a basic trading system for the S&P 500 using signals generated on the cash index to trade the ETF SPY (or "Spyder") on the long side and the ProShares Short S&P 500 fund (SH) on the short side.

One simple system would use intermarket analysis to outperform a traditional buy-and-hold approach. We could rely on a classic relationship between the long bond futures and the S&P 500. Basically, when the S&P 500 is in a downtrend and T-bonds are in an uptrend, buy SPY. When the S&P 500 is in an uptrend and T-bonds are in a downtrend, buy SH. To detect the trend, we could use a six-day moving average for the S&P 500 and a 16-day moving average for T-bonds.

Unfortunately, SH has only been traded since 2006. However, we can still see how the results for just the long side of the market – that is, trading SPY – compare to buy-and-hold. From May 1, 1998, to Nov. 7, 2008, we get the results shown in "Buy and sell" (left).

During this period, the strategy made 16.52 points. The first trade on July 24, 1998, had an entry price of $114.97. On Nov. 7, 2008, the market closed at $93.86. Clearly, the strategy greatly outperformed buy-and-hold during this period.

The world is changing. The Federal Reserve is trying everything possible to prop up the banking system by lowering rates and pumping liquidity into the markets. This is dramatically increasing our national debt. However, unless banks loan that money out to customers, we will have low interest rates without the benefits. This is the same scenario that has hamstrung Japan for more than a decade.

Unless we return to the heyday bull markets of the 1950s-60s and 1980-90s — a highly unlikely scenario — then America's middle class will need to find a new place to store its nest egg. The answer may be a new philosophy and a new investment vehicle to go with it. The era of buy-and-hold is over. That of active investing has begun. **FM**

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