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Why Our Advice Is Always the Same

Overview: It can be hard to hear the best course of action during tough market times may be to do nothing. It can be even harder to hear the message repeatedly as things seem to get worse. But it is a message we would not repeat if we did not truly believe it was in your best interests. The following discusses why our message is not wavering despite the market.

Buy and hold. Rebalance. Stay the course. That is the advice we repeat again and again. Over the long term, that advice has served our clients well. Yet, in the face of the persistent bear market, a common refrain from investors has gone something like this: “Yes, that advice has worked in the past. However, this time is different. It obviously isn’t working now! The market just keeps going down and down. There must be a better alternative than to sit and do nothing.”

While we empathize with investors who feel a great sense of loss, we don’t believe we are being stubborn. Our advice has always been (and will always be) based on the scientific evidence, not on our opinions about where the markets may be headed. And while this crisis is certainly different in some ways than other crises, we see no reason to change the investment advice.

Market Efficiency

For us to believe that we should abandon a long-term, buy-and-hold strategy, we would have to be first convinced that markets were no longer efficient. In other words, the market was now mispricing assets and was slow to react to new information.

It is hard to imagine that markets have gotten slower at reacting to news. In fact, markets incorporate news into prices almost instantaneously. After Treasury Secretary Timothy Geithner unveiled the Treasury Department’s plan to clean up toxic assets, the market reacted immediately, as evidenced by several indexes leaping to their highest one-day gains since last fall.

We see no evidence that active managers were able to predict this bear market. In fact, while there was a wide dispersion in individual stock returns (some stocks, like Wal-Mart were actually up), almost every single diversified mutual fund produced large losses. This would not be the case if markets were somehow inefficient. It is also important to note that there is no evidence that active managers consistently outperform in bear markets.

We believe that the market was and continues to be highly efficient. It is just that the news has been persistently worse than expected, causing prices to fall. This is what causes bear markets.

Market Timing

As to trying to time the market, we again rely on the historical evidence. When a client suggests just getting out until things are clear again, we point out that the evidence on market timing is even worse than on stock selection. For example, the publication *Timer Digest* showed that of the 112 market timers tracked from 1991 through 2000, only one managed returns that beat the S&P 500 Index. We don't like those odds. Neither should investors.

One reason that market timing fails is that so much of the market's return occurs during very brief and unpredictable periods. Another reason is that investors have to be right not once, but twice. Deciding to get out is easy compared to deciding when to get back in. Investors that go to cash may be "whipsawed." They will get out after a severe drop, miss a big rally and jump back in only to experience another severe loss. They end up worse than if they simply stayed the course. That is why we believe going to cash is not the winning strategy.

The Difference Between Information and Wisdom

We can define information as facts or opinions. In terms of investing, wisdom is information that can be exploited to generate excess (above market) profits. When we ask people why they are so willing to abandon their well-designed plan, they say something like: "Isn't it obvious that the situation is terrible?" Then they give a laundry list of negative items. The question they fail to ask is this: If it is in fact obvious, isn't the bad news already built into prices? After all, that is why prices have already gone down.

They also fail to understand the following: If things are so bad, that must mean the market is perceived as risky. If the market is risky, expected returns are now higher. Why would investors decide to sell now when expected returns are higher than when they originally bought?

Many investors have considered selling because of concerns about the "Europeanization of our economy." Should investors sell? To answer that question, one must understand that these concerns are well known by the market. While concerns about government intervention, higher taxes and an increased ratio of debt to gross national product can all affect stock prices, those concerns are already reflected in prices. That is why stock prices moved lower as the new administration unveiled its policies. As Bernard Baruch stated, "Something that everyone knows isn't worth knowing."

Investors feeling the need to sell should also consider the following. There is a "universe of risk." Since all stocks must be owned by someone, someone must hold the market risk. For everyone who wants to sell, someone else must be willing to buy at the same price. And they will only buy in a time of distress if they believe the market price fully reflects the high risks.

The Relationship Between Risk and Expected Return

If the perception of risks are high (which they are during bear markets), so must be the expected return. And the historical evidence is that investors persistently demonstrate a pattern of buying high (after bull markets when risk premiums are low) and selling low (after bear markets when risk premiums are high) when acting on their own. This destructive behavior is evidenced by the fact that investors typically underperform the very mutual funds in which they invest.

"Defensive" Strategies

Investing history is filled with examples of strategies that try to benefit from observable patterns of past market performance. Unfortunately, the realized returns haven't matched the promise.

Vanguard examined the performance of several different signals based on “conventional wisdom” to see if they actually translated into better risk-adjusted returns.¹ As one example, the authors studied whether investors could improve portfolio performance by defensively shifting equity exposure toward less-cyclical, lower-beta sectors (such as health care, consumer staples or utilities). This strategy is based on documented evidence that certain sectors tend to thrive in different stages of the business cycle. Unfortunately, they found that “a defensive investment strategy based on the leading signals of bear markets and recessions (focusing primarily on recessions) would not have resulted in better results than a buy-and-hold strategy.” Among the problems they found are “the low predictive power of even the best signals of bear markets and recessions as well as potentially high transaction and tax costs.”

Another signal they examined is the presence of an inverted yield curve (short-term interest rates exceed long-term rates), which is a well-documented leading indicator of recessions. Vanguard found that the yield curve signal is noisy: “For the period 1952 through 2006, the yield curve inverted 19 times, but the U.S. economy lapsed into recession only nine times.”

They also examined the forward-looking price-to-earnings ratio. The concept is based on the idea that a bear-market signal is given when the ratio is at historic highs. Unfortunately, this indicator is also noisy and, thus, has provided no value.

While the historical record shows that various sectors tend to outperform during tough times, Vanguard reached the conclusion that, “Even the most reliable indicators have low predictive power when used to execute real-time strategies. Investors seeking to mitigate equity market risks are better served with a strategic allocation to fixed income investments.”

Summary

Noted author Peter Bernstein provided this insight: “Even the most brilliant of mathematical geniuses will never be able to tell us what the future holds. In the end, what matters is the quality of our decisions in the face of uncertainty.”² Thus, our advice will continue to be the same, because that is what the science demonstrates is the most likely way to achieve one’s goals. When we find compelling evidence, published in peer reviewed academic journals, that there is a superior alternative strategy, we will do what smart people do; they change their strategy in the face of new evidence. Until then, our advice remains: buy, hold, rebalance and stay the course.

¹ Joseph Davis and Christopher Philips, **Noisy Signals: A Challenge to Tactical Strategies**. *Vanguard Investment Perspectives*, Spring/Summer 2008.

² Peter Bernstein, **Wimps and Consequences**. *Journal of Portfolio Management*, October 1999.

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