Buy and Hold: Is It as Simple as That?

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The body of academic evidence supports the belief that markets are highly efficient, and the best way to capture expected premiums is via a passive management approach. That is, efforts to identify mispriced (under- or overvalued) securities or to time the market are likely to prove counterproductive; a more prudent strategy is to design a passively managed portfolio that meets an investor's unique ability, willingness and need to take risk.

However, "passive" management should not be interpreted as lack of action, nor should it suggest only a "buy and hold" strategy. Quite the contrary, a passive approach involves ongoing action that is focused on a disciplined, long-term investment plan. This differs markedly from wasted efforts to chase the latest hot investment trends. Following is a description of some of the actions investors and their advisors can take to aggressively manage a passive approach.

Prevent Style Drift

Market movements can cause a portfolio's asset allocation to drift from the initial plan; periodic rebalancing ensures it does not drift too far astray. For example, if an investor had created a portfolio in 1990 that was 80 percent equities and 20 percent bonds, and then simply held the portfolio through 1999, it would have drifted to become more than 90 percent equities by the end of the decade, resulting in a much riskier portfolio.[1]

To prevent market movements from controlling the risk of a portfolio, investors should buy and hold — but should also periodically rebalance. Note that rebalancing is very difficult for most investors, since outperforming securities are sold and additional underperforming securities are purchased.

This means investors must have the discipline to buy securities when the outlook appears darkest and to sell when it appears brightest. Having this discipline often requires the guidance of an objective investment advisor, who can remind the investor of the critical role that rebalancing plays in achieving investment objectives.

Manage the Impact of Taxes

The tax code allows investors to deduct realized investment losses (within some limitations). Thus, investors can consider harvesting unrealized portfolio losses whenever the cost of harvesting is less than the tax benefit gained from doing so. Bear markets, like the one experienced in 2002, provide investors with the opportunity to improve after-tax returns by asking Uncle Sam to share the losses.

Manage Assumption Changes

If done properly, deciding upon a portfolio's asset allocation involves careful analysis of an investor's unique ability, willingness and need to take risk. This can be a complex process, and should include analysis of such issues as the investment horizon, the ability to stay the course during bear markets, the stability of earned income, the financial objective and the marginal utility of wealth. The sum of these factors forms an individual's investment policy. However, too often, the investment policy ends up carved in stone. Instead, one's policy should be reviewed — periodically and whenever a major life event occurs. If any of the underlying assumptions have changed, then the policy might require appropriate adjustments. Life-altering events such as a death or birth in the family, divorce or marriage, or a large inheritance or job loss can impact the asset allocation decision in dramatic ways. It also is important to note that even market movements can lead to a change in the assumptions behind an individual's investment policy and his or her portfolio's asset allocation. The impact of market movements is relatively complex and affects different investors in different ways. Consider the following step-by-step description:

In a bull market (when market prices rise higher than usual) …

1. Investors' portfolios perform well, so they achieve their objectives sooner than expected.
2. These investors who *participated* in the bull market should consider *lowering* their need to accept future investment risk.
3. Because market prices are higher than usual, reversion to the mean can be expected (although nobody can predict precisely when), resulting in lower future expected returns.
4. Investors who are *just beginning to invest* should consider *increasing* their need to accept future investment risk.

In a bear market (when market prices drop lower than usual) …

1. Investors' portfolios perform poorly, so they are further than expected from their objectives.
2. Investors who *participated* should consider *increasing* their need to accept future investment risk — to help their portfolios "catch up" to their goals.
3. Because market prices are lower than usual, reversion to the mean can be expected, resulting in higher future expected returns.
4. Investors who are *just beginning to invest* should consider *decreasing* their need to accept future investment risk. All this is another reason for investors and their advisors to periodically review their investment policies and the assumptions behind them.

The last five years have provided us with many examples of why the simple "buy and hold" strategy is insufficient, and should be accompanied by regular reviews and rebalancings as appropriate. In the late 1990s equities dramatically outperformed fixed income. Investors should have considered rebalancing by selling equities and buying fixed income, restoring their appropriate risk profile. Also, large-cap growth dramatically outperformed small-cap, value and real estate — and domestic outperformed international — further suggesting the need to rebalance (selling high and buying low). As explained above, the bull market of the 1990s lowered the need to take risk for many investors who participated in the increase and who could have taken advantage of this by lowering their equity allocation. 1998 provided opportunities to tax-loss harvest in some asset classes, including value, smallcap, real estate, international and emerging markets.

2000–2001 again presented the need to consider rebalancing, as small-cap value outperformed large-cap growth, and domestic outperformed international by a wide margin.
2002 provided many opportunities to tax-loss harvest equity holdings.
In 2003, investors saw international small-cap, emerging market and US micro-cap stocks become the top performers, leading to another potential rebalancing consideration.
To summarize, ever-changing market conditions along with unexpected life events can result in the need for constant vigilance and periodic action in maintaining an investment portfolio. But any actions taken should not be based upon attempts to forecast the market. Rather, they should support the fundamental assumptions we make in deciding upon the appropriate asset allocation. Market movements can also present opportunities to improve tax efficiency. It would be much simpler if the only decision investors had to make were to buy and hold. Unfortunately, neither life nor investing is simple. Thus the prudent strategy is to buy and hold — and also to periodically rebalance, tax-loss harvest, and review the assumptions that went into the asset allocation decision.

[1] In this illustration, equities are represented by the S&P 500 Index and bonds by Lehman Brothers Intermediate Government/Credit Bond Index.

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