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Buy and Hold Investing – Is It Always Right?

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Buy and Hold. That's what professionals recommend investors do to get the best performance out of their portfolios. I agree, and tell anyone who will listen that they should steadily purchase stocks over the course of their lives and slowly sell them during retirement.

The reason this advice is so good is that investors who time the market by selling when they think the market is at a short-term top or buying when it bottoms, are inevitably wrong over a period of numerous market cycles.

It is easy to be right ... sometimes. Consider that even a broken clock is right twice a day. But to make money by timing the market, you have to be right almost all the time. Even though you remember calling the market correctly, our memory plays tricks on us all the time. Ask any spouse, all of us are much more likely to remember when we were right, than when we were wrong.

Let's carry this buy and hold concept to the extreme and ask: Should investors always stay the course, no matter what? Truthfully, I think the answer is no and unfortunately this makes investing much more difficult.

I do not bring this up because I think we should all sell our investments and run for the hills – at least not today. However, I can think of low probability scenarios in which that might be the best advice.

One of the biggest problems with selling investments, or buying protection with put options, is that we are almost always too late. For instance, selling after the October 1987 crash; or when the markets reopened following 9-11, would have been huge mistakes. The markets adjusted quickly to the new reality and by selling you would have only locked in your losses, with no chance of recovery. There are also pesky tax issues that make these decisions even worse.

The expectation, which I guess proves the rule, was selling after the market crashed in October, 1929. Although no one knew it at the time, this would have been a good idea as the market went down even further over the next few years.

I guess my rule of thumb is that if the market is moving up or down due to regular economic cycles or changes in investor sentiment, it is a mistake to try to time the market or hedge investments with put options. But, if you notice a sea-change coming, moving to safer investments and buying protection is not always a bad idea.

These thoughts are conjured up watching the deteriorating situation in Iraq. (This article is being written just before President Bush's speech Wednesday night.) I can't help but get more and more nervous about the "nightmare" scenarios spelled out by the Iraq Study Group led by James Baker and Lee Hamilton. They believe, quite correctly I think, that this war, if not draw to a satisfactory conclusion, could potentially spin further out of control and eventually encompass the entire Middle East.

History teaches us many lessons and one of them I remember vividly from school concerned the French Revolution. Once events gain momentum, or to use a modern term, reach a tipping point, no one has command of the situation. In the French Revolution, it's easy to be sympathetic with the initial antagonists, but within a few years they lost their heads as the revolution took on a life of its own. As my teacher correctly taught us, it is relatively easy to initiate a rebellion, but almost impossible to control its course.

Will the Middle East be engulfed in a major sectarian war? I certainly hope not, but the situation is tenuous. Iraq has been the geographic buffer state between the Shiites and the Sunnis for hundreds of years. As we have learned, the majority of Iraqis are Shias along with the population of Iran and except for parts of Syria and Lebanon most of the remaining Middle Eastern population is Sunni.

Iran is already involved as it provided a safe haven to Iraqi's Shiite leaders during Hussein's rule. On the other side, the leaders of Saudi Arabia and their neighbors have made clear that they will act of necessary to protect Iraq's Sunni population from the Shiite majority. The Jordanians, Syrians and Turks also have good reasons to join in the fray.

Whatever our opinions about the start of the war, we all need to hope the situation remains contained. For now, I will leave it to political columnists to give you their views on the best course of action, but I think a "surge" at least postpones a regional crisis.

What do you do with your investments if everything blows up? I wish I had an exact answer, but it depends on what the market has already done and how bad things look. If you want to do something now, you might reduce risk in your bond portfolio by moving toward safer U.S. government securities and away from riskier corporate and international bonds. To reduce risk on the stock side, investors should consider hedging their positions by purchasing long-dated put options on the broader stock market indexes.

In summary, investors should generally avoid market timing, but it defies common sense to say we should never anticipate world events and hedge our risks. The question we all need to answer is, have we ignited a situation in Iraq that can be tamed or at the extreme, will we be confronted with the "nightmare" scenario of a regional war in the Middle East?

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