

Does Buy-and-Hold Beat Market Timing?

By Ric Edelman
From Inside Personal Finance

I've been wrong all these years. Okay. Fine. I admit it. For years I've been telling you that the buy-and-hold strategy always beats market timing. For years I've been telling you that you're doomed to failure if you try to engage in "market timing," a strategy where you try to buy stocks before they rise and try to sell them before they fall. For years, I've said that buy-and-hold always beats market timing.

I'm wrong.

This fact was revealed to me by a study published in the February issue of Financial Analyst Journal. This study tests and compares — once and for all time — the results between the market timing and buy-and-hold strategies. The authors studied data from 1926 through 1999, in an examination that included all six major U.S. asset classes. The objective: To determine whether market timing was an effective strategy compared to the buy-and-hold strategy.

They analyzed a variety of monthly, quarterly and annual market timing strategies, producing more than one million possible market timing sequences with, as you'd expect, more than one million different outcomes. Each of these outcomes was compared to the buy-and-hold strategy for the same time period. Now, you know me — and you know my position has always been that the buy-and-hold strategy wins 100% of the time against market timers. Yet, to my shock and dismay, this massive, authoritative, and indisputable study of a million-plus investing scenarios concluded that the buy-and-hold strategy did not beat market timing 100% of the time. Imagine my shock. Imagine my shame.

Imagine my astonishment to discover that the buy-and-hold strategy beats market timing only 99.8% of the time.

It's true. The study's authors determined that market timing beat the buy-and-hold strategy in only 0.2% of the back-tested, real-data simulations. So while I've always said that market timers will never beat those who buy and hold, the truth is, out of 1,000 people who try market timing, two of them will succeed. Imagine my embarrassment.

The fact is, it's easy to own stocks and stock funds when prices are rising. But just as "calm seas do not a captain make," rising prices do not produce successful investors. The trick to making money in stocks is not when you buy or when you sell, but how long you hold.

So, I've got a little quiz for you: Are you aware that nearly all (meaning, most likely, your) stocks and stock funds have fallen in value since the first of the year?

I hope you can answer "no" to this question, because that means you are a true buy-and-holder. People who have absolutely no plans to sell generally are uninterested in current market values. After all, if you're not going to sell your car, does it matter how much you could sell it for?

This explains my confusion when people tell me that although they have no intention of selling their investments, they track the prices in the daily paper anyway. Do you do this? Once again, a little quiz:

WHY DO YOU DO THIS?????

If you're engaging in a buy-and-hold strategy, if you plan to own your investments for five or 10 years or more, why are you bothering to look at their prices in the newspaper every day? You're not going to be selling anytime soon, so the current price is irrelevant. Thus, there's no point in checking.

Don't say that you check "just for fun" or "merely to stay abreast." The truth is this: Looking at the prices constantly (hourly or daily) or even frequently (once or more per week) could do you much

harm. Why? Because you will not buy more if the price is up (because you've already invested all your money), but you might be tempted to sell if the price is down. Thus, checking prices often could cause you to become a market timer. The best way to protect yourself from this disease is to not infect yourself with today's information.

To put your odds of buy-and-hold success into perspective, consider these statistics, published by the Forum for Investor Advice:

Odds that you'll win the lottery: 1 in 4,000,000

Odds that you'll be dealt a royal flush: 1 in 650,000

Odds that Earth will be struck by a meteor during your lifetime: 1 in 9,000

Odds that you'll be robbed this year: 1 in 500

Odds that the airlines will lose your luggage: 1 in 186

Odds that you'll be audited by the IRS: 1 in 100

Odds that you'll get snake eyes when rolling the dice: 1 in 36

Odds that you'll go to Disney World this year: 1 in 10

Odds that the next bottled water you buy will be nothing more than tap water: 2 in 10

Odds that you'll eat out today: 5 in 10

Odds that an investment in stocks will make money in any given year: 7 in 10

That's right, over the past 100 years, the stock market has made money 70% of the time. The fact that it didn't in 2000, or in 2001, is both uncommon and irrelevant to your long-term planning.

Therefore, you should not let this recent performance affect your long-term investment strategy.

Selling an Investment Begins with Why You Bought It

Despite the power of the buy-and-hold strategy, it isn't a strategy you should follow blindly. There are exceptions, and here's one of them. Ask yourself this simple question: Why did you buy the investment in the first place?

Were you buying it because you were hoping it would double in value like it did the year before?

That, of course, is not investing. That's speculating — and it's called greed.

Instead, you need to verify that your investments are part of a goal-oriented diversified portfolio. If you don't have a goal orientation (i.e., you're trying to achieve a certain level of wealth by a certain date), then yes, it's very possible that you need to sell your investment(s) and buy something else that is better designed to help you achieve the goals that you need to establish.

Selling to obtain better-suited investments is not a market-timing issue, but a goal-oriented one. By selling inappropriate investments now and replacing them with more appropriate, goal-oriented investments, you move from a market timing model to a buy-and-hold model, because once you have suitable and appropriate investments, you can begin to engage in a true buy-and-hold strategy for the next several decades.

One More Way to Determine If and When You Should Sell an Investment

Suppose you initially bought your current investment because you believed it to be a sound one, and you didn't buy out of sheer speculation. Even in this scenario, there's one reason why selling might be prudent. To understand this concept better, let's look at the dilemma described by a recent caller to my radio show.

Lance invested \$25,000 in a stock. It went up 69%, to \$42,250, before falling to \$19,250. He's lost 23% of his investment — or, if he really wants to feel bad, he's lost 55% compared with the high.

Lance made a mistake. No, it wasn't that he failed to sell at the high (because he didn't know at the time what the high was). His mistake was that, when he bought the stock, he failed to state when he'd sell. In fact, Lance should have set two target sell prices — one in case the stock went up and another in case it went down. Then he needed to promise himself that he'd stick to those limits. Ironically, Lance once said that he'd be thrilled to see his investment grow to \$40,000, but when that value was reached, he didn't sell. Instead, he held onto the stock, hoping (believing? praying?) that the value would rise even further. Although it did, the continued run-up was temporary. (Remember that old Wall Street adage: Bulls and bears both make money, but pigs get slaughtered.)

Now that Lance is facing a loss, he doesn't know what to do. His anxiety is exacerbated by the fact that he knows he could have sold at a big profit. Not only didn't he sell at his high-side sell point, his dilemma is made all the worse by the fact that he never set a low-side sell point. So, now that he's reached it, he doesn't realize it. All he knows is that he's lost a lot of money. But because he set no guidelines, he doesn't know what to do about it.

What he needs to realize is that his loss is completely irrelevant, because there's nothing he can do about it. His first task, therefore, is to look at the current situation. The value of his stock is now \$19,250, and that's all that matters.

So, Here's the Real Question...

If you were going to invest \$19,250 today, where would you put it? Would it be in the stock you happen to own already, or would you choose a different stock?

That's the question you want to answer. Simply holding onto a stock you already own merely because it's worth less than what you paid (in the hope that it will break even one day) is foolish. While it almost certainly will break even one day, it might take 25 years for that to happen! And in that same 25 years, an alternative investment might do much better. So, if you're focusing on "breaking even," you need to realize that all you're doing is trying to avoid admitting that your investment has lost money. And that means that you're dealing with psychological issues, not economic ones.

If you've ever found yourself in this situation, you need to change how you're handling your money, because this kind of thinking is not going to help you make anything in the long run. Even if it works for a while, it'll be serendipity, not smart strategizing.

The proper thing to do is to make the right decision, and if that decision is to sell the investment you own — the one that's lost money — then do so. Stop fretting that this forces you to accept the loss. Admitting to losses doesn't make you a bad person. And it doesn't mean you're a failure. In the world of investing, losses are inevitable. The only issue is whether your losses will lead you down the road to ruin.

If you'd really rather avoid dilemmas like these, avoid stocks and favor stock mutual funds instead, leaving the stock-selection decision to professional money managers. That's why the most successful buy-and-holders own mutual funds, not individual stocks.

written 4/01 updated 11.29.05