



## THE 'OLE "BUY AND HOLD" STRATEGY WON'T WORK!

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Gee, remember how much fun and how "easy" investing used to be? Back in the 90s, most every investment went up. Then, there was the tech bust in the early 2000s, but that was followed by four good years in equities. Now, everything has changed.

Actually, investing in equities for the 25 years from 1982 to 2007 was awfully good. On average, stocks were up 10-12% per year. Similarly, stocks performed well from 1943 to 1968, but how about the period 1968 to 1982 or from 1929 to 1942? Stocks were flat. In fact, if someone invested in a diverse portfolio of stocks in 1968 and held their positions through the ups and down of the 70s and early 80s, it would have taken until 1982 when the stocks returned to the 1968 levels. And, if we talk about "real" returns, that is, returns after inflation, they did not get the buying power back of their 1968 investment until 1992. So, over a 24 year period they had zero real return.

An investment in 1929 had the same experience. It took until 1943 for the indices to reach the 1929 level. But, in real terms, it took 24 years, or 1953, until that investor and his or her family had a stock portfolio with the same purchasing power

as it had in 1929. Buy and hold did not work in the 30s and it didn't work in the 70s. And it probably won't work now.

Unfortunately, our economic situation today is very similar to the 70s and in some ways is similar to the 30s. We are optimistic about the long-term prospects for the U.S. and World Economy. However, we are not optimistic in the next three to five years.

With US government bailout programs now approaching \$3 Trillion, we are all hoping that things will return to normal soon. While we may see a little bump in the markets due primarily to optimism and so much government stimuli, don't count on a sustained rally. Our economy has too many fundamental problems.

The best characterization I have heard to describe our economy, is that we are similar to a company that goes into Chapter 11, Reorganization. As a country and as individuals, we have taken on too much debt and consumed way beyond our means. Now, with many Baby Boomers nearing retirement, consumption is changing drastically. After years of earning and spending to their hearts' content, Americans are rediscovering thrift. The Baby Boomers that helped drive the US and World economy for the last two decades are now scaling back.

Furthermore, the housing market, whose rise has driven the economy in the last seven years, is in shambles. We don't see real estate, either residential or commercial coming back for another three to five years. Historically, housing prices until 2000 have grown 3 to 4% annually, similar to the long-term cost of living increases. Starting in 2000, lower interest rates, creative lending programs for homebuyers, money redirected from the stock market,

and speculation caused housing prices to double in six years. Now, that the bubble has burst, we expect housing prices to continue downward another 20-30%, perhaps reaching price levels in 2000. With consumption and housing down and individuals and the government paying down debt, our economy will be sputtering for a least a few years.

So, what do you do with your stock portfolio that is down 35-40% from last fall? Perhaps your options are to:

- Either hold your breath, keep reading positive reports, and hope that stocks will bounce back some time soon. Perhaps someone told you one time that it is not a loss until you sell and you should ride out the market until it returns.
- Or, acknowledge that you've had a good run for the last 25 years (or ten years or six years or whatever) but now is not the time to be heavily invested in the stock market and reallocate your portfolio to asset classes that have a better likelihood of producing positive results over the next three to five years. And, assuming a better stock market environment, return to equities three to five years from now.

Here's why we think the second choice is the right one for many investors.

If we go back to the 70s or the 30s, it took 14 years for the indices to return to their previous highs. About one year ago, the DJIA hit its high at 14,000. Let's assume that it will return to that level again in 13 years. Like the 70s and the 30s, let's project that during those 13 years, the market will go up and down and sideways but never really start a new push past 14,000. As this article is being written, the DJIA is 8,800. If I stay with my stock

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portfolio for 13 years and it increases from 8,800 to 14,000 in 14 years, my annual return is 3.6%, and that is before inflation.

However, if I get out of the stock market now and invest in other asset classes that may return 5, 6 or 7% for the next three to five years, that would be much better. Then, I may get back into stocks in 3-5 years when our economy is starting to turn around. If the DJIA is 6,000 in four years for example, I might invest some of my money in stocks, since growth from 6,000 to 14,000 over a 9 year period is 9.8% per year.

OK, you say, but you have four reservations. First, you don't want to sell at a loss. Second, what about taxes? Third, Warren Buffet just invested. And, fourth, where do you invest instead of equities?

First, what you paid for your investments, other than potential tax implications, is a non-issue. It is probably best to think of all of your investments as a pile of cash. Each day, you can decide if you want to invest the money in stocks, bonds or other investments. When you hold stocks, you are effectively making a decision every day to continue to invest in stocks, since you can get out anytime.

Second, all indications are that tax rates are going up. Capital gains rates may be up in 2009 and most certainly will be higher in 2010. The 15% capital gains tax is a bargain; one we probably won't see again for some time. Furthermore, with current values low, the realized gain may be less than what you would expect. 401k

accounts and IRAs are not subject to current income taxes in any event. And, lastly, with advance planning, the tax impact of rebalancing in taxable accounts to reduce or eliminate equities can usually be minimized.

Third, Warren Buffet is a legend and is admired by almost everyone, including us. As most of you know, a few weeks ago he invested some of his personal funds in stocks. His announcement in the New York Times on October 17th was entitled "Buy American. I am." Obviously, part of his motivation was to instill public confidence in the markets. However, he also made it clear that he wasn't predicting that the worst of the sell-off was over but indicated that over the long-term, the stock market news will be good. We agree.

But there is a big difference (measured in billions) between Warren Buffet and most investors. If Warren Buffet wants to invest \$100 million or whatever in equities, he and his heirs can withstand a flat market for the next 10-14 years. He'll be okay and have enough money for his retirement regardless of market performance. On the other hand, most investors, particularly those nearing or in retirement, can't afford to gamble that the 25% or 50% or 60% or more of their portfolio invested in equities may be flat or have little growth in the next 10 to 14 years.

Finally, we believe fixed income, alternative assets, and tactical investing should do better than equities over the next 3-5 years. Fixed income includes treasuries, agencies, investment grade corporates, municipals, and international bonds. Typically, we construct customized

bond ladders for our clients to provide diversification, attractive average portfolio yields, and minimize reinvestment risk and preserve principal. We also use bond funds.

Alternative investments are investments other than stocks and bonds. They include equipment leasing programs, oil and gas programs, hedge funds, and other non-traditional investments. Alternative investments are non-correlated with the stock market; which means their returns should continue to perform regardless if the market is going up, down or sideways. Alternative assets provide three distinct advantages; diversification, cash flow and, in some cases, tax benefits.

Lastly, tactical investing should be considered. Tactical investing identifies areas of strength and weakness in the markets and directs dollars into vehicles expected to outperform the market. Tactical investing therefore is far different from "strategic" investing which typically sticks to a constant mix policy (e.g. 50% stock and 50% bonds) and maintains that mix in up and down markets by rebalancing. Tactical investing may be 100% equities at times or 0% equities at other times, such as now.

So, in conclusion, for most investors, buy and hold won't work. Consider reducing or eliminating your equity exposure now, rebalance into asset classes that have a better chance of producing returns in the next few years, and then start getting back into equities when the economy starts to rebound in 3-5 years. We are optimistic that the rebound will occur; it just needs time.



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