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Expounding the Asset Allocation theory

Evolution from the Buy-and-Hold vs. Market Timing impasse

The Case for Buy-and-Hold

When asked what was the most important thing learned from mathematics, Albert Einstein said, "Compound interest. It's the most powerful force on earth." Buy-and-hold strategy takes advantage of this powerful force.

Buy-and-hold proponents' classic advice: select an index fund and make monthly investments until you retire. They claim that successful investors are buy-and-holders just like billionaire Warren Buffett who recommends that one buys good companies and holds them forever.

Proof Case 1 – The 20-year relative performance

Buy a basket of good quality shares and hold for any 20-year period. Statistics show that this strategy always out-performs bonds, gold, cash, real estate or most other investments over a similar time period. Then again, most investors do not typically hold their positions for more than 10 years. Truly long-term investors are a relatively small portion of the investment community.

Proof Case 2 – Missing the best days

Unless you are in the market all the time, you are in danger of missing the best days that account for a huge portion of the stock market's gains. For example, if you invested $100 in the US stock market in 1926 and held them through 2005, your investment would be worth $200,000. But if you tried to time the market and missed the 30 best months, your $100 would have grown to only about $8,000.

But, what if you are in the market all the time except for the 30 worst months from 1926 through 2005? Your $100 initial investment would have grown to around $19 million.

Taking the what-if game further, what if you had missed the 30 best and the 30 worst months? It would have grown to $320,000, and with a lot less anxiety. Buy-and-hold guarantees that you don't miss the best days of the market but be prepared to give some of the gains back during the bad days.

Proof Case 3 – Its Siamese opposite: Market Timing does not work

A recent published study exhaustively tested and compared market timing and buy-and-hold strategies, using data from 1926 through 2002. They analysed a variety of market timing strategies, producing more than one million different outcomes. Each outcome was then compared to the buy-and-hold strategy for the same time period. The study results showed that market timing failed to beat buy-and-hold over 90% of the scenarios. Mark Hulbert, publisher of the Hulbert Financial Digest which tracks 170 market timing newsletters, found that over 80% of newsletters underperformed their market indices.

The fact is: we are not statistical robots. Buy-and-hold works for people with the discipline to stay on the course. Unfortunately, many investors panic during bear markets and dump losing holdings, often doing more harm than good to their portfolio.

"They end up being worse off than someone following a statistically inferior market timing strategy, but who's willing to follow that through an entire market cycle," quoted Hulbert.

The Case for Market Timing

Market timing is often misused and misunderstood by many. No one buys a stock or unit trust expecting it will be worth less. They choose a "time" to buy, based on fundamental or technical considerations, and expect that over "time" it will be worth more. Then they sell when they expect its value will decrease over "time". Just about every investor is, in one way or another, a market timer.

Proof Case 1 – Bad timing does matter
An interesting study released in 2004 showed that investors tend to buy high and sell low, chasing winners in bull markets and dumping laggards in bear markets. During a 19-year period from 1984 through 2003, the average US equity investor earned an anaemic annual return of 5%, versus 12% for the S&P 500. Mutual fund investors are not better off. The average S&P 500 index fund did about 11%. After charges, the average actively managed unit trust returned about 10%. Coupled with bad "timing", the average mutual fund investor earned just over 6% per annum.

Typical investors are susceptible to bad timing, basing their investment decisions on their perceptions of the current market conditions. It is therefore no surprise that invariably, stock brokerages generate their greatest volume when the stock market is making new highs.

Proof Case 2 – Compounding can work for or against you
A TheStreet.com columnist, James "Rev Shark" DePorre, whose motto is "Saving souls from Buy-and-Hold", commented that compound interest can work both ways. If you buy a momentum stock that went bust, it could go down and down all the way, "compounding your losses year after year".

If you are among the investors who are still recovering from the tech wreck of 2000, you should know that it takes a 100% gain just to break even after a 50% loss. Hence, it may be wise to avoid losing money at all costs.

The Evolution – Asset Allocation

Whether it's buy-and-hold or market timing, I feel that they need not be mutually exclusive. In fact, the modern asset allocation system is the evolution of buy-and-hold and market timing philosophies, exploiting the potentials from both schools of thought.

In asset allocation, the strategist chooses a selection of funds he believes would provide the greatest opportunities for appreciation. However, it is impossible to capture the whole spectrum in the portfolio. Various sectors are constantly being over-weighted or under-weighted depending on when profit from outperforming funds is shifted to better opportunities in "undervalued" sectors or regions. This active asset allocation process is market timing in disguise. The portfolio remains fully invested in a varied mix of equity and bond funds. The actual mix would depend on the risk profile of the investor. The "fully invested" dogma derives from the buy-and-hold principle.

Unless your portfolio consists only of a global equity fund, the asset allocation process involves a certain degree of market timing. For example, why Japan equity and not US equity? Why emerging Europe and not Pan-Europe? All allocation decisions involve judging the "right time" to invest in a particular asset class. A static allocation model akin to the buy-and-hold strategy is seldom advocated as there are lesser avenues for the financial advisor to value-add to justify for the ongoing portfolio management fee.

Abuse of Asset Allocation

However, financial advisors often abuse the term by highlighting its overwhelming impact on portfolio returns – a point which is both evident and often irrelevant. To suggest that your returns will be improved by asset allocation is reminiscent of Mark Twain's advice, "Buy good quality common stocks and hold them until they go up. If they don't go up, don't buy them."

Pitfalls of Asset Allocation Models

Asset allocation faces some real challenges. Different investment strategies tend to outperform given a set of circumstances and under-deliver given others. Therefore, picking the right funds is inherently harder than picking the right stocks. Most portfolio strategists select funds with strong past performance and may end up investing into previously strong styles or sectors which ultimately regress and underperform.

Moreover, timing uncertainties can be longer than clients' patience, which leads to career risk – "never be wrong alone". Advisors' efforts to reduce career risk then create herding, momentum and extrapolation, eventually leads to underperformance when the markets correct sharply.

The Big Boys Theory

The baseline assumption that the stock market is dominated by the big boys explains why many actively managed portfolio under-deliver in the longer term.

The big boys in the market are the investment banks and hedge funds. Mutual fund managers may be big players, but their mandates require them to stay largely fully invested and thus are price takers than price makers.

Outperformance is only possible when we successfully time the market with consistency. To deliver α, or out-performance over the index return, cost and profit needs to be inflicted on some losers.

The financial statements of the investment banks show that they are generating above 20% annual returns on their trading activities. It is no wonder that the CEOs of many top investment banks on Wall Street are former star traders. Profits from the trading desks often constitute more than 50% of total earnings (including contribution from traditional activities like underwriting, M&A, fund management, lending and recently Leveraged Buy-Out deals). They outperform the general market by tens of billions of dollars a year. If the investment banks are collectively the winners, then who are the collective losers who are contributing to their α?

High Costs in Singapore

Compounding on the challenges of asset allocation is the high cost of owning unit trusts in Singapore. The fund management business in its totality (assuming all invest in actively managed unit trusts) creates no “value” (defined as outperformance of the index) but costs about 2% a year (average expenses ratio of equity based CPF-approved funds). If the world consists of only managed funds, professional fund managers must collectively underperform because of their cost. It’s like a poker game in which the good player must inflict his costs and profits onto the loser. To beat the index by 2%, someone must lose by 6% every year.

Assuming the long term returns for S$ equity is 8% p.a., after offsetting the fund expenses, it drops to 6%. Under wrap account structures, the average fee is about 1% a year. That leaves us with 5% return on the equity portion of the portfolio. If a sizable portion of the portfolio is invested in bonds, the annual return may be lower. For non-wrap unit trusts account, there is usually a bid-offer spread of 2-5%, which would reduce the effective return by 0.5-1% p.a. depending on the length of investment.

Some investors decide to spare themselves the agony and park their savings in fixed deposits, currently yielding about 3%. Others choose to invest in blue chip STI stocks and enjoy the stable dividends and capital gains over the years. Many investors have lost faith in the professional fund managers’ ability to generate any meaningful returns for them in the long run.

Unless active asset allocation plans can demonstrate clearly how they can out-manoeuvre the market in the long run, they are just added fees. Most would be better off sitting on a global equity fund like classic buy-and-holders. Boring it may seem, but it is definitely more rewarding.