

Is Buy and Hold Dead?

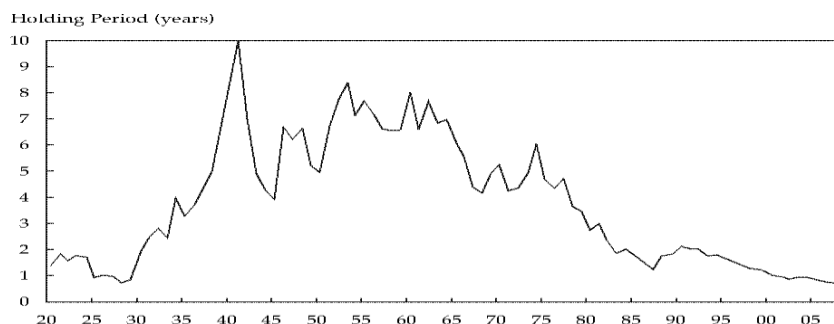
After a lost decade of stock market returns, investors may wonder whether the “buy and hold” approach to investing is dead. Of course, it is not uncommon for the investment community to question the merits of long-term investing during periods of high volatility. It can be difficult to ignore the sensationalist newspaper headlines and 24/7 media news flow focused on the minute-to-minute gyrations of the market. Perhaps there is no clearer evidence that buy and hold investing may be out of favour than to look at Warren Buffett, the legendary 80 year-old investor who proclaimed that the ultimate holding period for a stock is forever. Shares of Berkshire Hathaway, Buffet’s conglomerate, are changing hands at slightly over book value, the lowest valuation in decades.

In previous *Insight* pieces, we have discussed our investment philosophy at length. We have talked about our value discipline, the focus on quality businesses, and the importance of dividends. This discipline requires an ability and willingness to take a long-term perspective. In today’s fast paced and short-term focused environment, we believe that taking a long-term view creates more of a competitive advantage than ever.

INVESTORS’ PATIENCE IS DWINDLING...

In the post-World War II era, the average American investor held stocks for about four years and that trend was relatively consistent over the following thirty years. This sounds reasonable when you consider that stocks are not pieces of paper but represent an ownership stake in a business. During the mid-1970s, investors’ average holding periods started a secular decline. By 2000, at the height of the tech bubble, the average duration of an equity holding had fallen to eight months. As we learned in the aftermath of the tech crisis, this “new era” thinking was temporary and long-term investors were rewarded for their patience over the following few years. Unfortunately, while many of us hoped that investors had learned their lesson from the bubble, this was not the case. According to the latest reading in 2008, the average holding period stood at just 2 months. While we do not have data for 2011, judging by the mood swings of the market, we would not be surprised to find that holding periods are now being measured in days (or even minutes), and not months.

Average Holding Period: NYSE (1920-2008)

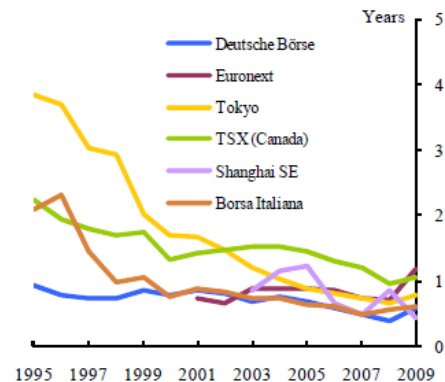


Source: Based on data from the NYSE.

Source: James Montier, *Applies Behavioral Finance: White Swans, Revulsion and Value*, FAJ, March 2009

Interestingly, the race to the bottom in terms of investment time horizons has been a global phenomenon. Over the past 15 years, the average holding period has fallen across the major international equity markets. With few exceptions, holding periods are shorter than one year.

Average Holding Periods of Global Stock Exchanges



Source: World Federation of Exchanges

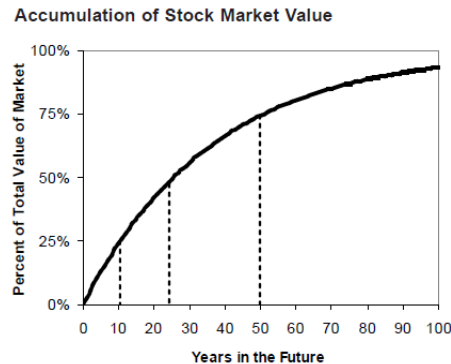
There are many reasons for these dramatic changes, including the proliferation of hedge funds, exchange traded funds, indexed futures, and the introduction of speculative products (e.g. leveraged ETFs).

Another example is high frequency trading (HFT) which involves the use of high speed internet connections and computer algorithms to trade in and out of stocks across the myriad of new and traditional trading venues, and to earn profits by collecting miniscule differences in prices. According to research by the TABB Group, it is estimated that algorithmic trading accounts for 70% of all trading volume in US equities. While not creating a new class of investor per se, the advancements in technology have been significant. Ten years ago, execution of HFTs was measured in seconds. Today, trades are executed in thousands or even millionths of a second. And unlike long-term investors, computerized traders do not bother to open up an annual report, meet with management, or spend time trying to understand the economics of a business.

The adoption of exchange traded funds (ETFs) has also contributed to the short-term nature of the market as it has made it just as easy to trade a basket of stocks as an individual stock. According to Morningstar, over the past four years, the number of US ETFs has more than doubled to almost 1,100, which account for more than \$1 trillion in assets. During this period, the correlation of stocks in the S&P 500 has also roughly doubled rising from 40 percent to 80 percent. In other words, 80 percent of the movement of a stock price is explained by the overall movements in the broader market rather than by the individual merits of the company. The nature of ETFs is not short-term in and of itself but the liquidity of these vehicles makes it easy for investors to make short-term bets on the direction of a particular sector or commodity. At the click of a button, market participants now have the ability to buy and sell a basket of stocks before breakfast.

STOCK MARKET MATH

Despite the focus on short-term holding periods, most investors will agree that the intrinsic value of a stock is the present value of its future cash flows over the life of a business. In other words, the value of a business is not in next quarter's earnings or even next year's earnings but in the cumulative profits of a business over several decades.



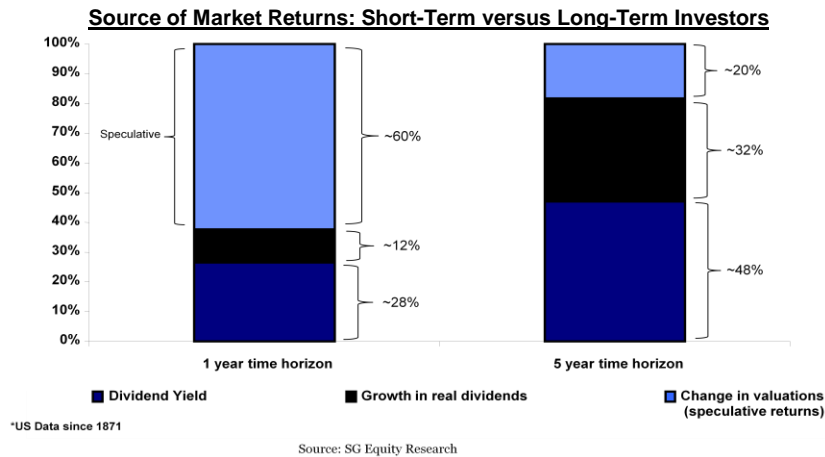
Source: GMO

With the dwindling time horizons of retail and institutional investors, it is often forgotten that stocks are long-duration assets. According to analysis by GMO (see chart above), the first 11 years of cash flows account for just 25% of a stock's value. Another 50% is derived from cash flows more than 25 years in the future. Given that stocks do not have an expiration date and cash flows tend to grow over time, why has it become so fashionable to churn in and out of stocks?

In the current market environment, with high volatility and correlation amongst stocks, it is not uncommon to see the market swing up or down 3% in a single day. It can be difficult for market participants to ignore the severe fluctuations of the market. However, long-term investors have an important advantage in dealing with the volatility.

To illustrate, let us compare the investment experience of a short-term (1-year horizon) and a long-term (5-year horizon) investor.

There are three sources of market returns: dividend yield, growth in real dividends, and the change in P/E multiple (speculative returns). As the chart highlights, in any given year the 'speculative' or capital gains component accounts for 60% of an investor's return. We can understand why those with a short time horizon would be uncomfortable with the mood swings of the market, given that the majority of their return is derived from a change in the market multiple, a fickle source of market returns. It is important to point out that the 'speculative' component works both ways: a positive contributor in up markets and a negative detractor in challenging markets.



However, for the investors with a 5-year horizon, approximately 70% of their return comes from more stable sources of returns: dividend yield and dividend growth. A long-term investor is able to cancel out the “noise” of the market. Even after going through a challenging environment like the one we experienced in 2008, a long-term investor can count on dividends to provide the majority of overall return. The bottom line is that speculative returns diminish as time horizon grows; an important advantage for long-term investors.

THE LOST DECADE – VALUATION STILL MATTERS

One of the most prominent arguments against buy and hold investing is that investors who tried this approach over the last decade have nothing to show for it. The argument follows that if one simply looked at the returns of developed market investors around the world over the past ten years, investors have experienced a round trip. If we set aside dividends for a moment (which have been excluded from the analysis), we would agree that, on the surface, the situation looks dire. As the following table illustrates, the Canadian market has been range-bound since 2000 and the situation is even worse for US and German investors alike who have seen the market fall back to levels first reached thirteen years ago.

As a value investor, we have never suggested a “buy at any price” approach to investing. In fact, we have long contended that the entry price is the most important determinant of your long-term returns. When one looks closely at the numbers, it becomes apparent that the reason for the lost decades is not that long-term investing does not work but that buying overpriced assets (no matter how long your time horizon) often ends badly.

P/E Multiple Contraction in Sideways Markets

| Country | Index | Last Close | Month First Reached | Trailing P/E Initial | Trailing P/E Current |
|---------|----------|------------|---------------------|----------------------|----------------------|
| Canada | S&P/TSX | 11,178 | August 2000 | 33.1x | 14.2x |
| U.S.A | S&P 500 | 1,124 | April 1998 | 27.0x | 12.3x |
| Germany | DAX | 5,217 | April 1998 | 13.6x | 9.3x |
| U.K. | FTSE 100 | 4,944 | July 1997 | 19.9x | 9.5x |
| France | CAC 40 | 2,851 | June 1997 | 22.9x | 8.2x |

†Data as of October 4, 2011. Source: Bloomberg, Merrill Lynch.

Today, valuations have come down to more attractive levels. It would be a mistake to take the experience of the past decade and extrapolate it into the future. At a time when investors are throwing in the towel, P/E multiples have fallen dramatically, offering a more attractive entry point. The Leuthold Group has compiled data that highlights the performance of equities following a 10-year period of sub-par returns such as the one from 1999-2009. Dating back to 1939, the average 10 year equity return was 10.8% in the periods following sub-par returns.

10-Year Returns after Worst Equity Performance Periods

| | Prior 10-yr Avg. Ann. Return | Avg. Ann. Return | Cum. Return |
|--------------------|------------------------------|------------------|-------------|
| Q2 1939 to Q2 1949 | -3.65 | 8.62 | 129 |
| Q1 1939 to Q1 1949 | -2.79 | 9.12 | 139 |
| Q3 1939 to Q3 1949 | -2.74 | 7.74 | 111 |
| Q1 1938 to Q1 1948 | -2.54 | 11.76 | 204 |
| Q1 1940 to Q1 1950 | -1.42 | 9.65 | 151 |
| Q2 1940 to Q2 1950 | -1.42 | 12.19 | 216 |
| Q4 1938 to Q4 1948 | -0.65 | 7.21 | 101 Worst |
| Q3 1938 to Q3 1948 | -0.10 | 8.12 | 118 |
| Q3 1940 to Q3 1950 | 0.18 | 12.57 | 227 |
| Q4 1937 to Q4 1947 | 0.20 | 9.61 | 150 |
| Q4 1939 to Q4 1949 | 0.23 | 9.09 | 139 |
| Q2 1938 to Q2 1948 | 0.44 | 9.52 | 148 |
| Q3 1974 to Q3 1984 | 0.49 | 15.58 | 325 Best |
| Q1 1941 to Q1 1951 | 0.71 | 14.47 | 286 |
| Q4 1974 to Q4 1984 | 1.24 | 14.76 | 296 |
| | | Average 10.76% | 183% |

Source: Leuthold Group.

While we can't predict what will happen to the market over the next few months or even year, we believe that the next decade will be kinder to long-term investors than the previous one.

TIME ARBITRAGE – AN OPPORTUNITY

“A serious investor is not likely to believe that the day-to-day or even month-to-month fluctuations of the stock market make him richer or poorer.”

-Benjamin Graham, The Intelligent Investor

All professional investors seek to find an investment edge: an advantage that distinguishes them from their peers that will allow them to generate above-average returns over the long run. There are different ways to get an edge. Investors can focus on areas of the market that are not widely followed (e.g. small caps) or on more complex transactions (e.g. restructurings). One of the most overlooked edges is time horizon. The term “time arbitrage” was coined to describe the concept of having a longer view than the crowd does. This idea is neither new nor original. If the investment approaches of some of the most successful investors of our time including Warren Buffett, Sir John Templeton and Peter Lynch are assessed, they all share one thing in common: a focus on the long term.

There’s an old saying: *how do you beat Tiger Woods? Play him at anything other than golf.*

By definition, the more investors play in the same arena, the more efficient the market will become. Despite this, we have an entire segment of the industry that is devoted to seeking a short-term edge, a hyper-competitive area of the market. According to Morningstar, mutual funds with the highest portfolio turnover rates have underperformed the lowest-trading funds by an annual average of 1.8% over the past decade. In a bygone era when investors held stocks for a period of years, having a long-term view was not sufficient to stand out from the crowd. In today’s environment, having a view on a company’s profitability over the next two to three years has become a variant. At Sionna, we believe our ability to take a longer perspective than most market participants is a sustainable competitive advantage. We are happy to let other investors try to challenge Tiger on his home course!

Andrew Pastor, CFA
Equity Analyst
Sionna Investment Managers