

Beating Buy and Hold

Or... Why Active Management Doesn't Have to Be Perfect

A 1994 study conducted by the University of Michigan¹ on the effect of daily and monthly market swings on a portfolio's performance came up with an interesting statistic on using active management to invest only in the positive days of the market.

Based on monthly data..."the perfect timer would have turned a \$1 investment in January 1926 into \$690 million in December 1993....In comparison, a \$1 investment in the market index would have grown by \$637.30, while a \$1 invested in Treasury bills would have grown by \$9.20."

Why the dramatic different in returns? It comes down to the mathematics of gains and losses. It is far easier to lose money in the markets than it is to make money. It doesn't take a 25% gain to make up a 25% loss, it takes 33%. A 50% loss requires a 100% gain to return to breakeven.

The same study went on to look at the impact of missing the best and worst months of the market between January 1926 and December 1993. It's no surprise to find out the study concludes if one does nothing but miss the best months of the market, returns decline dramatically. Missing the worst months results in a dramatic improvement in returns, while missing both the worst and the best resulted in outperforming a buy-and-hold position.

While arguments against active management typically focus on the impact of missing the best periods of the market, the third point, missing both the best and the worst is often overlooked. It is true that some of the market's best periods have closely followed down markets. For example, the highest monthly return for large company stocks over the past 25 years occurred in 1974, when, after seven consecutive down months, total return for the S&P 500 surged 16.57%, followed by two more down months. A typical trend following active strategy would probably have missed the 16.57% gain. But would it really matter, if the investor also missed the nine down months?

A look at the numbers shows that an investor would have been far better off missing the nine down months and the one up month than a buy-and-hold investor who

¹ **Stock Market Extremes and Portfolio Performance**, A study commissioned by Towneley Capital Management and conducted by Professor H. Nejat Seyhun, University of Michigan. 1994.

participated in all the ups and downs. Over that 10-month period in 1974, large company stocks declined 43.72%. It took a 78% gain to make up capital lost during the nine negative months, far outweighing the benefit of participating in the best month for large company stocks over the 25-year period.

Impact on Annual Return of Missing the Best and Worst Days of the Market

1/1/84 through 12/31/2004

S&P 500 Index Average Annual Return for period – 9.96%

Missed # of Days	Miss the Best Days	Miss the Worst Days	Miss Best & Worst
10	7.19%	14.42%	11.37%
20	5.22	16.67	11.45
30	3.49	18.37	11.40
40	1.94	20.11	11.35

Source: Analysis performed by Hepburn Capital Management, LLC

In fact, if you look at the 10, 20, 30 and 40 best and worst days for total returns for the S&P 500 over the 20-year period ending December 2004, it becomes quite obvious that missing the worst can have a far more beneficial impact on returns than participating in the best months.

While there is no such thing as a perfect active investment strategy, the University of Michigan study dramatically illustrates the value of missing bear markets. With a \$689,999,300 margin for error over the 68-year period, active management doesn't have to be perfect to produce superior returns over a full market cycle of both bull and bear moves.