Passive Investing – Dead or Alive?

By Michael Kemp

Passive investing is an investment technique whereby available capital is deployed in the stock market for the long haul. No attempt is made at market timing hence it is often also referred to as "buy-and-hold". It is driven by the time-in-the-market philosophy that states "It's not about timing the market, it's about time in the market".

There has been much talk recently that passive investing has become less relevant. Whilst a drover's dog could tell you that the buy-and-hold philosophy hasn't been looking too good over the last couple of years, no investment technique should ever be judged over such a short time frame. This is particularly true of buy-and-hold since, by definition, it is a technique that derives its return over the long haul. The recent shift in sentiment has much to do with the fact that as humans first, and investors second, our conclusions as to the appropriateness of an investment technique are overly influenced by prevailing market conditions. John Maynard Keynes expressed this eloquently when he said: "the facts of the existing situation enter, in a sense disproportionately, into the formation of our long term expectations". Thus even though the present might not be indicative of the long term trend, it tends to become our guiding light at any point in time.

So is passive investing really dead? Is it still relevant? Or is it in hibernation? Let the judgement begin.

The folly of changing investment fashion

American historian, Carl Becker, once wrote: "A man without history is the victim of amnesia". Well it seems that there are plenty of victims of amnesia around at the moment. You see, we've been here before. The concept of passive investing is neither new nor is this the first time that its relevance has been challenged. William Worthington Fowler extolled the benefits of buy-and-hold 130 years ago in his classic book "Twenty Years of Inside Life in Wall Street". And he was by no means the first. Since Fowler two influential proponents of buy-and-hold have been Edgar Lawrence Smith ("Common Stocks as Long Term Investments" – 1924) and Jeremy Siegel ("Stocks for the Long Run" – 1994). However, the fact that both books were published during the course of bull markets shouldn't be ignored. Smith's credibility was crushed during the course of the grinding bear market that followed the 1929 Crash. Siegel's credibility has held up a bit better. Since his book was first released the Dow has more than doubled despite its poor performance over the last 11 years.

The central tenet of Smith's book was that since companies typically retain a proportion of earnings their capital base, future earnings and share price should, over time, grow exponentially. Unfortunately those who used Smith's book as their guiding light to investment found any success to be short lived. After the Crash of 1929 they had to wait 25 years before the Dow returned to its nominal pre Crash level yet alone grow exponentially, as Smith had advocated. And in real (inflation adjusted) terms it didn't recover to its

September 1929 level until December 1958. Countering this, a buy-and-hold investment made a few years after the 1929 Crash would have produced very favourable returns. But aren't we now talking about timing the market?

Market timing

Proponents of buy-and-hold are often quick to argue that market timing is not possible. They say that diving in and out of the market exposes an investor to the vagaries of chance and that mistiming a move can result in both significant real losses as well as opportunity costs. But this does not, nor should it, sit well with those who have used market timing to their advantage. Successful market timing is a skill that takes time and experience to develop. But for some this skill might never be achieved. For this group buy-and-hold could prove to be their best strategy. The choice between market timing and buy-and-hold also boils down to personal traits, to what suits one's character. Warren Buffett tends to buy-and-hold and, as he puts it: "it is a quirk of character appealing for a mixture of personal and financial considerations".

The dividend factor

Despite the fact that the return from stock investments comes from two sources (dividends and capital gain), investors tend to ignore or downplay the income component and focus excessively on the capital gain component. Much of this stems from a preoccupation with index watching. But the contribution of earnings to overall returns should never be understated. Interestingly if we analyse returns more closely we will find that much of what we refer to as capital gains are in fact the result of retained earnings. Edgar Lawrence Smith hit on this point in his 1924 book. Buffett's Berkshire Hathaway is a case in point. Berkshire doesn't pay a dividend. A significant factor in its capital growth has been the retention and reinvestment of retained earnings. Even without adjusting for this factor, Jeremy Siegel tells us that returns from real (inflation adjusted) capital gains have been less than half that of returns from dividends over the last two centuries. This adds some strength to the case for buy-and-hold and reminds us that when considering investment returns we shouldn't simply study charts of non-accumulating indices. So if you don't feel confident in timing the market just buy solid stocks, sit back and reinvest the dividends.

How strong is the dividend factor? Well I've already said that from 1929 to 1958 the US market gained no ground when measured on an inflation adjusted capital value basis. But what of the investor who continued to hold stock from 1929 and reinvested the dividends? When dividends are included in investment returns the time period to get square would have been halved.

Best and worst

We have already established that buying at the crest of a bull market can seriously erode the benefits of a buy-and-hold strategy. But the reality is that few investors actually invest this way. More typically investment capital is drip fed into the market over a period of time. It would be an extremely unlucky investor who actually devotes all of his capital to the market at the peak of a bull run. But is there a way whereby potential buy-and-hold investors, with a lump sum to invest, can avoid investing the lot at a peak?

Whilst market tops are notoriously difficult to pick, there are tools which might help us to identify when markets are seriously over-cooked. If we can avoid the bad ones then our buy-and-hold strategy has a better chance of working out for us. Dow theory is one method but let me introduce another.

Ben Graham and David Dodd gave us a clue back in 1934. In acknowledging that one of the greatest weaknesses of the PE ratio was its use of a single year's earnings as the denominator, Graham recommended instead the use of 10 year average earnings. This reduced the vagaries of the business cycle on the calculation. More recently Bob Shiller has applied Graham's concept of average earnings to derive a useful and objective index in the search for over-valued markets. In deriving his index Shiller divides the real S & P Composite Index by the 10 year moving average of real earnings on the Index.

Shiller has constructed a spreadsheet which shows the monthly indices going back to 1881. This spreadsheet is regularly updated by Shiller and you can find it as well as a graphical representation of the figures at www.econ.yale.edu/~shiller/data.htm. After entering the site just click on Excel file (xls) to download the data and the graph.

Interestingly Shiller's index reached its highest levels in 1901, 1929, 1966, late 1999/early 2000 and 2007, all years that should be readily recognised as historical bull market peaks. Whilst the index is not predictive, it is, at any point in time, indicative. By comparing the current level of the index with other periods it is possible to obtain a feel for the market's prevailing value. Let's see then if the use of Shiller's Index would have helped us in the past in timing entry to the market. Could we have commenced a buy-and-hold strategy at a more appropriate time or alternatively avoided entry at a poor time?

Below I have listed the 10 best and the 10 worst years over the course of the last century to have commenced a buy-and-hold strategy. This information has been taken from Smithers and Wright's book "Valuing Wall Street". They have not chosen a specific number of years to represent their buy-and-hold period. Acknowledging that buy-and-hold means different things to different people, they calculated the average return achieved over a range of different time horizons (1 to 40 years) for investments that commenced in any particular year from 1900 to 1996. To be included as a good investment year the ensuing 1 to 40 years had to, on average, rate highly when compared with those following alternative commencement years. Next to each year I have listed what the Shiller Index was in January of the same year.

Worst 10 Investment Periods	**Shiller Index**
(Commencement Year)	**(January of Associated Year)**
1972	17.26
1929	27.08

1968	21.53
1967	20.43
1971	16.46
1965	23.27
1928	18.80
1969	21.19
1973	18.71
1909	14.76

Best 10 Investment Periods (Commencement Year)	**Shiller Index (January of Associated Year)**
1932	9.31
1948	10.42
1920	5.99
1953	13.01
1949	10.25
1942	10.10
1921	5.12
1974	13.53
1931	16.71
1947	11.47

It is interesting to compare Smithers and Wright's list against Shiller's Index. We see that at the commencement of only one of the ten worst investment periods was the Shiller Index below the long term average of 16.4. That was in 1909. And at the commencement of only one of the ten best investment periods was the Index above the long term average (in 1931). There appears to be a strong correlation between a high Shiller Index and poor portfolio performance in the following years. Conversely it appears that a low Shiller Index would indicate a good time to invest.

Where now?

So where is the Index now? As at June 2, 2010 it was at 19.99, 22 percent over the long term average. On this basis, it could be argued that despite recent falls the US market is still over-priced. But the Index is certainly nowhere near the highs of 1929 (32.56) or late 1999 (44.20), after which buy-and-hold performed so poorly.

You might by now be thinking that this has been all about the United States and since your investments are in Australian stocks you want to see an Australian version of the Shiller Index. I don't have one but hands up those who weren't watching the Dow's fluctuations like a hawk during the 2008 melt down. And who thinks it was sheer coincidence that on October 20, 1987 the Australian market had its largest ever one day fall only hours after the US market had its largest ever one day fall?

You see the big corrections in our market tend to be triggered from offshore and to date from the US. To buy in after the corrections and then hold your ground should continue to be a good plan for those who don't want to or don't have the skill to continually market time.

Still want to hear about Australia?

Okay, then let's talk about Australia. Andex Charts constructs accumulation charts based on share price growth plus dividends. Research undertaken by them during the GFC looked at 585 10 year buy-and-hold investment periods commencing every month end from January 1, 1950 to August 31, 2008. The investment vehicle they considered was Australian shares. The period considered takes in 10 bear markets and includes the large 59 percent fall in 1973/74.

They found that the highest 10 year return was 28.7 percent a year (for the 10 years ended September 30, 1987). The worst return was 2.9 percent a year (for the 10 years ended September 30, 1974). Thus no 10 year period resulted in a loss.

Considered over a longer period, the Australian market has provided an average annual return of 10.5 percent over the last 40 years. Using buy-and-hold you would have ended up with a capital pool double that if you had invested in cash or bonds. How would you have gone against a market timer? If you had found a good one I suspect they would have done better. But a bad one could have done much worse.

Conclusion

So is buy-and-hold dead as a strategy? Definitely not. Is it appropriate as a strategy now? Based on the Shiller Index today might not be ideal. There have been better times: but neither is it currently a highly dangerous time. Remember that the US market was extremely overpriced in early 2000. The market has been struggling ever since. The Dow is now at the same level it was over 10 years ago. In order to justify the prices paid back then, earnings have had to and will need to continue to increase. Over the same period the Australian market has done better, presently up over 40 percent. But our economy has been performing much better than the US.

The Shiller Index will never ring a bell when it's time to enter the market but it will at least reduce the chances of you buying in just before it's about to blow up. So keep an eye on it particularly in what you suspect to be over-heated markets. A final and very important point is that ultimately it is companies that you will be investing in. Unless you are simply buying Index Funds there needs to be some process of company selection. The search for value can be undertaken at any stage of the market cycle. It's just that at market lows the search will be much easier and the subsequent returns are likely to be more fruitful. You shouldn't get hurt if you start a buy-and-hold strategy now but look for value and be prepared to hold on for the long haul. Don't change your mind midstream. Even if the market comes off from here it's 10 years out that you should be thinking about. You either adhere to the philosophy or you don't.

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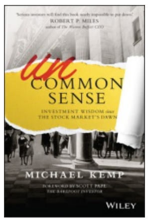

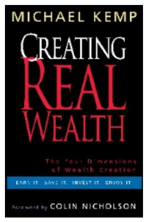

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.