



Active Management: Not a Silver Bullet, but Better than 'Buy-and-Hope'

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If you've lost faith in the stock market and your clients have lost faith in you, you're not alone. According to a recent survey by Russ Alan Prince and Associates, a market research firm, 57 percent of investors plan to fire their advisor and a jaw-dropping 86 percent said they would tell others to avoid investing with their advisor's firm. Only two percent of investors said they would recommend their advisor's firm to other investors.

Although media attention has focused on the Wall Street banks and the expense to taxpayers of bailing them out, the retail financial services industry also shares blame for the trillions investors have lost. If you use traditional asset allocation in your portfolio, your losses over the last eighteen months have been stomach-churning. Advisors using passive asset allocation have stood by and watched with their clients as the stock market and the economy have turned from bad to worse. Their only guidance is a Wall Street mantra: "Stay the course." They charged fees for this advice.

Passive asset allocation works well during bull markets, especially the last one — the greatest bull market in history — which lasted from 1982 until 1999. But buy-and-hold has a fatal flaw.

Modern Portfolio Theory and its supporting corollaries, Efficient Market Hypothesis and Random Walk Theory, are built on incorrect assumptions. As the famous investor George Soros recently said, "The idea that markets tend toward equilibrium, that deviations in return are random, and that markets are self-correcting is true most of the time, but not all of the time." When a 100-year storm hits, buy-and-hold theories get washed away in the flood — along with the portfolios tied to them.

If traditional buy-and-hold strategies are flawed, then what should be Plan B? The alternative is some form of active asset management.



But we've been told active management doesn't work and that it's impossible to time the market. Maybe that assumption is wrong, too. We've learned a lot since 1952, when Harry Markowitz first introduced Modern Portfolio Theory. It's about time we set aside the old theory and took a fresh look. Let's take a quick review of some of the market realities that make active investing necessary, an example of an active strategy, and an explanation of why it works.

Risk and uncertainty

Risk denotes the precise probability of specific eventualities. When you flip a coin, you know the probability of the possible outcomes. Most investors think risk is the only consideration when it comes to investing. They think in terms of heads and tails: I'm either going to make money or lose money. But investing isn't like flipping a coin; the outcomes aren't black and white. Investing is rife with uncertainty.

Risk has limits, but uncertainty has no boundaries. Think about the 9/11 attacks, this year's credit crisis, natural disasters, war, political instability; the possibilities are endless.

The concept of uncertainty is inherently complex because the potential events and outcomes are infinite. It's not only risk, but more profoundly, uncertainty, that makes passive investing so dangerous. Where there is uncertainty, anything can happen.

The former U.S. Secretary of Defense, Donald Rumsfeld said it best: "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things we know we do not know. But, there are also unknown unknowns. These are things we do not know we do not know."

Guarding against uncertainty

If you recognize the existence and potential effects of unknown unknowns you understand the concept of uncertainty. It then becomes logical for you to employ an investing process that will limit your exposure to the stock market, where history has shown uncertainty to be the omnipresent catalyst of both triumph and ruin.

To protect yourself from bear markets, you need a defensive strategy — a process that will tell you when there is too much risk and uncertainty. You want to know when to own stocks and when not to. You need a trigger for your buy and sell decisions.



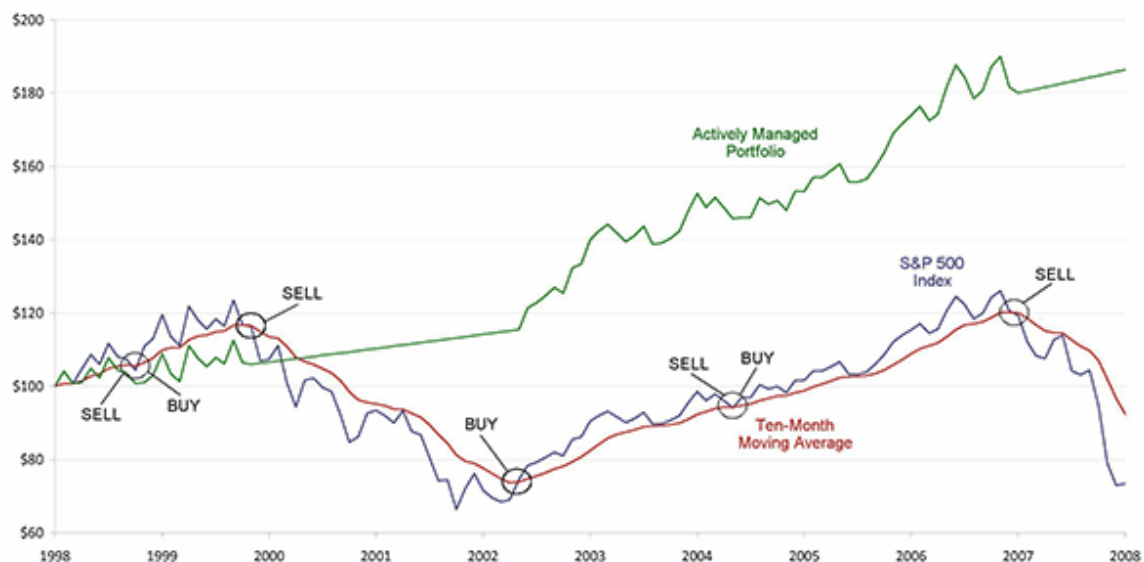
Establishing your buy/sell decision-making process isn't hard. The challenge is having the discipline to follow it. The obvious analogy here is a fitness routine. Creating the exercise program is easy, but success hinges on execution.

Once you find an investment process that puts the odds in your favor, stick with it. It's best to remove all emotion from your process and focus on execution rather than short-term results. Understand the roles of time, probability and market cycles. Like passive investors, active investors must be patient and dedicated to their long-term plan.

Choosing an indicator

Your indicator — the analytical tool that tells you when to buy or sell — is the backbone of your decision-making process. There are a number of good indicators that have outperformed the stock market on a historical basis. One I like for its simplicity and effectiveness is the *ten-month moving average*.

The ten-month moving average can be displayed as a line on a chart showing the history of a stock index, such as the Standard and Poor's 500 Index. If the line that represents the S&P 500 is above the line that represents the ten-month moving average, you have a "buy signal." If the line that represents the S&P 500 is below the line that represents the ten-month moving average, you have a "sell signal."



The chart above covers the last ten years and shows three lines: the performance of the S&P 500 (blue line), its corresponding ten-month moving average (red line), and a hypothetical investment portfolio (green line) that used



the ten-month moving average to generate buy and sell decisions as described above. Over this ten year period, the annualized return on the S&P 500 was -3.0%, versus +7.0% if using these buy and sell signals. What's more, the active strategy had a lower standard deviation. It was only exposed to stock market volatility 63% of the time. So the active strategy delivered higher return *and* carried less risk!

Asset Preservation

The ten-month moving average system has worked well over the last ten years, and it has also outperformed the market over the last thirty and fifty-year periods. Why? Two words: *asset preservation*.

The most successful investors know that preserving capital in poor markets is just as important as growing capital in strong markets. The famous investor Warren Buffett often reminds us of his two golden rules of investing.

Rule #1: Don't lose money.

Rule #2: Don't forget rule #1.

It's striking how Buffett's rules stand in stark contrast to traditional investment advice, which tells us to buy and hold, no matter what. Clearly, Buffett believes in limiting losses. He understands the value in asset preservation. He is not a passive investor.

The benefits of asset preservation are profound. Preserving assets during a bear market, empowers you to take less risk down the road — you won't be pressed to make up for the big losses you're likely to suffer in a buy-and-hold strategy.

Some will criticize this approach as being too simple to be effective. Moving averages lag the market and sometimes provide false signals. While we don't use this particular approach in our active management, we show it here to demonstrate that even a simple indicator can prevent a catastrophic loss. There are certainly more sophisticated indicators and tools that can improve effectiveness.

Even the simplest of indicators could have helped you outperform buy-and-hold over the last ten years, last 30 years and last 50 years. This isn't rocket science or black magic, but it does require an industrial amount of discipline. Active management is no silver bullet, but there are some basic technical indicators that can help you grow and protect your clients' assets.

If you're tired of 'buy-and-hope,' consider using some simple technical analysis to limit risk and offer the opportunity for better return. Understand that the payoff



will come when bear market losses are avoided. The benefit of avoiding the worst of bear markets is far more valuable than participating in every gain in bull markets.

If you're not convinced that an active approach to investing is safer and potentially more profitable than a passive one, let me leave you with a final question to ponder. If you come up with an answer, please let me know. I've asked thousands of people this same question, and so far no one has been able to give me an answer:

Can you think of any goal-oriented activity where taking a passive approach improves your chances of success?

Raising children? Advancing a career? Prevailing on the athletic field? In life, taking a passive approach to what's important to you is usually harmful. That's why you take a proactive approach to the things you care about. You've made thousands of important decisions in raising your children. You've worked hard to make advancements and achievements in your career. And on the athletic field you've been competitive, aggressive and relentless. In pursuing your goals, you know that a proactive approach is best because it is the best way to manage risks and achieve the outcomes you want. Investing should be no different.

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