



Letter to the Editor: Re Clark M. Blackman's letter to Bob Veres

April 7, 2009

The following is in response to Clark Blackman's article last week, [Glass Houses? An Open Letter to Bob Veres](#).

I must thank Mr. Blackman for cogently laying out the argument for buying and holding versus attempting to actively manage client portfolios, and for recognizing Bob Veres as someone who helps the industry discuss matters that give rise to passionate debates about what is best for clients. In this case, I am responding to several points raised by Mr. Blackman in his letter.

Mr. Blackman asserts that "the more sophisticated group (*of advisors*) consists of those who stayed calm and rational in the face of a stampeding herd spooked by fears that things could only get worse." As someone who spent the first sixteen years of my career as a buy and hold, strategic asset allocator, I would respond that there is nothing sophisticated about buying and holding asset classes in any market environment. Anyone can do it, and it doesn't take much time, energy, research, or expertise. It does take an abiding belief in one of two things: either the investor believes in the theory behind buying and holding, or the investor doesn't believe in the theory, but believes there is no better alternative.

The theory of buying and holding rests on many misguided assumptions, beginning with the efficient market hypothesis. Efficient markets theory rests on the principles that the economy is not subject to structural change and that investors have perfect economic foresight. Both of these central ideas were disproved with the bursting of the tech bubble, the real estate bubble, and now the credit bubble, not to mention academic research led by H. Woody Brock, Mordecai Kurz, Robert Shiller, and many others. To deny that endogenous risk exists, or to deny that economic regimes can change, strikes me as an extraordinary argument to make in such turbulent times.

Mr. Blackman does an excellent job of addressing the second issue with active management, when he says that it can't be done. If I tell you I can "day trade" by buying the market at its low price and selling at its high price, and can earn 1,000% per year on my money, the correct response would be that the comment doesn't deserve a serious reply because the assertion is impossible. It can't be done, so why discuss it.

Mr. Blackman's attack on active management attempts to put the entire notion of professional analysis of markets and value-based investing in the same light. He says,



“Market timing is a gamble, no matter how you cut it. And when one gambles and is correct, that doesn’t make the gambler a genius.” His is the classic rhetoric of advisors who don’t realize that buying and holding is also a gamble, albeit one that is less informed. Buying and holding assumes that the risk premiums of the past have some meaning, *regardless of the current prices on those assets*. This notion is not only misinformed, it is a high risk proposition when markets are expensive. The data is so overwhelming that valuation has an important and significant impact on future returns that I dare anyone to refute it.

The question then becomes can anyone actually identify good value in markets. To beat a buy and hold approach to investing, we need to either identify relative value or absolute value. Relative value allows us outperform a buy and hold benchmark, and absolute value allows us to potentially outperform cash. Different advisors will find value in either approach. To make a big bet against a fixed benchmark in an actively managed portfolio requires that an investor have high conviction in his forecast. There is no requirement that active managers make big bets and there is no requirement that they always have high conviction in their forecasts. However, it is a requirement that they make a forecast. It is only in the narrow world of investment advisors, trained in the ways of Modern Portfolio Theory and the Capital Asset Pricing Model, that the study of markets in order to make a forecast is deemed unnecessary and even unprofessional. In every other corner of the investment universe, smart and professional investors are consumed with the desire to identify good value, however they define it. If the search for good value results in a transaction in their portfolio, Mr. Blackman will be there to label them as a market timer and cast them out with the other untouchables who “gamble” with client money. Ironically, in denying that valuation matters, it is Mr. Blackman who is the gambler. He is so certain that value can’t be ascertained that he is willing to gamble on buying and holding markets regardless of their price. I don’t how that makes anyone a “sophisticated” investor.

Determining value is a difficult proposition. I think of it as a craft to be learned. I often wonder how one becomes an investment expert and what magic must occur before you are allowed by our profession to actually make a forecast of market performance other than the one we are taught to make, which is that markets will deliver the average performance of the past. As an industry we solve this problem by paradoxically hiring active money managers for each asset class in our portfolio and expecting them to find value. Clearly they have some genetic predisposition for making forecasts that financial planners are presumed not to have.

Advisors will find that making an accurate forward looking forecast will require a different level of expertise about the macro-economy and market cycles. It will require a better understanding of market internals, or the endogenous risk that Kurz says is responsible for 60% of the movement of market prices. Finally, it will take a better understanding of the traditional measures of value, like P/E multiples, earnings yields, etc. As Veres says, advisors will find different solutions to the problem of obtaining a



higher level of investment expertise. At the very least, making a market forecast is something to be celebrated, not vilified.

I am not surprised that many in our industry are uncomfortable with the prospect of making these forecasts. It is better to deny that you are making them at all, especially since we've all been trained that buying and holding is the right thing to do. Unfortunately, in secular bear markets buying and holding requires advisors to make a choice. They can buy and hold with the virtual certainty of underperforming expected historical average returns, desperately hoping that better days are just around the corner for their clients. Or they can choose to actively manage portfolios with a good probability of outperforming the vast majority of advisors who seem to think that valuation either doesn't matter, or good values can't exist.

I agree with Mr. Blackman that no one can know with certainty whether the latest 22% run in the market represents a "dead cat bounce." That is the nature of risk. Mr. Blackman chooses to rely on diversification and the belief that the average historical performance of asset classes has meaning in order to manage risk and make a forecast. I would much prefer to study market values, real estate prices, consumer spending data, the government's Public-Private Investment Program (PPIP), and other data to make my forecast. I suppose that advisors will have to determine which represents the more "sophisticated" approach to portfolio construction.

I want to thank Mr. Blackman for his well written and enlightening letter.

Kenneth R. Solow, CFP®, is a Founding Principal and Chief Investment Officer with Pinnacle Advisory Group, Inc., a Registered Investment Advisor located in Columbia, Md. He is the author of the soon to be published book, Buy and Hold is Dead (AGAIN).

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>