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Investors are Told to Buy and Hold, but Do They?

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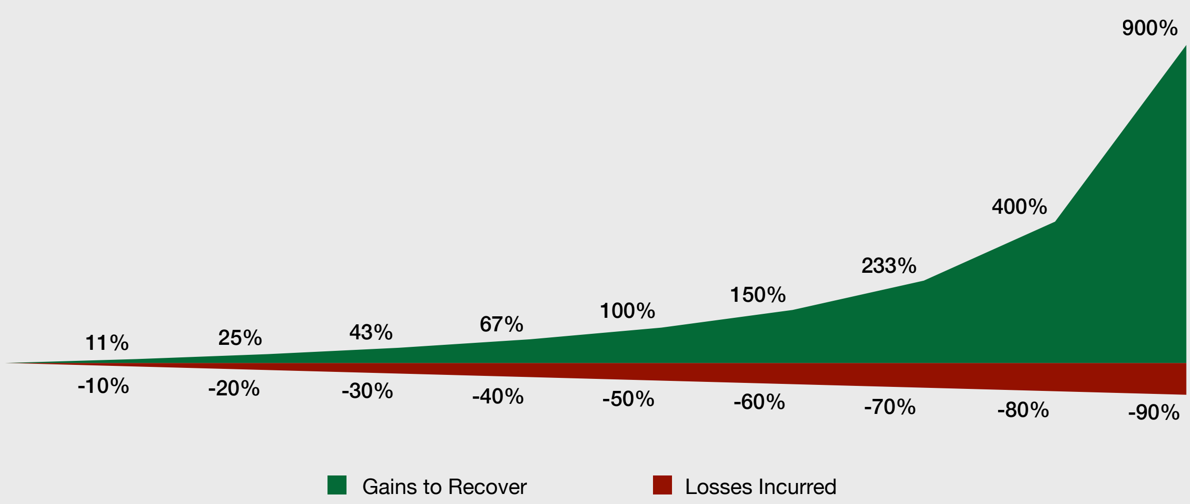
Investors need to be successful if they ever want to achieve their retirement goals. Yet studies show that many investors are failing. Why?

Over the past 40 years, the financial services industry and media have conditioned investors to believe in the idea of buy and hold and Modern Portfolio Theory, which is the concept of optimizing risk and return through diversification to build efficient portfolios. These folks suggest that investor decision making is compromised by fear and greed which can cause them to try to time the markets. However, we feel their decisions have nothing to do with fear and greed. Rather, when investors are faced with large losses, they have the choice to fight or flee. Investors make the logical decision to flee in an effort to protect their hard earned money.

During the latest bull market, low-cost passive indexing has become all the rage. However, we know many investors still struggle to remain invested through market volatility and will likely do what they have done repeatedly in the past—buy high and sell low. This is the insanity that will continue to compromise their financial futures. Recent studies show that the average investor fails to capture even a fraction of market returns by trying to use traditional approaches. So how can investors be more successful?

The financial services industry and mainstream media have long told market participants to invest passively. However, investors who follow the "buy and hold" mantra also expose their capital to the markets' biggest losing days, which can have a devastating effect on return.



Source: WBI.

Investors often focus on annual returns to make investment decisions without understanding that the sequence of returns—gains and losses—can significantly impact their capital and overall investment success. Annual returns can trick investors into thinking that published returns are consistently achieved, when they are not.

To unravel the illusion, let's take a look at this example. Let's say you have $1,000,000 to invest and you have two investment managers to choose from: Manager A achieved an average annual rate of return of 33% and Manager B produced a 5% average annual rate of return. Many people would naturally gravitate toward the manager that produced a 33% return.

Let's take a closer look at how Manager A performed over three years. In year one, the $1,000,000 increases by 99% to $1,990,000. In year two, the account declines by 99% to $19,900. In year three, the account increases again by 99% to $39,600. While the manager achieved an average return of 33%, the account declined by 96% in value.

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Now look at Manager B who produced an average rate of return of 5% over three years. Which would you choose? We believe high returns are often an illusion. Investors should focus on the amount of capital managers can maintain in both good and bad markets.

Manager A — 33% Average Return

	Starting Value	Rate of Return	Ending Value
Year 1	$1,000,000	**99%**	$1,990,000
Year 2	$1,990,000	**-99%**	$19,900
Year 3	$19,900	**99%**	**$36,600**

Manager B — 5% Average Return

	Starting Value	Rate of Return	Ending Value
Year 1	$1,000,000	**15%**	$1,150,000
Year 2	$1,150,000	**-15%**	$977,500
Year 3	$977,500	**15%**	**$1,124,125**

Performance shown is for illustrative purposes only and not indicative of any investment.

CAPITAL MATTERS

While we admit the above scenario is a bit extreme, there have been instances over the last two decades where investors have experienced very large drawdowns. These drawdown events highlight the fact that markets can fall twice as fast as they rise. Let's take a look at how large-cap equities fared during the Dot-Com bubble, the Financial Crisis, and the fourth quarter of 2018 as represented by the S&P 500 Index. Table 1 highlights the burst of the Dot-Com bubble at the turn of the century. Large-cap stocks were down -47% from their respective highs in 2000 to the lows on October 9, 2002. Do you know how much return was required for investors to get back to even? If you guessed close to 80%, you would be right. Large-cap stocks took over 4 years to recover from the losses incurred as the market melted down. Investors who bought and held S&P 500 tracking investment products made no money from the year 2000 through October of 2006. Investors who bailed during market declines may have missed the recovery rally altogether.

TABLE 1 — DOT-COM CRASH
1/1/1999 - 12/31/2006

	Max Drawdown	# of Days	Peak Date	Valley Date	Recovery Date	# of Days to Recover
S&P 500	-47.41	768	9/2/2000	10/9/2002	10/23/2006	1,475

Source: Morningstar as of 3/31/2019. Total Return, Daily. Recovery Date: the recovery date from valley to peak decline during a specific record period of an investment or fund.

Unfortunately for those S&P 500 investors, it didn't take long for accounts that recovered to decline again. Let's take a look at how the large losses of the Financial Crisis impacted investors in Table 2. From market highs in 2007 through March 9, 2009, large-caps declined by -55.25%. As we've shown, once an investor's capital experiences a decline of 50%, the returns needed to get back to even are 100% or more. Investors who bought and held products tracking the large-cap S&P 500 index had to wait almost 5 years before markets rallied enough to restore their capital balances back to even in April of 2012… if they stayed invested. As it turns out, that is a big "if". Just take a look at Chart 3 which illustrates investor fund flows.

TABLE 2 — FINANCIAL CRISIS
1/1/2007 - 12/31/2012

	Max Drawdown	# of days	Peak Date	Valley Date	Recovery Date	# of Days to Recover
S&P 500	-55.25	517	10/10/2007	3/9/2009	4/2/2012	1,120

Source: Morningstar as of 3/31/2019. Total Return, Daily. Recovery Date: The recovery date from valley to peak decline during a specific record period of an investment or fund.

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In the years since 2012, markets remained relatively calm with little volatility until the fourth quarter of 2018. As shown in Table 3, from the peak in September through Christmas Eve (December 24th), large-cap investors saw capital balances decrease by -19.36%. Fortunately, the market had a miraculous recovery between Christmas and New Year's helping soften the blow by the end of the year. By April 12, 2019, large-cap portfolios recovered. Investors who have become fixated on S&P 500 Index returns also need to understand the performance of the thousands of small and mid-cap (SMID) stocks that make up the "market". Unfortunately for investment products tracking the Russell 2000 Index, as of April 30, 2019 they were still waiting for the returns needed to get back to even from a larger Q4 meltdown that handed investors a 26.89% decline.

TABLE 3 — 2018 VOLATILITY
1/1/2013-4/30/2019

	Max Drawdown	# of days	Peak Date	Valley Date	Recovery Date	# of Days to Recover
S&P 500	-19.36	95	9/21/2018	12/24/2018	4/12/2019	109

Source: Morningstar as of 4/30/2019. Total Return, Daily. Recovery Date: The recovery date from valley to peak decline during a specific record period of an investment or fund.

One challenge facing advisors guiding investors through market volatility is that many investors only look at calendar year returns, not realizing that those are only one component in the sequence of returns. As discussed, it took almost 5 years for investors who bought and held products tracking large-cap indexes to get back to even after the Financial Crisis. But by only looking at calendar year returns, a passive investor who bought and held the S&P 500 Index may have believed they were fully recovered from the Financial Crisis loss by the end of 2010 (Table 4).

With the drawdowns of the three time periods illustrated here alone, investors following the S&P 500 spent over 2,700 days or nearly 7-and-a-half years just rebuilding the capital they lost. This is why we believe a buy and hold strategy in a passive equity index product is not an ideal way for investors to save for retirement. Maybe diversification, another mantra of the financial services industry, is the key to investment success?

TABLE 4 — THE ILLUSION OF CALENDAR RETURNS

	2007	2008	2009	2010	2011	2012
S&P 500	5.49	-37.00	26.46	15.06	2.11	16.00

Source: Morningstar as of 3/31/2019. Total Return, Daily.

THE DIVERSIFIED INVESTOR EXPERIENCE

Let's examine how several commonly used market benchmarks have fared over the past 20 years in Chart 1. We see that equities, again represented by the mighty S&P 500 Index, had a compounded annual rate of return of 5.6%. If we look at the commonly recommended diversified allocation blends of equity and fixed income, illustrated by the S&P 500 and Bloomberg Barclays U.S. Aggregate Bond Index, we can see that they performed comparatively well. However, the average investor, as measured by J.P. Morgan, only had a 1.9% return. The mainstream media touts the conventional investment wisdom that people should buy and hold low-cost indexing products diversified to stocks and bonds. However, large losses outside of investors' risk tolerances have driven investors from markets. Trying to follow the industry's buy and hold mantra has led investors to buy high and sell low. This has caused investors to end up with a dismal return like 1.9% when compared to the index's 5.6%. This seems like bad advice to me.

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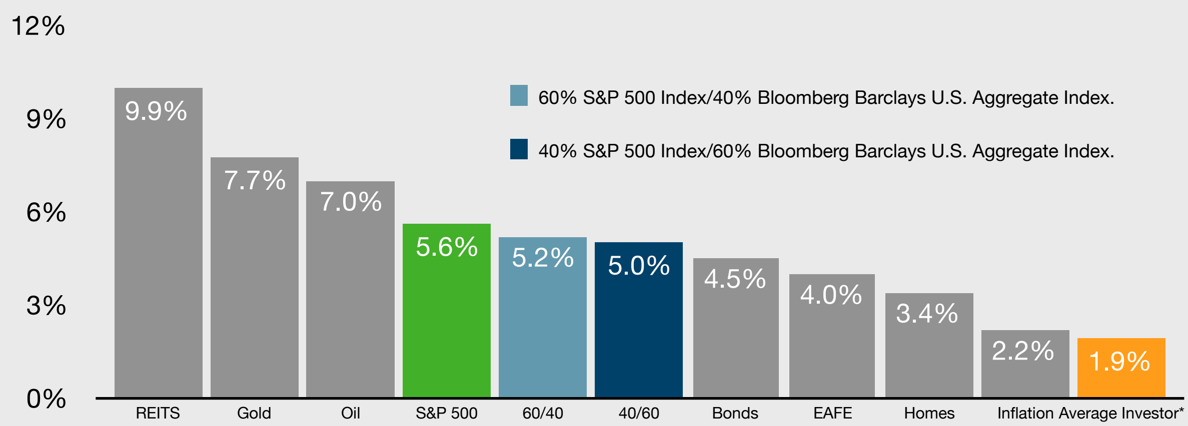
Chart 1

20-Year Annualized Returns by Asset Class (1999-2018)

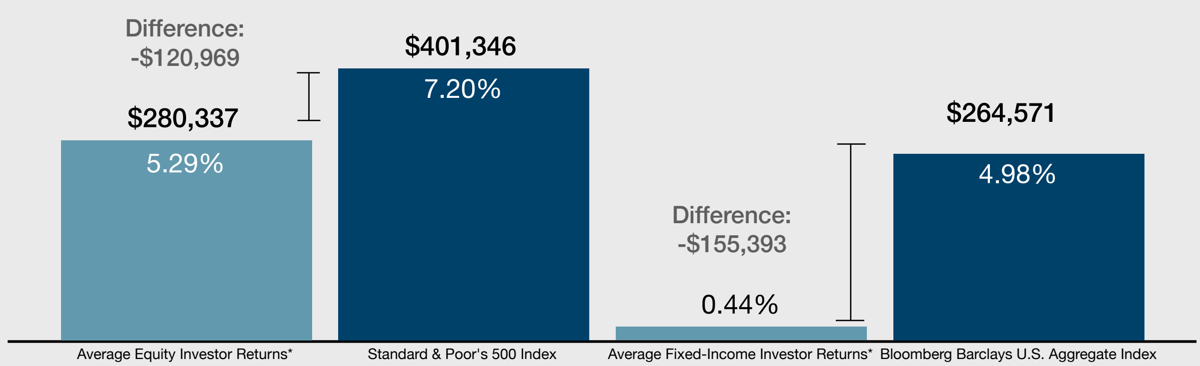


Source: J.P. Morgan Asset Management. 2Q 2019 *Guide to the Markets,* 2019.

A similar recent study analyzes the comparison from a capital viewpoint instead of annualized returns. As you can see, Chart 2 pits the average equity and fixed-income investor against their comparable indexes using a similar 20-year time period from 12/31/1997-12/31/2017. The outcome illustrated here, when compared to the J.P. Morgan study, includes an extra year of bull market return in 1998 and no loss in 2018, however, the point remains clear to us. With an initial hypothetical $100,000 investment, the average equity investor accumulated $280,377 while the S&P 500 Index yielded $401,346. We believe the difference in the investment growth is the result of investors who bailed when losses piled during bear markets and then attempted to chase returns to catch back up. Underperformance was not limited to equity investors. Bond investors shared the same experience during one of the longest bull markets for bonds in history. In the same study, the average fixed income investor grew $100,000 to $109,178, dramatically underperforming the Bloomberg Barclays U.S. Aggregate Index with an ending capital balance of $264,571.

Chart 2

Growth of a Hypothetical $100,000 Investment (12/31/97-12/31/17)



Source: American Funds. *DALBAR Investing Study,* 2018.

It doesn't matter if you are a bond investor or an equity investor, when a bear market comes to town the effect on capital can be scary. According to a study by DALBAR, the average equity fund investor lost twice as much money in 2018 as the S&P 500 Index, down 9.42% when compared to the loss of 4.38% for the S&P 500.[1] According to DALBAR's Chief Marketing Officer, Cory Clark, "Judging by the cash flows we saw, investors sensed danger in the markets and decreased their exposure, but not nearly enough to prevent serious losses." I believe they decreased their exposure at the wrong time, when the markets were down, and likely remained on the sidelines during the initial rebound.

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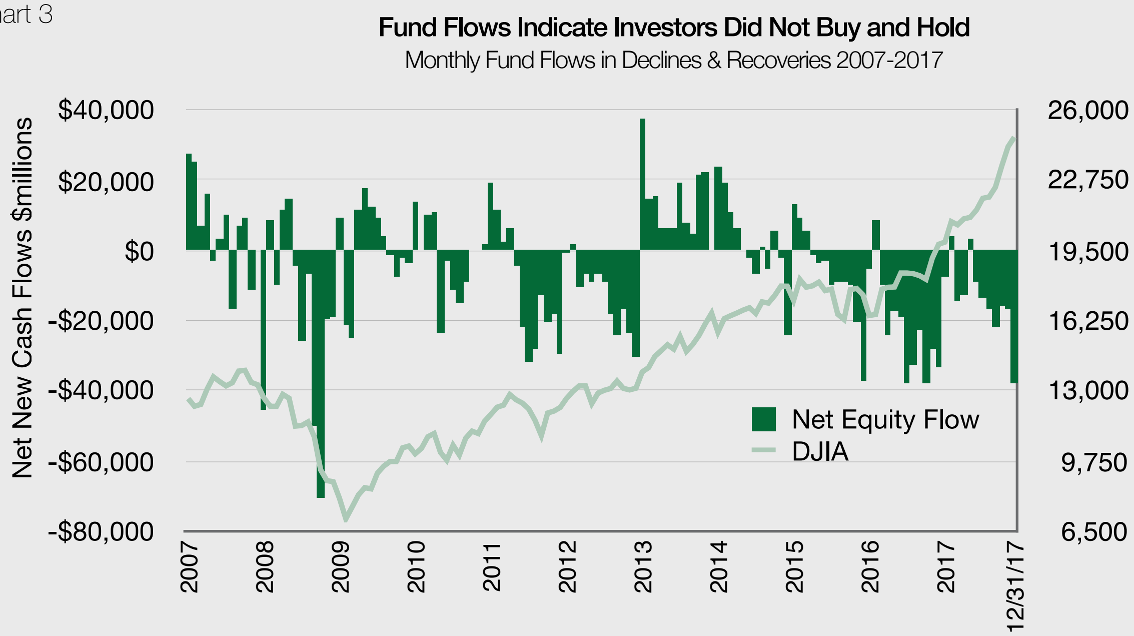
Often, we see investors bail and fail on their investment approach, buying at market highs for fear of missing out and then selling at market lows after seeing their capital deteriorate. The Investment Company Institute (ICI) fund flow data in Chart 3 corroborates this notion with sharp outflows coinciding with market declines. It's important for market participants to be diligent and find good managers to guide their investments through market storms. We believe the key is to determine an investor's loss tolerance and then build a portfolio solution that attempts to keep them comfortably invested through good and bad market cycles. If investors can limit devastating bear market losses, then they can participate more fully during bull market rallies and be better positioned for success.

Chart 3



Source: Investment Company Institute, 2018.

WHAT CAN PROVIDE BETTER LONG-TERM RESULTS?

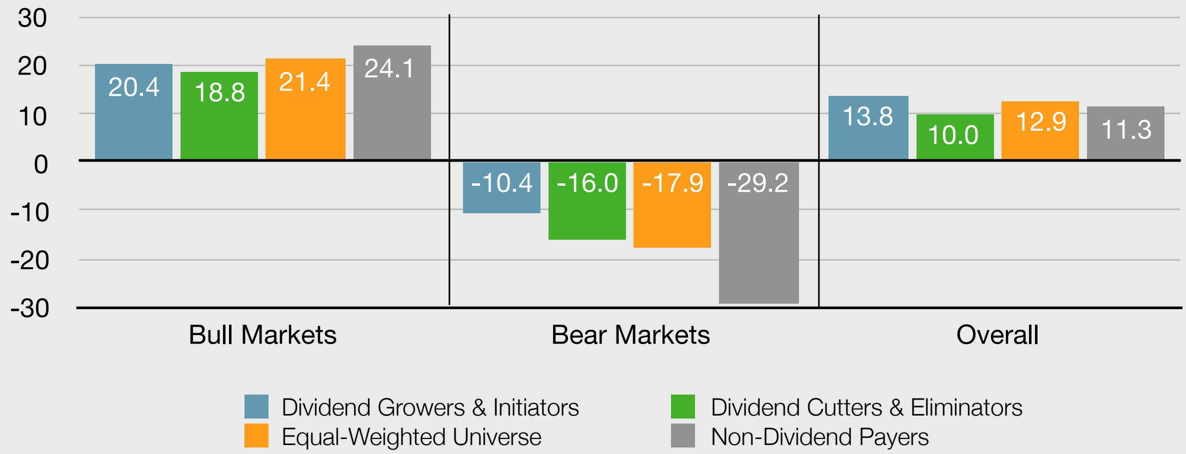
Dividends have always been a core part of WBI's investment philosophy. We found it interesting to review the historical average returns of dividend-paying stocks vs. non-dividend payers as shown in Chart 4. During bull market cycles over 40 years (12/31/1978-12/31/2017), dividend growers and initiators earned 20.4% return, while non-dividend payers captured a 24.1% return, giving them a 3.7% advantage. Growth and momentum stocks (non-dividend payers) tend to outperform in a bull market environment, but that is only half the story.

Although non-dividend paying stocks outperformed during the bull market periods, companies that initiated or grew their dividends preserved more capital during bear markets. Non-dividend paying stocks were down 29%, and growers and initiators outperformed almost 3:1, down only 10%. Therefore, stocks that don't pay dividends can see more return in a bull market, but you may pay the price during bear markets by taking more downside loss than dividend payers.

As a result, dividend growers and initiators have a 2.5% performance advantage per year over the full period in this study. Albert Einstein once stated, "compound interest is the eighth wonder of the world. He who understands it, earns it…he who doesn't…pays it." Compounding can be a powerful force. The benefits of dividend-paying stocks combined with the compounding power of capital preservation could have helped the average investor achieve returns more in line with the market.

Chart 4

Historical Average Returns of Dividend Categories (12/31/1978-12/31/2017)



Source: iShares by BlackRock. *Deep Dive Into Dividends: An iShares Guide to Dividend Investing with ETFs*, 2019.

SUMMARY

I think the evidence is fairly significant—investors are active to their own detriment. Through their difficult experiences over the last few decades, investors have found a diversified passive portfolio of stocks and bonds may not adequately protect them during a bear market. If you are a passive investor with a blend of fixed income and equities, it is important to understand the downside risk or loss of capital your portfolio may be exposed to. As a result, you should try to offset that with risk managers who have an active and disciplined process to manage risk.

In addition, we think it is smart to incorporate one of the most powerful long-term performance drivers by focusing on stocks that are growing their dividends. These stocks can boost compounding with dividend reinvestment. Additionally, dividend growers and initiators have demonstrated lower volatility and loss when market trends turn negative. They have also provided superior returns to non-dividend paying growth stocks and equally weighted indexes like the S&P 500.

Investors should work with their advisors to identify their true loss tolerance and design a plan they can stick to. Remember, investing isn't just about the return, but also how quickly your capital recovers after a bear market. When you lose half your assets, even if you bought and held, you have damaged your portfolio's ability to compound. We believe in taking a measured approach to investing, which focuses on maintaining and growing your capital in bull and bear market cycles by minimizing loss, so investors can stay the course to capture the market's potential of maximizing return.

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Mr. Schreiber is responsible for the day-to-day oversight of WBI's business operations. As Chief Investment Strategist, Mr. Schreiber's responsibilities include market and economic analysis, portfolio strategy, and product design and development.

Mr. Schreiber is integral in keeping WBI at the forefront of investing across all types of products, including separate accounts and exchange-traded funds. In 2014, Mr. Schreiber was essential to WBI's headline-making debut of 10 actively managed exchange-traded funds, followed by an industry record with $1 billion in assets on the first trading day.

Considered an expert in his field, Mr. Schreiber appears frequently in the press to provide his perspective on investments, markets, and economics.

Mr. Schreiber hosts a successful podcast series, Bull | Bear Radio. In addition, he was a Top Contributor on Financial Advisor IQ's ThinkTank in 2017.

Important Information

*Returns for average equity and fixed-income investors calculated by DALBAR. DALBAR uses data from the Investment Company Institute (ICI), Standard & Poor's, Bloomberg Barclays Indices and proprietary sources to compare mutual fund investor returns to an appropriate set of benchmarks. The study utilizes mutual fund sales, redemptions and exchanges each month as the measure of investor behavior. These behaviors reflect the "average investor." Based on this behavior, the analysis calculates the "average investor return" for various periods. These results are then compared to the returns of respective indexes. Ending values for the indexes and hypothetical equity and fixed-income investor investments are based on average annual total returns.

Sources

[1] "U.S. Investors Lose Twice as Much as the S&P 500 Last Year: DALBAR". Investment Executive. March. 25. 2019.

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