REVIEW & COMMENTARY
3RD QUARTER 2010

The sum of all fears, buy and hold is not dead

Since the near collapse of the US banking system in March of 2009, the equity markets have continued to recover, contradicting statements prevalent in the media recently that buy and hold investing is dead. This strategy to which SIM is, and has always been committed, remains vital and appropriate for investors. As US equity investments in the prior decade, as measured by broadly held US equity indices, were flat, the death of buy and hold strategy became the war cry for all the short term traders, hedge fund managers and those just generally inclined to vociferously pile on to the latest market cynicism. However, this was not the case in Canada and many other countries and even when we look closer at the US markets, buy and hold still makes sense – and money.

The common argument among non-believers of buy and hold is that in the first decade of this century US indexes were flat. Although the indexes didn't make any money, investors who were properly diversified certainly would have done better. Looking closer at the SP500, we can see that a few sectors were very influential. If one looks no further than the financial sector, it is somewhat clear why the index fared poorly. In 2000, the weighting of the financial sector was 17.3%. As these financials prospered and grew larger so did their influence in the index. As the U.S market peaked in 2006 so did the weighting of the financial sector at just under 23%. Thus, if you were an index investor at that time, almost one-fourth of your portfolio was in financials. Over the next three years, financials around the world fell dramatically. The US financial index in the last three years of that decade lost approximately 65% of its value. An index with a weighting so heavily concentrated in one sector will be subject to volatile returns as would any investors equally concentrated in one sector. Thus a buy and hold investor more sensibly weighted in the financial sector would have posted positive returns over the decade despite the recent financial disruption.

From this we should be mindful of several things. One is that index watching is dangerous particularly given most indexes throughout the world are market cap weighted, meaning that the larger a company becomes the more influential it becomes in the underlying index. Second, depending when you measure and from where you start you can get significantly different results. Is 10 years the best measure of long term investing? While it certainly is a good start, 7 year and 15 year compound rates of returns on the SP500 were 5.5% and 8.0% respectively. In Canada, measured by the TSX/SP, the same time periods provided compound returns of 11.2% and 9.3%. Third, trying to time the market is full of peril; you run the risk of missing significant moves like the one we had in the last three months- the TSX/SP was up almost 11% dividends included and the SP500 gained over 11% (in US dollars). It is difficult to predict the direction for the next three months in the equity markets but time continues to prove that equities provide superior long term returns.

… "No passion so effectually robs the mind of all its powers of acting and reasoning as fear" stated Edmund Burke. Fear of losing capital, fear of markets unraveling again, fear of sovereign default and an overall fear that the future is uncertain are prevalent. The majority of equity investors have been scared onto the investment sidelines concentrating on fixed income. Flows from equities into fixed income number in the trillions- hard to imagine when the equity markets provide returns as they have. Investors remember when the market fell to its low point of 6600 on the Dow Jones rather than the appreciation of close to 65% since then. Earlier this year when sovereign default among several of the less influential Euro zone countries were prevalent most market watchers will remember the calls for the Euro to hit parity (it went down to 1.18 US) but they fail to recognize that it now trades higher than when all the concerns started this past April.

Fixed income investors must re-examine their risks. Both IBM and Microsoft, long standing companies synonymous with American capitalism, recently floated 3 year bonds issues offering 1% and 0.87% respectively. Both issues were oversubscribed. While it is hard to argue that three year bonds are risky it does suggest something about the fear investors presently embrace. This reminds us of the period in 2009 when many of the Canadian Banks were issuing preferred shares with coupons less than the yield on the common shares. One must remember that preferred are only marginally safer than common equity if a company gets into trouble. Again, in this case, the yield on the common shares of both IBM and Microsoft are several times higher than the interest they are paying. In fact some of the proceeds of the bond issues are being used to buy back their own company stock. Few people know their business better than those who run it and if they are borrowing money and buying their own stock investors should take note. IBM common share price has actually returned over 4% since the bond issue was announced and that isn't including the dividend!

We are not saying that investors should be over weighted in equities but to avoid them is folly. Some fear that the markets are overpriced. They certainly may be in the short run; the past quarter was quite strong. But with interest rates low, the possibility that central banks are ready to employ further quantative easing if required equities do provide an attractive alternative. In addition to all the money investors have parked on the sidelines, many companies have trillions and some are ready to spend. Potash Corp is a target of such ambition. Interest rates are so low it will be hard to support any kind of systemic price earnings multiple compression any time soon. As we have discussed in previous notes, many of the large companies listed on the exchanges are doing quite well even though the economy is still struggling. These well financed, operationally efficient companies will do considerably better if global economies continue to rebound. And if equities have done this well with all that money on the sidelines parked in fixed income, just imagine what might happen when that financial tide starts to reverse. It may make the last quarter look mild in comparison.

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