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Mapping a game plan for the novice investor

The Straits Times Index plunged from a lofty height of 3900 points to the low of 1400 points in March this year before staging a spectacular rebound of close to 70%. So, whether you are a newbie investor trying to map out your investment game plan or a veteran investor re-examining your investment strategies, the markets may be giving you very conflicting signals indeed.

Recently, I have met many bewildered investors who are questioning whether the “buy and hold” strategy that has been preached by many investment experts does really work – or would they be better off just focusing on short term trading strategy and taking quick profits whenever possible?

Not all traders can be winners

Before examining the validity of the “buy and hold” mantra, let’s take a closer look at its Siamese opposite, the “buy and trade” or simply, the “trading” strategy.

Over the past months, I find a growing number of investors believing that the best ways to “play” this volatile market is to use a short term trading strategy in order to participate on the upside with minimum downside risk. The strategy usually involves buying into some selected stocks and to exit the positions once they make maybe a 5-10% profit. This certainly sounds like an intuitively brilliant strategy. However, upon closer examination, an immediate concern that comes to mind is that most retail traders may not have the same tools at their disposal compared to their stronger institutional counterparts, often the very people they are betting against.

The fact is that institutions account for 90 per cent of the daily global stock market volume and half of all these transactions are carried out by the world's 50 largest investment firms, which have vast resources and deep pockets to ensure that they achieve the targets they have set for themselves. These mutual funds, hedge funds, and program traders have access to, and do indeed deploy, every possible tool available to give themselves an edge for every trade.

Nevertheless, many novices, mostly executives and professionals, are planning to try their hand at trading, encouraged by the strong equity markets of late and the many so-called experts who sell them sophisticated computer programs that are supposedly able to out-time the market and the pros.

Unfortunately, novices who excel at trading paper money often fumble when handling real money. In contrast, the best traders and managers have risk controls and sell disciplines, and they stick to them, so they never hang on to a losing stock or commodity position. Therefore if you ever get started on trading, do make sure that you first convince yourself why you would be the one out of a hundred who will eventually make it to the winner’s roll.

“Buy and hold” doesn’t always work

So then, does the “buy and hold” strategy really work in the long run? Let’s take a minute to examine some interesting facts on the US stock market. Since 1871, real stock prices have grown by only about 2.5 per cent a year after taking inflation into account. Much of this growth is however due to an increase in valuation or an expansion of the price-earnings (P/E) ratio. In other words, investors have simply been paying more for a dollar’s worth of earnings during the period.

But what about those studies that show stocks growing by about 9 per cent a year? Well, this can partly be explained by the fact that these calculations include dividends, which have averaged about 4 to 5 per cent. Also, contrary to what many think, indices do not accurately reflect the actual results turned in by their component companies.

For example, if you compare the current Standard & Poor’s (S&P) 500 Index with the 1950 version, or the current STI with the 1980 version, you will find that the component stocks look very different. This is largely due to “survivor bias”, a phenomenon in which poor performers are dropped from an index while strong performers are retained or added.

Indices are actually “buy and trade” instruments

The truth is that indices are actually “buy and trade” instruments, rather than “buy and hold” instruments. For instance, General Electric was included in the Dow in 1896, dropped in 1898, included again in 1899, dropped in 1901, and then included yet again in 1907.

In fact, investors today will not recognise any of the companies in the 1900 version of the Dow except General Electric. That’s because many of the component stocks that were dropped then have since gone bust; and that’s not all. Some 60 per cent of the S&P 500’s component stocks have changed in the course of the past 30-odd years. What’s more, most of the large cap companies in the current S&P did not even exist 40 years ago.

To further illustrate this point, let us look at the inclusion and omission of IBM and Coke over the years. Both were added to the Dow Jones Industrial Average in 1932. Coke was substituted by National Steel three years later, while IBM was replaced by United Aircraft in 1939. IBM was included in the Dow again only in 1979, while Coke was reinstated only in 1987.

Clearly, buying and holding the component stocks of the Dow and holding them for long periods would not have produced the same returns as doing so for the managed index. In fact, the returns may have been quite dismal. That is why investing in index funds, which alter their holdings according to the changes in the index, may make more sense for many investors.

However, due to the dearth of index fund options in Singapore, ETFs (Exchange Traded Funds) have became the popular alternative for investors looking for low-cost managed indices investment vehicles. The relentless pace over the past few years which ETFs were launched attest to the strong demand for them.

Verdict

The moral of the story is, if given a simplistic option of leaving a novice investor to swim with the sharks in the trading game or advising him to embark on a more prudent “buy and hold” game plan, my choice is still unequivocally the latter.