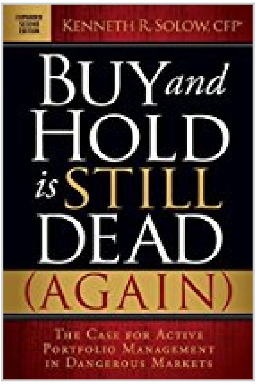

Buy and Hold is Still Dead (Again): The Case for Active Portfolio Management in Dangerous Markets

By Kenneth R. Solow

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Solow advocates a different approach called Tactical Asset Allocation, and he offers the reader an unparalleled look into the methods, techniques, and safeguards of active portfolio management. Now in its second edition with updated material and a new chapter, "Buy and Hold is Dead (Again)" remains an invaluable investment guide for our financially challenging times.

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Buy and Hold is Still Dead (Again): The Case for Active Portfolio Management in Dangerous Markets By Kenneth R. Solow Bibliography

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Editorial Review

Review
“Solow’s one-two punch book delivers a compelling account that the old conventional wisdom of buy-and-hold should be a relic of history. The modern understanding of secular stock market cycles drives his compelling knockout that active portfolio management is essential for today’s investor.” --- Ed Easterling, Author, Unexpected Returns: Understanding Secular Stock Market Cycles

“It is perhaps embarrassing that we must turn to books like Solow’s for insights that the CFA curriculum should have been inculcating for two decades. This book not only explains these insights, but translates them into practical policies that investors can utilize to meet their true objectives.” --- H. “Woody” Brock, Ph.D. Founder and President, Strategic Economic Decisions, Inc.

“If the government fails to mop up the recent flood of liquidity, active asset allocation, as Solow advocates, will be required to adjust for a dangerous new inflation environment. This is an excellent book for financial advisors.” --- Steve Leuthold, Founder and Chief Investment Officer, The Leuthold Group

About the Author
Kenneth R. Solow is the co-founder and Investment Committee Chair at Pinnacle Advisory Group, Inc. A popular speaker and writer, he is nationally known for his views on active management, and his 2009 book, Buy and Hold is Dead (Again): The Case for Active Portfolio Management in Dangerous Markets, is considered the definitive work in the field.

Portfolio Strategy In A Post-Lehman World

When Lehman Brothers declared bankruptcy on September 15, 2008, it ushered in a new era for portfolio managers. Prior to Lehman investors were familiar with market risk--or systematic risk--as one component of total portfolio risk explained in William Sharpe’s CAPM pricing model (discussed in Chapter 3). In CAPM, portfolio risk is divided into two parts, non-systematic risk, or business risk, and systematic risk, or market risk. By diversifying within asset classes, investors are presumed to be able to eliminate business risk, so the risk that is left to be managed is market risk. As we have discussed, using the tools of mean-variance optimization and Modern Portfolio Theory, a diversified multi-asset class portfolio was considered to be the best method for managing market risk and portfolio volatility. Prior to Lehman, investors concentrated on finding asset classes where the correlation of returns was low versus one another (cross-correlation) and predictable. As long as correlations stayed low (meaning returns zigged and zagged at different times across the entire portfolio of asset classes), then investors were doing all they could to manage volatility within the limits of MPT. Since correlations, variances, and returns, are presumed to be mean reverting, the historical average of asset class returns was used to build the MPT model and the resulting portfolio was presumed to be efficient in terms of earning the highest returns for each unit of risk.

However, in the post Lehman investment climate, market risk has taken on a whole new meaning. Instead of discussing systematic risk in the context of CAPM where market risk is tame and manageable through portfolio diversification, investors now discuss systemic risk in a more ominous context for risk where risk means the possible meltdown of the entire financial system. During the October 2007 to March 2009 bear market, investors with diversified portfolios watched with horror as all risk assets suffered dramatic declines at the same time. When liquidity dried up and investors lost confidence in the banking system around the world, stocks, commodities, real estate, and a variety of alternative investment strategies like hedge funds and private equity, all suffered dramatic losses.

Having already experienced two major market declines in the past fourteen years, the first from March of 2000 to October of 2002, and the second that included the Lehman bankruptcy, individual investors are worried that another major bear market will permanently impact their lifestyle and ability to achieve their financial goals. Institutional investors worry that a continued period of less than expected returns will result in underfunded pension plans falling further into the red, and endowments having to severely curtail their annual giving. The fear is that policy makers have not understood, much less solved, the many systemic problems facing today's investors, and that subsequent bear markets may not be the 'normal' bear markets that are closely tied to historically average fluctuations in the global business cycle, but more like the frightening bear market declines we have experienced since the year 2000. As a result of Lehman, investors have become more focused on tools and techniques that will defend portfolio values in the event of another major and drastic systemic portfolio decline like the 2007-2009 bear market, a period when diversification did not properly manage risk. Prior to the Lehman bankruptcy, those overly concerned about systemic risk seemed like conspiracy theorists who were not to be taken seriously. Today, however, the opposite is true. Those who are unconcerned about systemic risk seem out of touch with the grim realities of today's financial system. A few of the more well-known systemic problems facing the world's financial markets include:

Too Much Sovereign Debt

Global growth has been supported by forty years of debt creation described by some as the "debt super-cycle." As we near the end of this super-cycle, the solvency of the countries that issued the debt will become a major risk to investors. In fact, consumers, corporations, and sovereigns have all extended their balance sheets to levels that require an extended period of deleveraging. In the past, deleveraging has resulted in numerous debt-related financial crises that consequently resulted in decades of poor economic growth and relatively low returns on risk assets.

Aggressive Central Banks

Central Banks around the world have adopted a policy of trying to enhance global growth through aggressive monetary policy. These policies have resulted in zero interest rate policies and an expansion of Central Bank balance sheets that is unprecedented in modern times. Unfortunately, the long-term implications of these policies is unknown. Past examples of profligate Central Bank monetary expansion have resulted in hyper-inflation and decades of lower than average economic growth, both of which result in the destruction of real returns.

Fiat Money

The world's economy is no longer tied to a gold standard, but instead rests on a system of fiat money that is not backed by any identifiable standard of value. A fiat monetary system is completely reliant on the trust and confidence of the economic participants in the system. Aggressive central bank policies implementing “quantitative easing” may well test the trust and confidence of investors on a global basis. There are no guidelines about how far Central Bankers can push their policy of creating money out of thin air without destroying investor confidence, but the current scale of monetary expansion is unprecedented (again) in modern times.

Derivatives

Warren Buffet has described derivatives as “financial weapons of mass destruction.” The use of derivatives as a means to create additional profit centers for the banking system, as opposed to having any purpose in properly allocating capital in our economic system, has added an unnecessary and non-quantifiable layer of financial leverage and risk to the entire system. The bailout of AIG is but one example of what occurs when derivative investing goes wrong. Had AIG gone under a number of remaining financial institutions would have met the same fate as Lehman. Estimates of the notional value of derivatives owned by both the traditional banking system, and the shadow banking system of hedge funds and other large financial institutions, vary widely. However, the number is so large as to constitute a significant systemic risk for investors contemplating how to manage their portfolios. Critics maintain that recent legislation has been watered down to the point where it will do little to minimize the risks related to derivative investing.

Too-Big-To-Fail Banks

The Lehman Bankruptcy highlighted the risk of today’s too-Big-To-Fail money center banks. With the repeal of the Glass-Steagall Act in 1999, the Chinese wall that was set up to prevent banks from speculating with consumer deposits was destroyed. The resulting series of mega-mergers and acquisitions in the investment banking industry created bank supermarkets that were so large that regulators had to bail them out at tax payer expense when speculative investments and large amounts of leverage resulted in insolvency. Consequently the entire investment banking industry has been merged out of existence or morphed into traditional banks where deposits are backed by government guarantees. What remains are money center banks that are so large that a new round of bank failures could result in another Great Depression. While recent legislation (namely the Dodd Frank Wall Street Reform and Consumer Protection Act) attempted to remedy the “Too Big to Fail” threat, many critics maintain that it falls far short of actually resolving the problem of banks that are so large that they create systemic risks for investors. In fact, today’s bank supermarkets are actually bigger than the banks were prior to Lehman.

Users Review

From reader reviews:

James Davis:

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