How Rip Van Winkle Investors Can Wake Up Happy

Doing Nothing Is Often A Solid Investment Strategy

Richard Morrison

If you're an independent investor, how often do you trade? Once a week? Once a month? Once a year?

At the busiest end of the spectrum are day traders, who sometimes don't even bother to learn the names of companies they own, since it's not worth researching something you bought this morning that will be sold this afternoon. At the other end are the Rip Van Winkle investors, named after the old story about a man who falls asleep and awakens 20 years later, having missed the American Revolution. Rip Van Winkle investors buy shares in companies then put them in a drawer and forget about them. Sometimes these investors wake up with a collection of worthless stakes in companies that went bankrupt. More often, however, they have a portfolio that has outperformed the market.

The brokerage industry has little time for buy-and-hold-forever investors like Mr. Van Winkle, since active traders generate the most commissions. Similarly, the media must have content for its newspaper pages, TV airtime and web sites, and it's difficult to catch the attention of people who already own what they want and have no plans to sell. The publishers of Buy and Hold magazine, for example, would have a tough time making new recommendations after the first issue. Similarly, an investment pundit such as CNBC's Mad Money host Jim Cramer would be rendered silent (a stretch of the imagination but try) after he'd listed all the stocks a buy-and-hold investor needed on the first program.

Had Rip Van Winkle nodded off 20 years ago while holding stakes in Exchange-Traded Funds (ETFs) linked to broad stock market indexes, he would almost certainly wake up much happier than if he'd owned a portfolio of actively-managed mutual funds.

Managers of so-called growth funds may feel pressured by their superiors to trade, especially if the amount of new money coming into the fund slows, while management of passive funds is minimal. The odds are against managers who try to outperform the index. In 2018, only about 35% of actively managed U.S. stock funds outperformed their average passively managed counterparts, down from 46% in 2017, says Morningstar's semiannual Active/Passive Barometer, released earlier this year. The report covers 4,600 funds that account for about US$12.8 trillion in assets, or about 69% of the U.S. fund market.

A white paper produced by Vanguard Group Inc. this year says "once investing costs are subtracted, it is much more difficult for investors to outperform the market as a whole. To be successful at the zero-sum game, investors must be able to find the minority of active investments that can consistently beat the market, despite their higher costs."

Within actively managed funds, too much trading can end up hurting returns, a 2017 Canadian study by Claudia Champagne at the Université de Sherbrooke, Aymen Karoui at York University and Saurin Patel of the University of Western Ontario on portfolio turnover and mutual fund performance found. "Overall our results suggest that frequent churning of a portfolio is value destroying for investors and signals a manager's lack of skill," said the report.

Mr. Van Winkle's 20-year tradeless stretch would not be far from that of Berkshire Hathaway chairman Warren Buffett, who has long criticized active trading. Among his famous quotations on the subject: "The stock market is designed to transfer money from the active to the patient," "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years," and "Our favourite holding period is forever."

As a value investor, Mr. Buffett identifies a profitable business, then waits for the chance to buy a large stake in it or to acquire it completely at a reasonable price. Over the long term, Berkshire Hathaway has outperformed the S&P 500, although this year Berkshire's shares have stayed relatively flat while the S&P 500 is up nearly 20%.

Mr. Buffett is a disciple of the late Benjamin Graham, touted as the father of value investing. Mr. Graham's most famous book *The Intelligent Investor* says investors should stick to large, dividend-paying businesses with little debt whose shares trade at low multiples to earnings and book value per share, thereby providing the investor with a margin of safety. Mr. Graham said investors should try to imagine the market as an irrational business partner who alternates between extremes, offering to sell his shares on the cheap when he is pessimistic, and to buy yours at an inflated price when he is optimistic. Trading frequency would therefore be linked to market volatility.

Along with Mr. Buffett, Investopedia lists a handful of well-known fund managers who have managed to attain wealth by shrewdly applying Mr. Graham's principles: Michael Lee Chin, David Abrams, Mohnish Pabrai, Allan Mechum and Tom Gayner. Readers are welcome to try to duplicate their management skills. In my opinion, however, finding market bargains was easier when Mr. Graham wrote in the 1940s and 1950s, when financial statements were typed on paper and stored in filing cabinets. Company insiders and money managers had plenty of time to buy stakes in great companies that were trading at low ratios to their net assets before the rest of the market caught on. Today, millions of investors have instant access to financial statements and apparent Graham-type bargains usually end up being cheap for a good reason. In economic terms, today's market is much more efficient.

Rip Van Winkle's 20-year nap may have allowed him to sleep through a multi-year market downturn but holding stakes in anything but the broadest market indexes exposes you to sector-specific risks. In the sub-prime mortgage crisis of 2008-2009, for example, an investor who was asleep while holding a portfolio consisting of investment bank Lehman Brothers, savings banks IndyMac Bancorp, Washington Mutual and CIT Group, real estate investment trusts General Growth Properties and Thornburg Mortgage, together with automakers General Motors and Chrysler would, one year later, have a portfolio worth exactly zero as all went under.

A buy-and-hold strategy is also not recommended for investors who hold shares in companies whose fortunes are tied to commodity prices such as oil, natural gas, gold and silver. These must be actively traded lest they be dragged down by multi-year slumps. For example, a quick look for the worst performing ETFs over the past one, three and five years, shows natural gas, oil and energy funds causing the most pain for investors, followed by gold and silver.

Any investor can outperform most professional money managers by taking a stake in one of the giant, low-fee funds that track broad stock markets, then falling asleep, or at least refusing to trade.

In the United States, Mr. Van Winkle would have had much more success in falling asleep while holding ETFs that track the performance of the S&P 500 Index or the Dow Jones Industrial Average. Although there is a sprinkling of energy and mining companies in the S&P 500, both indexes are a proxy for the global economy, which has been growing gradually if not smoothly.

Had Rip Van Winkle invested the SPDR S&P 500 ETF Trust (SPY/NYSE) 10 years ago, then fell asleep, he would have enjoyed an average annual return of 9.5% without having done any trading beyond collecting the 1.9% in annual distributions, figures from the fund's manager State Street Global Advisors show.

Mr. Van Winkle's 10-year average annual returns would have been 13.4% had he invested in the Vanguard Total Stock Market ETF (VTI/NYSE) an "everything" fund with stakes in about 3,500 companies from around the world. His average annual returns would have been an even better 14.6% had he invested in the iShares Core S&P 500 ETF (IVV/NYSE), the iShares site says.

For some investors, the act of buying and selling stocks is a hobby like collecting stamps or coins. Investors who enjoy trading can use the "core and explore" method and trade within a small part of their overall portfolio, anywhere between 10% and 30%, while leaving the rest alone.

Any investor can outperform most professional money managers by taking a stake in one of the giant, low-fee funds that track broad stock markets, then falling asleep, or at least refusing to trade. You can improve your returns by holding some part of your portfolio in cash, then when a plunge in the stock markets hits the news, buy more to lower your average cost.

As Mr. Buffett has said, "A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices."

If you feel you may not share Mr. Buffett's stock picking ability simply buy index funds on dips.

Such broad ETFs mean there is no company-specific risk and if you buy the Canadian-dollar hedged versions of the funds, currency risk is eliminated as well, although you will pay extra for the currency hedging. If any of the broad market ETFs falls to zero, that means the world economy has collapsed and you will need what little cash you have left to stock your bomb shelter with canned food, medicine and weapons. In other words, you will have bigger problems than the performance of your investment portfolio.

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