

Investment maxims: Truths or myths?

Mixed verdict at best for five adages, and success depends a lot on investor's skill



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Despite concerns over the weakening global economy, stock markets around the world have rallied since the start of the year.

The Dow Jones Industrial Average is near record highs while the local Straits Times Index (STI) recently rose above the 3,400-point level, for the first time since January 2008.

No wonder some analysts are preparing for a possible correction and trotting out the well-used line "sell in May and go away" in recent weeks.

But is there any truth in such sayings? Or are they pure myths?

The Sunday Invest takes a look at five popular sayings in the investing world and analyses the merit, if any, to these adages.

#1 Sell in May and go away

One of the most popular sayings be-



PHOTO: REUTERS

Value investors such as Mr Warren Buffett take the buy and hold approach because to them, buying a company is about buying into its intrinsic value.

ing tossed around during this period is for investors to stop putting money into the stock market in May, cash out their holdings and start trading only in October.

This is based on observations that the stock market tends to do worse between the months of May and October, compared with other months of the year.

This advice is not completely without merit.

In 2001, the bursting of the dot.com bubble saw the STI fall by

23 per cent from May to October. In 2008, the financial crisis saw the index plunge 43 per cent over the same period.

So is it true then that May to October is a bad period for shares, and that the maxim is a useful strategy to employ?

In fact, over 13 years since 1999, the STI advanced seven times during May to end-September. When it came to declines, the STI fell six

Before investing, do your homework

times during the same period.

In a report that looked at US stock data since 1871, research firm CXO Advisory showed that if an investor used the simple buy and sell strategy, it would beat the "sell in May and go away" method by a huge margin.

In the buy and hold strategy, \$1 grew to nearly \$200,000. The sell in May and go away strategy yielded about \$1,000 over the same period.

Aberdeen Asset Management's head of Asia-Pacific strategy and asset allocation Peter Elston says: "There is a perception that the middle part of the year does worse than other periods. But clearly holding cash for a fixed amount of time is inferior to staying invested in the market."

Verdict: Mixed when it comes to historical data and fares even worse when employed as an investment strategy.

#2 Buy and hold

So is buy and hold, then, the best strategy for investing in the stock market? This strategy has often been articulated as a sure-win to get wealthy, but only over the long term.

Based on over 100 years of US stock data, if you had put in a dollar in 1871, you would get roughly \$200,000 now.

Likewise, if you had started investing \$1,000 in the local stock market back in 1987, you would get about \$4,000 today.

Professor of finance Benedict Koh from the Singapore Management University's Lee Kong Chian School of Business notes that such a strategy is a passive one because transactions are kept to a minimum.

"To reduce volatility, investors should buy and hold a diversified portfolio of stocks spread across different industries," he says.

Value investors such as Benjamin Graham and his most famous disciple Warren Buffett believe strongly in such an approach.

To them, buying a company is about buying into its intrinsic value, says Mr Elston. "The business, and its

Return and risk of asset classes in the US (1928-2009)

Asset class	Arithmetic mean return (%)	Standard deviation of returns (%)
Stocks	11.27	20.33
Long-term government bonds	5.24	7.78
Treasury bills	3.74	3.03

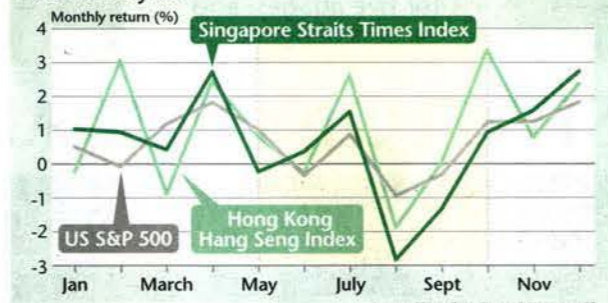
Source: ASWATH DAMODARAN, STERN SCHOOL OF BUSINESS AT NEW YORK UNIVERSITY

ST GRAPHICS

Average monthly returns from 1988 to 2012

The chart shows the average monthly return for three major stock indices – the STI, Hang Seng Index and the S&P 500.

It shows that the stock market generally performs worse between May and October compared with the rest of the year.



Source: BRIAN TAN, FINANCIAL ALLIANCE

ST GRAPHICS

ability to generate profits, is what should be valued and not the stock price."

But critics of such a passive strategy point out that Mr Buffett has billions of dollars in cash to tide him over even if the stock market is deep in the red.

OCBC's wealth management vice-president Vasu Menon says a better approach would be to adjust one's portfolio in today's much more volatile world. Taking profits when the opportunity permits also allows investors to lock in profits.

For instance, the STI was trading at around the 800 level in September 1998 and is at around 3,400 now, representing a significant 320 per cent total return in almost 15 years.

"But an investor who had ploughed his money into the STI in September 1998 could have done very well if he had locked in profits just 15 months later as the index had surged more than threefold to about 2,600 in January 2000, at the height of the technology fervour," he notes.

If the investor had waited another four years, his profits would have been much less, with the STI trading at around the 1,800-point level in 2004.

Says Mr Menon: "If the original premise for your investment changes and the fundamentals take a signifi-

cant turn for the worse, it may be better to liquidate your holdings before your investment horizon runs its full course, even if it means suffering losses."

Verdict: Mixed at best, although timing the market is also not the easiest thing to do.

#3 The markets are efficient

The advent of electronic trading has brought trading down to the nanosecond, with some high-speed traders making a living out of trading in between trades.

With information now efficiently disseminated, there is a strong view among some asset managers that there is no point trying to pick stocks.

Passive investing through vehicles such as exchange-traded funds (ETFs), which track indexes of key stock markets at a low cost, will bring about better returns, says this group of investors, led primarily by ETF managers such as Vanguard and Blackrock.

Studies do seem to back this up. Prof Koh notes that a variety of studies of mutual fund managers in the US showed that the majority of managers did not do as well as their benchmark indexes.

For instance, the first such study examined the performance of 115 US mutual funds between 1955 and

1964 and took into account differences in risks.

"The main conclusion of the study was that the average mutual fund underperformed the broader US stock market after adjusting for risks. Only a minority of mutual fund managers outperformed the market by a significant margin," he noted.

But fund managers such as Mr Elston say the theory that markets are efficient is just that – a theory.

"Rubbish. Markets are made up of humans. Humans are irrational," he says.

Indeed, the rational and efficient market cannot explain why a company can be valued at \$1 one day, and then \$2 two months from now, despite the core business remaining the same.

If indeed markets are wholly efficient, there would be very little volatility.

Instead, markets have been extremely volatile since 2008, hit by bouts of fear and exuberance – all signs of human irrationality, notes Mr Elston.

In October 2008, the STI hit a high of 3,822 points but halved its value in a year to 1,513 points in late 2009, despite the companies in the benchmark remaining the same.



The advent of electronic trading has brought trading down to the nanosecond. With information now efficiently disseminated, there is a strong view among some asset managers that there is no point trying to pick stocks. But some fund managers rubbish the theory that markets are efficient.

ST FILE PHOTO

Verdict: Mixed, depending on the skill of the investor. Some managers handily beat the benchmark while others labour behind it.

#4 No risk, no gain

For most people, investing comes with an element of risk.

Risk is potentially rewarded by gains, and the converse is true.

This is the main reason 10-year US Treasury bills, a form of debt issued by the US government, pays a measly 1.66 per cent a year. Most believe that the US government will pay its debt and that there is a low chance of default.

In turn, high-yield bonds, also sometimes known as junk bonds, of small companies can sometimes pay in excess of 10 per cent.

In a study of US asset classes between 1928 and 2009, professor of finance Aswath Damodaran at the Stern School of Business in New York showed that there was a clear correlation between riskier assets and volatility.

Volatility, measured by the standard deviation of the stock's returns, was considerably higher for stocks, which had an average return of 11.27 per cent a year.

In turn, long-term government bonds returned 5.24 per cent a year but had significantly lower volatility, notes SMU's Prof Koh.

"This saying describes the trade-off relationship between expected return and risk. It is important to differentiate between expected return and realised return as the trade-off may not hold between realised return and risk for specific trading periods."

But for value investors such as Mr Buffett, the opposite is true – pick stocks with a margin of safety so that risk is minimised.

Mr Elston says Aberdeen subscribes to this philosophy: "The problem with the definition of risk is that volatility is not a true measure of risk."

He points out that volatility can measure temporary risk, which takes into account factors such as short-term business cycles. But there is no good measure of permanent risk – whether the company's business is in structural decline or that it is going to be bankrupt, Mr Elston adds.

The best way? Do proper homework before you invest, whether it is in buying individual stocks or unit trusts.

As Mr Buffett puts it: "Risk comes from not knowing what you are doing."

Verdict: Generally true. Riskier assets generally do yield potentially higher returns. But the skill of the investor can help mitigate the risks of investing.

#5 Diversification reduces volatility

One oft-cited way of minimising volatility is to diversify one's portfolio.

For instance, a general portfolio should consist of both stocks and bonds. Those with slightly riskier appetites can also think about putting money into alternative investments such as currencies, or use hedge funds.

National University of Singapore Business School senior lecturer Ravi Jain says diversification can reduce volatility of a portfolio's returns without a corresponding reduction in expected returns.

"An investor who spreads his wealth among many investments can reduce the volatility of his portfolio, provided only that the underlying investments tend not to move up or down as a group in lockstep," says Mr Jain, adding that studies have shown that maintaining a well-diversified portfolio of 25 to 30 stocks can lead to a substantial reduction in volatility for investors' stock portfolios.

For individual investors, diversifying can include investing in a broadly diversified and low-cost equity ETF, such as the STI ETF.

But diversification can work only up to a point.

In 2008, the financial crisis brought most asset classes to their knees, with the exception of government bonds and gold, proving that even if you had diversified, you would not be completely spared.

Financial Alliance's associate director of wealth management Brian Tan notes that how one diversifies is also important.

If an individual diversifies his investments across two separate asset classes that fall within the same industry – for instance, a property stock and an investment property – he would still be hit by a property downturn.

But if one goes too far and holds too many types of stocks in different industries, he might end up replicating the overall market, says Mr Tan.

"This would mean that the stocks correlate with the market and thus when the market goes up, their whole portfolio goes up, or vice versa, giving the portfolio no guard against market volatility despite holding several different stocks."

"The only truly effective diversifier in a portfolio is cash."

Verdict: Diversification helps but only up to a limit.

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