

ING Advantage

Does Buy and Hold Still Make Sense?

It's tough to argue with a buy-and-hold investment philosophy in rising markets, but when markets turn down it seems that everyone has a better approach. Here's a closer look at the buy-and-hold strategy, its conceptual underpinnings, and its relevance for today's investors.

Every market downturn, it seems, brings a new round of pronouncements that the buy-and-hold approach to investing is dead or, worse, downright dangerous for investors. These assertions tend to come, of course, from traders who have a vested interest in buy and hold's passing. Their goal, after all, is to get control of disappointed investors' assets. Still, the stock market's performance over the past three years — from the dot-com bust, through the corporate scandal crisis, to the current war-driven doldrums — has been poor enough to raise questions: Do those pundits have a point? Is the buy-and-hold investment strategy outdated?

For long-term investors, the answer to that question remains a resounding “no.” The investment markets have experienced difficult times before, some short-lived — like the 1987 “Black Monday” crash and recovery — and others of substantial duration, including the “stagflationary” years that stretched from the mid-1970s to the early 1980s. A well-designed buy-and-hold strategy brought investors through those markets in good shape, and it may work just as well today.

However, to understand why this approach still might make sense, we need to take a closer look at what the term “buy and hold” *really* means, especially in an investment world where mutual funds, rather than individual stocks and bonds, are investors' preferred vehicles.

Beyond the Straw Man

Most critics who attack the buy-and-hold approach to investing start by setting up a straw man. While their formal definitions may differ, they generally rest on one flawed proposition: that buy and hold means “buy whatever you feel like buying, whenever you feel like buying it, and hold it forever.” The critics assume that investors buy mutual funds:

1. *Without* clear investment objectives.
2. *Without* defined timeframes for reaching their objectives.
3. *Without* regard to a fund's financial dynamics, investment emphasis, performance history, or portfolio management policies and practices.
4. *Without* regard to long-term trends in the economy and business marketplace.

In short, the critics treat buy and hold as a passive — even thoughtless — approach to investing. And thus defined, it's easy to knock down.

In reality, buy and hold is anything *but* passive. Granted, one of its goals is to seek to substantially help reduce the risks, transaction costs and tax burdens involved in frequent buying and selling of mutual funds, whether driven by emotion or technical market trends. But achieving that goal usually demands the active, disciplined and continuous assessment and management of a series of factors, including your client's investment goals and time horizon; the appropriate asset allocation to reach those goals; fund analysis and selection; and comprehensive investment portfolio structure. It is to those factors that we now turn.

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Taking a long-term perspective

Most notably, buy and hold is *not* a one-size-fits-all strategy, nor is it necessarily inherently conservative. It is a strategy best suited to long-term investors, with risks and returns determined mainly by asset allocation.

Looking first at investment timeframes, the conceptual basis of buy and hold is that usually higher *long-range returns* can be expected from stocks as compared with bonds or money market instruments. Investors with long-term objectives, such as saving for retirement or a child's college education, will generally achieve the best results from this approach.

What does *long term* mean? According to the 2003 edition of Ibbotson Associates' *Stocks, Bonds, Bills and Inflation Yearbook*, long term refers to a time period before withdrawal of at least 15 years. The reason is simple: As of 12/31/03, stocks have outperformed bonds in 59 out of 64 rolling 15-year periods since 1926. As timeframes tighten, volatility rises. For example, for rolling 10-year periods, the results are still quite compelling: Stocks outperformed bonds in 59 out of 69 periods. When we look at five-year periods, however, the results are much more variable. While stocks remain a sound investment, having posted positive returns more than 70% of the time, their returns were neither always positive, nor the best among the asset classes Ibbotson measures.¹

While the data can be complex, the interpretation is straightforward: Historically, the longer the time horizon, the better the chance that buy and hold has worked in an investor's favor. Although past performance is no guarantee of future results.

Asset Allocation

Many investors with a buy-and-hold approach don't make major "bets" on a single asset class or a few securities. Instead, they define their investment objectives and construct diversified portfolios that help provide the expected long-term returns required to meet those objectives.

Most investors, of course, have an intuitive grasp of the importance of diversifying their portfolios by time (short-term vs. long-term holdings), asset classes (U.S. and international stocks, bonds and money market instruments), securities (avoiding overly concentrated positions in any single holding), and stock market sectors (avoiding heavy exposures to a single industry or a set of closely related industries, such as technology, telecommunications or healthcare). They often don't, however, have a clear idea of why it's important to avoid putting all their investment eggs in one basket.

One reason involves avoidance of what statisticians term "investment correlation." In fact, one of the greatest risks

faced by any portfolio is that identical or closely related negative developments or economic forces could affect all of the investments it holds. For example, a portfolio may be diversified across the U.S. stock market, but if a broad economic slowdown or recession hits, most, if not all, of its holdings are likely to decline in price.

Effective asset allocations help reduce the risks associated with investment correlation by holding diverse securities in line with the fund's investment objectives. While the mathematics behind portfolio theory can seem complex and abstract, the conclusions are straightforward and practical.² By holding a range of asset types that are not strongly correlated, long-term investors can maintain potentially higher portfolio returns while keeping risk in check. This ability to help reduce the risk assumed to earn a given return is, in a nutshell, one potential advantage of asset allocation. Asset allocation cannot assure a profit or protect against loss in declining markets.

Determining the appropriate asset mix can be the most demanding aspect of the buy-and-hold strategy, since doing so requires that investors clearly define their time horizon and goals, the return required to meet them, and the risks they are willing to accept to achieve the required return. With professional guidance, these considerations can determine the appropriate allocation of assets among investment alternatives to help meet a given objective. For most investors, the dominant asset classes in a buy-and-hold portfolio will include stocks, bonds and money market instruments. Many high-net-worth investors could also benefit from investing in asset classes with special risk and return characteristics and investment requirements, including hedge funds, derivative instruments (futures and options), real estate, precious metals, art and antiques.

An investment in hedge funds involves special considerations and risks not associated with investments in traditional mutual funds. Risks of investing in hedge funds include limited liquidity, delayed tax reporting, and the fact that underlying hedge fund managers may earn an incentive allocation regardless of the funds' overall performance. In addition, hedge funds may use leverage, short sales of securities, arbitrage techniques using offsetting long and short portfolio positions, derivative securities and other speculative investment techniques that could increase the risk of investment loss.

Why is the guidance of a professional financial advisor so important? The reasons are straightforward. First, left to their own devices, inexperienced investors tend to overestimate or

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1. Source: Calculated by ING Funds using data presented in Ibbotson Analysis Software, ©2004 Ibbotson Associates, Inc. The 1926–2003 results were derived from copyrighted works of Roger G. Ibbotson and Rex Sinquefeld. For this period, stocks are represented by the S&P 500 Index, a widely used measure of U.S. stock market performance; bonds are represented by Ibbotson's Long Government Bond Index. Indices include reinvestment of income, but not transaction costs or taxes, are unmanaged and cannot be purchased directly by investors. **Past performance does not guarantee future results.**

2. *Modern Portfolio Theory* is based on research conducted by Professor Harry Markowitz of the City University of New York.

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underestimate their risk tolerance. Some believe they can put up with just about any risk in the pursuit of high long-term returns. In that case, they often find themselves overexposed during major market declines. Others can't bear the thought of even temporary declines in the value of the investments; these investors generally sacrifice significant long-term performance. In either case, the temptation can be strong to throw strategy to the wind and begin investing based on emotion — generally a losing proposition over the long haul. Since research has shown that people tend to feel the pain of a loss 2 to 2.5 times as strongly as they feel the pleasure from gain,³ it's particularly important for investors to seek professional advice throughout the investment process and on an ongoing basis.

By keeping clients focused on their total portfolios rather than individual funds or securities, you'll keep them on track toward helping them realize their financial objectives. In a diversified buy-and-hold portfolio, there will usually be asset classes that disappoint; it's the nature of diversification and noncorrelation. If clients fixate on underperforming asset classes, they may lose sight of the long-term strategy and try to "adjust" pieces of their portfolio in reaction to immediate market conditions. In short, clients need a reason to stay away from market-timing traps, and professional advice can allay fears and provide the guidance needed to do so.

Clients need professional help in order to establish an ongoing investment plan consistent with a buy-and-hold strategy. For some investors, that plan may involve dealing with "new money," such as a large bonus, proceeds from the exercise of employee stock options, or an inheritance. For others, especially those who pulled out of the investment markets during their steep decline and are now wondering how to get back in, it will likely involve setting up an informed, focused and systematic investment plan, such as dollar cost averaging. This may sound simple enough, but planning, discipline and sound financial advice are essential. Since such plans involve continuous investments regardless of price levels of fund shares, investors should consider their financial ability to continue purchases through periods of low price levels.

Funds and Fundamentals

Given their strong long-term returns, equities tend to play a dominant role in the asset allocation strategies of buy-and-hold investors. However, it is vital to note that not all equities work equally well in a buy-and-hold context. In fact, the strategy generally works best with funds that focus on (1) established, high quality companies in (2) strong, growing industries, with (3) sustainable competitive advantages, that are (4) selling at attractive prices relative to their long-term earning power and current value.

Buy and hold works effectively with equity funds that concentrate on the stocks of established growth companies — firms that are leaders in their industries today, and have the internal strengths and market dynamics to maintain their leadership in the future. Of course, the "buy" part of the buy-and-hold equation arises when these characteristics are in place. The "hold" part holds only so long as those fundamentals do.

The point isn't that the best funds for buy-and-hold portfolios will remain static. Instead, they will have a clear buying and selling *discipline*. Purchases and sales will not be made to "lock in gains" or to "take profits," both of which represent market timing under different guises. In fact, managers may hold high potential stocks even when they are out of favor if they believe the fundamentals for long-term performance are in place. As a result, we believe the best funds for buy-and-hold investors will have low turnover, be focused on earning solid long-range returns while seeking to avoid the transaction and tax costs that frequent trading entails.

This point holds not just for portfolio managers, but for individual investors as well. As noted earlier, "buy and hold" means allocating assets wisely at the outset, and typically selling under two conditions: when an investor's goals have changed, or to rebalance a portfolio in light of internally driven changes in asset allocation.

To understand the second point, suppose that after reviewing a client's particular situation, you determined that a portfolio containing 70% stocks and 30% bonds was the right allocation to help your client's meet their investment goals. As a result of changes in the market, however, that allocation has shifted to 60% stocks and 40% bonds. A buy and hold strategy does not mean ignoring that structural change and accepting the different (and lower) expected return it entails; instead, it allows for selling some bonds and buying more stocks to return to the target allocation.

This action, of course, is counterintuitive to most investors. For many, selling an asset class that is doing well and buying one that appears to be underperforming simply "feels wrong." That's why it's important to understand the conceptual basis of buy and hold. The strategy is grounded not on short-term fluctuations in the performance of various asset classes, but on their long-term and demonstrable expected returns.

Potential Advantages of a Buy and Hold Strategy

As our discussion to this point suggests, buy and hold can be a demanding approach to investing. Since its goal is to help investors reach long-range objectives by producing solid, dependable returns over time, it may not be the best performing approach in any given period. It requires

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3. Research based on the works of academics in the area of behavioral finance, particularly Professor Richard Thaler of the University of Chicago and Professor Daniel Kahneman of Princeton University.

looking at the performance of an entire portfolio, not just its individual components. And it requires the ability to avoid emotional traps and stick with an investment plan over time, through tough times, downturns and market aberrations. For long-term investors, however, the advantages of the buy-and-hold strategy far outweigh those issues. With a buy-and-hold approach, investors:

May be more likely to achieve solid performance over time.

Because selling is kept at a minimum, clients theoretically will seldom realize long-term investment losses. Over time, the upward bias of the market and a smart asset allocation will likely overcome any short-term paper losses.

Don't need to be concerned about daily fluctuations. Instead of fretting about day-to-day market movements or tracking technical changes, clients can instead be educated on fundamentals and portfolio structure.

Don't need to forecast the future. As Nobel Prize-winning economist William Sharpe has demonstrated, active traders need to be right about when to buy and when to sell fully 75% of the time to simply equal the returns produced by a well-designed buy-and-hold strategy. Significantly, they don't need merely to be generally right. They need to call market tops and bottoms precisely in order to simply match a buy-and-hold strategy's results.

May enjoy greater tax efficiency. Since trading will be relatively infrequent, clients won't incur unnecessary tax liabilities. What's

more, if your client dies, she or he can pass any unrealized capital gains on to heirs with a stepped-up cost basis.

In short, reports of buy and hold's demise have been greatly exaggerated. It's alive, it's well and it remains a sound investment strategy for long-term investors.

Buy and hold

Buy and hold isn't an easy strategy. As with any strategy, investors are assuming a series of risks. With the proper professional advice and a prudent asset mix, those risks should be defined, coordinated and controlled by diversification — and they are likely to be rewarded over time. That's reassuring for your clients and for you, since informed clients mean less work and more lucrative relationships over time.

- Work with your clients to define their goals, investment timeframe, required return and risk tolerance. Develop and implement an asset allocation plan that addresses those points.
- Understand that the goal of buy and hold isn't to maximize return; instead, it's to achieve the return required to meet your clients' objectives over time.
- Maintain a disciplined approach to ensure that your clients' asset allocations and total portfolio structure remain aligned with their objectives and risk tolerance over time and are updated as situations change.

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