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Active Management as an Investment Strategy

When looking at the past, often we ask ourselves the questions of life.

"What if I had studied Law or Medicine instead of Business" or "What if I had taken that other job with a smaller firm?"

But rarely do we ask the difficult questions in regards to our finances.

"What if I invested in the stock market primarily when prices were rising and when they were declining I moved my investments to a money market fund?

"What if I used active management as an investment strategy?"

A strategy that would help to avoid down markets while benefiting from market gains that stocks have to offer. With computer technology and access to available market and economic data, active management is gaining much attention from individuals and investors. Professional investment managers today are applying this thought and process and using it along side of mutual funds, exchange traded funds (ETFs), stock baskets and even various types of bonds to manage client assets. Due to the results that can help to reduce the risk associated with investing in the stock market and improve opportunities for investment returns, the rate of growth of assets being managed by active investment managers is growing at a dynamic rate[1].

Market events are not random.There are relationships that exist between data points and the performance of financial markets. With the innovation of computer technology, active investment managers can begin to understand these short and long term trends.

When looking at illustration 1 above, one can start to understand that during a perceived "UP",or increasing leg of the market, investments are positioned in equities to achieve the greatest return. The investments are then moved into cash or bonds when the market appears to have leveled out, waiting for the next "UP" period to begin. Active management will not "beat the stock market" vs a buy-and-hold position each period, but over time the results may appear in a manner displayed by this hypothetical illustration.

Professional investment managers use and monitor many proprietary mathematical models that generate "buy" and "sell" signals as the market changes. In response to these signals, the investment manager moves investment assets between stock, bond and money market funds (or on a tax-deferred basis in variable annuities). The main objective of this move is to provide investors with the opportunity

(Illustration 1) Past performance does not guarantee future results. This is a hypothetical illustration only and it's performance is not indicative of any particular investment strategy.

to avoid major price declines. As long as investment managers evade these market declines and move funds during strong and weak periods, studies show that they can still outperform a buy-and-hold strategy.

To explain how this theory could be applied in actual market situations, one can look back at the stock market from 1983 through 2007. If an investor had missed the best ten days during this period, his return would have dropped from 9.8% to 7.4%. If he had missed the worst ten days, his return would have increased to 12.9%. By missing both the best and worst ten days, he would have generated a 10.6% return[2] which is an 8% better return than the buy-and-hold results. (These results are due to the dramatic impacts of bear markets. A bear market is when the S&P 500 has fallen at least 20% in value.)

There have been 14 bear markets between 1927 and 2007. When one does not take into consideration the crash of 1929 (when values declined 87%) the average loss of these remaining 13 bear markets was -34%. During these 79 years, a bear market began, on average, every five years with an average duration of 17 months. Again, when omitting the crash of 1929, it took an average of 3.6 years just to return to a break even position. Not only are investors losing money during bear markets, they are also losing time. If a portfolio is reduced by -34% (the average -34% bear market) it would need a +52% return in order to break even. In this instance, an investor would have spent two thirds of their time breaking even and only one third benefiting from the stock market. (52 of these 79 years were spent in a bear market or recovering from one to break even.)

Therefore, one can see the importance of working with a professional investment adviser that fully understands active

S&P 500 Index Bear Market Study

September 1929 through 2012

Bear Market	Duration	% Decline	Time Needed To Break Even
Sept. '29 - June '32	33 Months	86.7	25.2 years
July '33 - Mar. '35	20 Months	33.9	2.3
Mar. '37 - Mar. '38	12 Months	54.5	8.8
Nov. '38 - Apr. '42	41 Months	45.8	6.4
May '46 - Mar. '48	22 Months	28.1	4.1
Aug. '56 - Oct. '57	14 Months	21.6	2.1
Dec. '61 - June '62	6 Months	28.0	1.8
Feb. '66 - Oct. '66	8 Months	22.2	1.4
Nov. '68 - May '70	18 Months	36.1	3.3
Jan. '73 - Oct. '74	21 Months	48.2	7.6
Nov. '80 - Aug. '82	21 Months	27.1	2.1
Aug. '87 - Dec. '87	4 Months	33.5	1.9
July '90 - Oct. '90	3 Months	19.9	0.6
Sept. '00 - Mar. '03	30 Months	49.0	6.8
Nov. '07 - Mar. '12	15 Months	53.0	4.3

Source: Telephone Switch Newsletter, Summer 1992. Updated through 12/2012.

management as a strategy where the main objective is to reduce the risk of fluctuation in an investment account's value, while achieving higher returns than other investment styles with similar risks.

Many individuals and institutions have chosen not to fully invest in the stock market for fear of short-term losses and the inability to invest long-term. For these investors, active management gives them the opportunity to participate in the market with the goal of reducing risk.

While no investment strategy is perfect and not every active manager beats buy-and-hold results, there are studies that support the benefits of using an active manager. According to a study published in the Journal of Portfolio Management[3], 92% of the 25 active managers tracked by MoniResearch Newsletter outperformed the market averages in the 1987 collapse, as did 96% during drops in January 1990 and August 1992. Furthermore, another report published in the Journal of Investing shows that active investors can miss up to 20% of the bull market's rise and participate in 20% of the bear market decline and still equal the performance of a buy-and-hold investor[4]. Additionally, when risk (the variability of an investment's returns over time) is figured into the returns these studies have shown that active managers consistently outperform the market.

Ask your active money manager how to reduce risk and achieve higher risk-adjusted returns.

References

1 "Investors don't have to be big to be smart." Michael Fritz, Investment News, Oct. 1998, page 1

2 "Timing Doesn't Have To Be Perfect to Beat Buy and Hold." study of the S&P 500 over a 16-year period by the Society of Asset Allocators and Fund Timers, Inc. Initially released September 2000. Updated by Hepburn Capital Management through 2007

3 "Market Timing Works Where It Matters Most. . . in the Real World" The Journal of Portfolio Management, Summer, 1992. Study of 25 market timers' audited market signals from 1985 to 1990

4 "Why Market Timing Works" The Journal of Investing, Summer 1997.

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