Kel Butcher reminds us that 'only educated traders survive' in a bear market.

The Death of the Buy-and-Hold Investor

The rout experienced by all the world's equity markets during 2008 will be etched in the memories of share traders and investors for many, many years. Tales will be told, long after the bear market has ended, of fortunes lost and made during this implosion of share prices – stories that will be the repeated at dinner parties and in online chat rooms for years to come.

Many of the stories will be of woe and despair as distraught long-term investors struggled to comprehend and deal with the losses they suffered in their supposedly secure long-term investments. These 'buy-and-hold' investors have had their portfolios decimated by the events of the Global Financial Crisis and the severity and extent of the current bear market. Many have watched, frozen in fear and horror, unable to take decisive action as their portfolios halved in value (in some cases even more) and their retirement plans, via their superannuation funds, were almost destroyed.

Those who placed their faith in, or abdicated their financial responsibilities to, fund managers, financial advisers, or other so-called experts are even worse off, because fees and commissions are still being drained from their accounts – even though the investments have suffered massive losses.

The buy-and-hold strategy employed by many equity investors and 'traders', which appeared to be working quite nicely during the extended bull market up to the latter stages of 2007, has proved disastrous as the market has collapsed. Many people have been left holding stocks that have become virtually worthless – for example, Royal Bank of Scotland (figure 1) and Citigroup (figure 2). Others, with holdings in the likes of ABC Learning (figure 3) and Centro Properties, have seen their investments completely wiped out.

What is value?

Even blue-chip companies, like the major banks and others in the Top 20, have seen their share prices savaged by the extended bear market. Whilst there may be an argument that these prices are cheap, represent great value, or represent 'great buying at these levels', three questions need to be asked. First, how do you know they are cheap? Second, what's to stop them becoming even cheaper? Finally, who says they are cheap?

If the answer to that last question is the same person or organisation that advised you to buy them in the first place, and then either told you to hang on and wait for the prices to turn around, or, worse still, encouraged you to participate in that age-old furphy of averaging down and buying more as prices continued to fall (to reduce your average cost), then it might be about time to consider a new approach to your engagement with the share market. A cursory glance at just about any share price chart at the moment will show you just how ridiculous this strategy is. See the charts for Royal Bank of Scotland, Citigroup, and ABC Learning – stocks that were being advocated as cheap by certain experts and advisers, all the way down.

It remains to be seen whether those who are averaging down will live long enough to experience any gain from reducing their average price, given the massive price corrections experienced by nearly all stocks.

Waiting for the bounce... and still waiting

Mary had been steadily accumulating shares in Macquarie Bank (MQG) (figure 4) from early 2000. She had built a sizeable holding that was worth a considerable sum of money at the values reached in mid 2007, when the race was on to see if Macquarie could make it to $100.00 per share. Mary watched with alarm when the price dropped suddenly from just over $98.00 per share in May 2007 to around $66.00 in mid August. Her husband and financial adviser convinced her to hang onto the shares. He thought it was only a short-term correction and that Macquarie would turn around and continue its upward move through and then well beyond $100.00.

All seemed well for a while, when the share price recovered to just under $90.00 in mid October 2007. When it tumbled back down to the $65.00 area in January 2008, Mary was once again convinced by her 'adviser' to hang on, as the price would recover again just as it had before. But this time it didn't. Paralysed by fear and inertia, Mary held on and watched as the price crashed to around the $20.00 level at the time of writing. You guessed it – Mary still has her shares. Whilst in theory Mary hasn't actually 'lost' money, she has suffered a huge reduction in wealth. From an investment worth just over seven figures, this one position is now worth around $200,000.00 – a wealth reduction of over 80 per cent. Needless to say, it will be a very long time, if at all, before Mary's position in MQG reaches the dizzying heights of mid 2007.

Turbo charging the crash

Many losses have been exacerbated through the effects of over-geared and over-leveraged accounts. Many uneducated and unprepared market participants were using margin loans and highly leveraged instruments to 'gear up' their exposure to the share market. Spurred on by stories of the never-ending bull market, the commodity super cycle, and the China effect, these people were throwing money into the market on a whim in order to be part of the action, and make their fortune share trading 'in as little as one hour a day'. Unfortunately, they had no real idea of what they were doing. Nor did they have an understanding of the concepts of risk management and money management. Over exposure, lack of a trading plan, and disdain for money-management concepts wreaked havoc when the market crashed. Cash margin calls, the forced sale of shares, and in some cases other assets, to meet margin calls added more fuel to an already raging inferno.

Know when to hold 'em... know when to fold 'em

A major problem with a buy-and-hold strategy is knowing which ones to throw away (and when), and which ones to keep. In hindsight it's all crystal clear. 'If only I'd sold ABC and held XYZ,' is a common lament. Whilst holding some stocks for the really, really long term may well prove beneficial for those with exceptionally long time spans, perhaps generations, for most share market participants it is not a successful strategy because it simply doesn't work.

Actively managing your share portfolio – cutting losing trades, knowing where and when to exit profitable trades, understanding money-management and position-sizing techniques – is the only way to ensure success in any market. Share prices may recover over the long term but how long will it take? How long will it be, for example, before we see RIO back to $160.00 a share?

How much extra profit and wealth could

FIGURE 1: ROYAL BANK OF SCOTLAND

Source: www.i-deal.com.au

FIGURE 2: CITIGROUP

Source: www.i-deal.com.au

have been created by Mary if she had a pre-defined exit plan for her MQG holding? Not only would she have known when to sell and capture her accumulated profits, she would have saved herself from the mental anguish and emotional turmoil she has experienced over the past 12 months as her monetary wealth declined. She would also have had a clearly defined plan or set of rules for re-entering trades when new opportunities presented themselves.

By better using her capital through an active rather than passive approach, her returns could have been dramatically different. Deploying the use of a well researched and proven system for trading shares, such as the SPA3 system from Share Finder Investment Services (see also 'Trader's Story' in this issue) is one way to implement a clear and concise trading strategy for engaging the share market. The alternative is to develop and implement your own system – one that has been rigorously tested and that has unambiguous entry, exit and position-sizing rules. Then you will no longer rely on the views and opinions of so-called market 'experts', you will be free to develop the skills required for actively and responsibly managing your own financial wellbeing.

Hedging your bets

Portfolio hedging has allowed those who know how to use it to offset losses incurred in their long-term portfolios with profits made from their hedging activities. By short selling index CFDs and equity index futures, and by using put options and warrants, these investors have been able to weather the storm to a much greater degree. This is a much more fluid approach than simply sitting on the sidelines waiting for things to get better. It takes time, effort, a detailed trading plan, and a knowledge and understanding of the various instruments available to use for hedging for its effective and profitable use. The effort required is more than rewarded, however, if losses of profit and capital can be minimised.

Learn and move on

As YTE's tag line says, 'Only educated traders survive'. Educated share traders and investors have survived the 2008 bear market – many have even made substantial profits through an understanding of short selling techniques and the use of appropriate tools and instruments to generate profits during this gloomy and pessimistic period for those with a long-only bias, or buy-and-hold mentality. Uneducated, foolish and irresponsible market participants have been the most adversely affected. If you have been adversely affected by the bear market, now is a prime time to educate and enlighten yourself to the possibilities available through taking a more active approach. It's a great time to study the markets, read, listen, and work on your new approach to the equity markets.

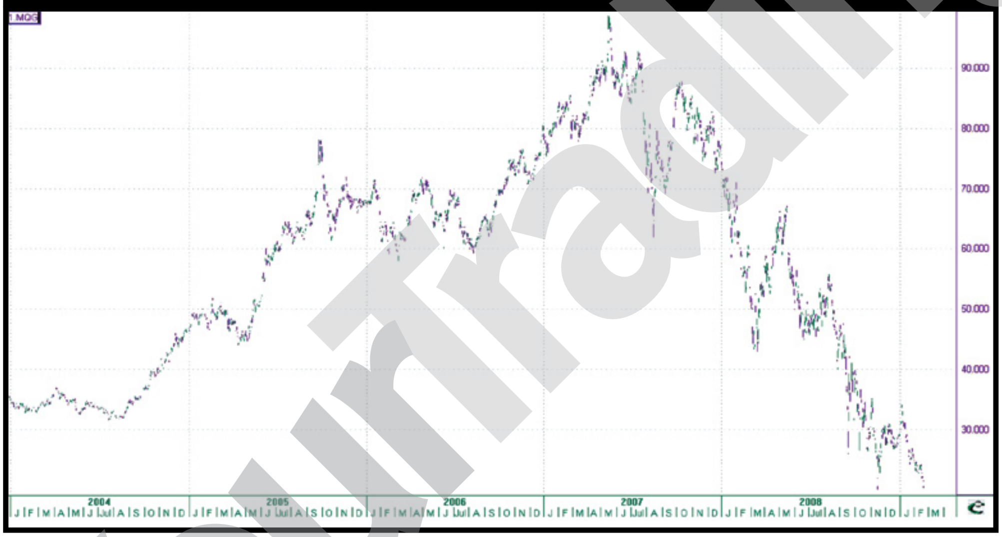
Accept and grow rich

The most important lesson to take from the 2008 crash is one of acceptance. Accept that the market is always right; accept that you are wrong; and accept that you have made mistakes. The hard bit is admitting it. Once you have done so, you can analyse the mistakes, learn from them and move forward. Take time to review your actions (or inaction,

FIGURE 3: ABC LEARNING

Source: Market Master

FIGURE 4: MACQUARIE BANK SHARE PRICE



Source: Market Master

as the case may be); take responsibility for them and commit to doing it better from now on. Document a well-researched trading plan that covers all aspects of your trading business. Develop or use a trading system that suits your trading style, available capital, and available time. Then follow it meticulously – adhere to the rules of the system, and become as mechanical as possible in implementing every aspect of your system.

Now is the time to become proactive in all your trading and investing decisions, and in the management of all your personal finances. It is not OK to adopt a 'head in the sand' approach to your finances, because as this bear market has shown, that approach won't work. Your finances aren't like a leaking tap in the kitchen. You can't claim ignorance and a lack of tools and knowledge and call the plumber in to fix it. The truth is that no one knows and understands your financial situation as well as you do, and no one else can manage your money any better than you can, if you have the right training and tools.

We all make mistakes and we all do dumb things from time to time, particularly when learning a new skill. Abdicating responsibility to others to manage our finances and investments need not be one of them. Actively learning about the markets and about trading and investing is rewarding at every level. Actively managing your investment decisions is a skill you can learn and implement so you no longer need to listen to the advice of 'experts'.

R.I.P. the buy-and-hold investor.

Trade well.

Kel Butcher *is a full time futures, equities and derivatives trader. He is the author of 'A Step-by-Step Guide to Buying and Selling Shares Online'. He also acts as a mentor and coach to other traders. He can be contacted via email at kel@tradingwisdom.com.au*