The Indexer

A Steady Hand Pays Off In Unsteady Markets

Richard A. Ferri, 03.08.10, 6:00 PM ET

Each December, four of my friends gather at a coffee shop to exchange pleasantries and talk investments. The four then decide what changes, if any, they will make to their portfolios and then and go out and execute them.

My friends discussed Modern Portfolio Theory in an intelligent fashion during their December 2007 meeting. This approach revolves around establishing a portfolio with a set ratio of stocks and bonds and then rebalancing once a year to maintain the original weightings. The idea is that this Steady Eddie investment process will maintain the integrity of the portfolio and potentially increase returns long-term.

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All four friends decided to give modern portfolio theory a try. At the beginning of 2008, they independently invested $100,000 each in two exchange-traded funds that track stock and bond indexes. This involved each putting $60,000 into the Vanguard US Total Stock Market ETF and the other $40,000 into the Vanguard Total Bond Market Index ETF. The plan was then to rebalance annually to restore this 60/40 mix.

As we now know, 2008 was destined to be a brutal year for stocks. All four of my friends lost money, and by year's end their $100,000 portfolios had shrunk to $80,567 each.

The mood at the December 2008 gathering was somber. Talk centered around government bailouts, the ballooning federal deficit and the generally depressed tone that had overtaken America. When the discussion turned to investments, there was grave concern about the future. Finally, the four friends questioned whether modern portfolio theory was the right strategy for the new investment environment.

In a sign of the lack of agreement, each of the four ultimately pursued different paths. Panicky Pete decided he couldn't take it anymore. He sold out of the Vanguard stock ETF entirely in early 2009 and put the money in his bond index fund.

Nervous Nelly was also very concerned about the stock market and sold half her stock position around the same time. She also added the proceeds to her bond ETF.

Wait-and-See Willie didn't know what to do, so he didn't do anything at all--except worry.

Disciplined Diane stuck with the original plan and rebalanced at the beginning of 2009, as if oblivious to the stock market store raging around her. Diane took about $10,000 out of her bond ETF and put it into the stock ETF, bringing her portfolio back to her original target allocation of 60% stocks and 40% bonds.

Diane had no better idea than anyone else what would happen to the stock market in the year ahead. She had, however, seen enough recessions to know that the stock market and economy eventually right themselves. That wasn't her the main reason for hanging tough, though. Diane told me she was tired of following get-in get-out advice and wanted a plan that was more stable and long-term. Modern portfolio theory was that plan.

Earlier this year, I asked my friends how their $100,000 accounts had done during 2009. Here is the summary of their results:

Disciplined Diane was far ahead of Panicky Pete and Nervous Nelly, who'd sold into the downturn (see table below). She is also ahead of Wait-and-See Willie by about 2.6 percentage points. This excess return was earned because Diane rebalanced last year while Wait-and- See Willie didn't.

	2009 Year-End Value	Total Return, 2008-2009
Panicky Pete	$83,526	-16.5%
Nervous Nelly	90,320	-9.7
Wait-and-See Willy	93,053	-6.9

Disciplined Diane	95,706	-4.3

Diane's results provide a nice example of why a buy, hold and rebalance strategy is more beneficial to long-term investors than a buy, hold and do nothing strategy--and far more beneficial than a market-timing strategy.

So what are my four friends doing in today's uncertain market?

Panicky Pete is still out of stocks and desperately waiting for the next shoe to drop so he can get back in. Nervous Nellie brought her stock holdings back up to 60% of her total this year, but at prices that averaged 30% higher then those at which she'd sold in 2009. Wait-and-See Willie is still "watching" for the best time to rebalance. Disciplined Diane again undertook her annual rebalancing in early 2010 to return to a 60% stock and 40% bond mix. This time it involved selling a slug of her stock ETF shares because they had risen sharply since her last rebalancing act a year earlier.

Last week I spoke with Diane. She doesn't spend much time thinking about markets anymore. In fact, she told me that her concern is no longer what to do about her portfolio, because she knows what to do. She knows what works. Diane's biggest worry is about what to say at this December's gathering. A buy, hold and rebalance strategy works, but it is terribly boring. A more exciting topic, perhaps, would be to discuss how much bigger her account is than those of her friends.

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