Buy & hold outperforms market timing?
12/04/2008

Yes, as the title suggests, and despite a global equity collapse this year, many still believe that buying and holding outperforms those who are trying to time the markets.
A good friend of mine is a broker at Canada's largest brokerage firm, and earlier today, we had an informal exchange, at which time he presented his argument for buying and holding.
Bob (not his real name) is a very intelligent fellow, and the first thing he did was to find evidence to support his case. Knowing that I am a market timer, he took a look at some of my charts, and he spotted what he was looking for in OIH.
This is the story:

Yes, Bob's energy portfolio is down about 70% for the year, but getting in and out of the markets could be worse he said, and he had a very strong case.

- By following our model, he spotted four buy signals since August when the market began unraveling.
- All four buy signals have failed so far, because each signal failed to establish a new trend.
- The average loss on each buy signal is about 20%, therefore, a trader is now down 80% using these buy signals to enter the market.

- Thus, his buy & hold model beats my timing model by 10%, and could be more if the downtrend continues.

Excellent argument.
He is absolutely correct.
If I were to buy the buy signals blindly without set ups, and without proper risk management, yes, I could go broke buying a bear market.
This, I did not tell him. He doesn't want to know, and I had no intention to win the argument.
I wanted to share this with you, because it helps to explain clearly to some newcomers, why I have been very cautious and conservative, and not jumping in on the buy signals.
Bear market rallies are often sharp and powerful, especially in the resource sectors of energy and gold. Each time when that happens, I always receive emails from eager traders suggesting that I have missed the train.
<u>Fact is, all buy signals will fail during a bear market, except one. The one which picks THE bottom when the bear market ends.</u>
Yes, without proper set ups and good risk management, one can go broke buying a bear market hoping to catch the beginning of a bull market. Buying and holding may be an alternative to the undisciplined traders and investors. Of course I am not recommending you to do that, only a fool will think suffering a 70% drawdown is a victory because some folks can do worse by buying a bear market.

Summary

So, how do we know when the bear market is over and the markets have bottomed?
First clue is when our daily configs have turned bullish, that is when we start taking positions aggressively.
Second clue is when we have a major buy signal, at which time some of our positions will become core positions, and we continue to accumulate positions upon set ups.
Yes, I accept the fact that the markets can be quite a lot higher than the actual bottom by the time we have a bullish config, and most certainly when a major buy signal is confirmed; but I will have most or all of my capital to invest in the new bull market, by not wasting much of my capital trying to pick bottoms during the bear market.
Meanwhile, we can consider taking trading positions long or short if we have set ups, and if risks are manageable. If in doubt, we stay out.

End of tutorial