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26 July-26 October 2019

The distinction between investment and speculation in common stocks has always been a useful one and its disappearance is a cause for concern. We have often said that Wall Street as an institution would be well advised to reinstate this distinction and to emphasise it in all its dealings with the public. Otherwise the stock exchanges may some day be blamed for heavy speculative losses, which those who suffered them had not been properly warned against.

Benjamin Graham
The Intelligent Investor (4th ed., 1973)

If you follow the behavioural and business principles that Graham advocates ... you will not get a poor result from your investments. Whether you achieve outstanding results will depend on the effort and intellect you apply to your investments, as well as on the amplitudes of stock-market folly that prevail during your investment career. The sillier [is] the market's behaviour the greater [is] the opportunity for the business-like investor. Follow Graham and you will profit from folly rather than participate in it.

Warren E. Buffett
(Preface to *The Intelligent Investor*, 4th ed., 1973)

In plain language, the manager who intends to deliver net returns 20 percent better than the market [for example, 9.6% versus the market's 8%] must earn a gross return before fees and transactions costs that is more than 40 percent better than the market. If this sounds absurd, the same equation can be solved to show that the active manager must beat the market gross by 22 percent just to come out even with the market net.

Charles Ellis
[The Loser's Game](#)
(*Financial Analysts Journal*, January-February 1975)

A Defence of “Buy and Hold”

“Since its first publication in 1949,” wrote Benjamin Graham, “revisions of *The Intelligent Investor* have appeared at intervals of approximately five years. In updating the [1973] version we shall have to deal with quite a number of new developments since the 1965 edition was written.” These included:

... a fall of about 35% in the price level of leading common stocks, ending in May 1970. This was the highest percentage decline in some 30 years. (Countless issues of lower quality had a much larger shrinkage) ... [Other developments included the] bankruptcy of our largest railroad, excessive short- and long-term debt of many formerly strongly entrenched companies, ... a disturbing problem of solvency among Wall Street houses [and] the advent of the “performance” vogue in the management of investment funds, including some bank-operated trust funds, with disquieting results.

In response to these developments, and unlike most market participants, Graham stuck to his guns:

The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate ... We have not allowed these fluctuations to affect our general attitude toward sound investment policy, which remains substantially unchanged since the first edition of this book in 1949 ...

Any investor worthy of the same must strive to develop – or emulate – Graham’s fortitude. She must also recognise that

1. In any given year, ca. 40-90% of portfolio managers fail to “perform” (i.e., match their benchmarks), and [during the past decade this percentage has been rising steadily](#); as a result, [over periods of five years or more the vast majority \(ca. 90%\) of managers “underperform”](#) (on the other hand, [Leithner & Co. is one of the small minority that has “outperformed”](#));
2. For this and other reasons, [only a small minority of today’s market participants possess track records that extend over decades](#) (Leithner & Company, by the way, is currently marking its 20th anniversary).

3. No more than a handful of investors' long-term track records are remotely comparable to [those achieved by Graham and his protégé Warren Buffett; yet those who emulate them have tended to do well.](#)

During the past generation, few people who've called themselves "investors" (most are actually speculators) have been as resolute in the face of difficulties as Graham was from the 1930s to the 1960s (and Buffett has been since the 1950s). Indeed, most have forsaken him; in particular, one principle which he commended has long been denigrated. Jim Paulsen, at the time the economist and chief financial officer of Wells Capital Management, for example, stated in *Barron's* (1 July 2002):

It dawned on me that just maybe the buy and hold mantra of today's generation of stock-market investors might at long last be destined for the ash-can of history and that a solid stock-market recovery might not be just around the corner. In fact, the rules of the game seem to be changing in ways likely to shatter the expectations of millions of investors.

Barron's shared Paulsen's view. On 1 July 2002 it published five "New Rules of Investing." The first rule, which directly repudiated Graham's adherence to principles that withstand the chilly winds of short-term misfortune, was "forget the old rules." It elaborated:

The buy and hold mantra that was drilled into investors' psyches by the bull market of the 'Eighties and 'Nineties no longer leads to nirvana. One can't buy the dips anymore and expect to be bailed out. Just look at what has happened to all the bottom fishers over the past two and a half years. Most are now losing money with little prospect of any appreciable rebound.

Its second rule was "trade the ranges:"

Over the next five to 10 years, the stock market is likely to be caught in a trading range, held in check by high valuations and anaemic earnings growth ... Once a range seems to be established, it can be traded, though the terrain could be treacherous for non-professionals.

The assessment of *The Wall Street Journal* ("The Buy and Hold Mantra Deserves Closer Examination," 9 July 2002) was even more dismissive:

Buy and hold may be the last undiscovered scam of the bubble era. As investors cottoned to the stock market in the 1990s, professionals offered basic ad-

vice. Buy and hold for the long term. Stay the course. Buy the dips. Never surrender. The defrocking of buy and hold is just the latest body blow for individual investors. Already, they've endured Enron's [fraud], Merrill Lynch's double-talking research analysts, Arthur Andersen's shredding ... and, most recently, WorldCom's explosive confession of book cookery that may top all lists. Now, the received wisdom of buying and selling is no longer the sure thing it was sold as. Individuals who have steadfastly bought and held this market right down to the sub-basement ... may finally be realizing that they're the last ones holding the bag.

The *Journal* concluded:

Like many of the shortcuts we took during the bubble era, buy and hold is actually a rather evil truncation of an intelligent investment strategy ... The buy and hold mantra seems more a feel-good nostrum than an effective strategy. Still, some individual investors continue to cling stubbornly to the buy and hold thesis. Perhaps they'll be vindicated. The question is whether they can hold on long enough to find out.¹

Many Gross Misconceptions – and a Couple of Hints of Comprehension

According to *Barron's*, buy and hold is a “mantra” that once begot but no longer delivers “nirvana.” It's apparently a mere matter of “buying the dips” and then expecting a “bailout.” *WSJ's* view was a confused mish-mash. On the one hand, buy and hold is “more a feel-good nostrum than an effective strategy;” yet at the same time, it isn't just a “scam” – it's a “rather evil truncation of an intelligent investment strategy.” Further,

buying and holding ostensibly applies differently to stock investors and fund investors. For stock investors, buying and holding makes little sense, since companies and trends change over time. A stronger case can be made for buying and holding an array of diversified mutual funds ... But even with funds, buying and holding is no elixir. You could buy and hold the life out of an Internet fund, but that won't make it come back to life.

¹ More recent disparagements of buy and hold include Lee Brodie, [The Death of Buy and Hold](#) (CNBC, 10 November 2008), Richard Henry Suttmeier, [Buy and Trade Beats Buy and Hold](#) (*Forbes*, 7 July 2010), Jake Zamansky, [The Death of the “Buy and Hold” Investor](#) (*Forbes*, 5 July 2012) and Charles Hugh Smith, [The Death of Buy and Hold: We're All Traders Now](#) (*Seeking Alpha* (8 March 2018)).

These points, as we'll see below, are either false or misrepresent what Graham advocated and practiced. At the same time, the *Journal* managed to make two important sets of points. First,

the best way to think about [buy and hold] is buy-and-watch, or buy-and-beware ... A potential variant on the blind buy and hold concept is to buy good companies and hold them. The challenge is in identifying good companies [and then watching them].

Second, it cited Jeffrey Bronchick, chief investment officer at Reed Connor Birdwell, a Los Angeles investment firm, who observed:

The fact is, buy and hold is not that easy a system. The reality is there are far fewer companies that are buy and holdable than there are publicly traded securities. [A sensible portfolio will thus comprise a relatively small number of entities; moreover, they will be chosen from among the small number worth holding for the long term].

What Is “Buy and Hold”?

Criticisms of “buy and hold” over the past quarter-century, written by journalists in prominent publications and bolstered by quotes from leading institutional investors, seldom bother to define it explicitly (never mind analyse it rigorously). Robert Kleinberg, a private investor working in Shanghai, expressed its gist clearly, concisely and insightfully (*The Wall Street Journal*, 9 July 2002):

When brokers and their firms often encourage excessive trading based on flawed or biased recommendations and ignoring tax consequences, buy and hold is not a mantra but a damn good idea. *The question isn't what's wrong with buy and hold, but rather what you buy in the first place.* If you're going to hold long term (more than five years), then there's always risk you'll be wrong with some of your [decisions]. But if you (as I do) buy a basket of stocks, from several industries, which have the following characteristics:

- Clean balance sheets
- Sound management and strategy
- Focused on a core business, no gimmicks
- Proven record of steady earnings growth
- Reasonably priced

then most of them should do well over the long term. You won't need to buy and sell except for a few that turn out to be duds. Transaction fees and taxes will be minimized, and meantime you own something worth owning [italics added].

To "buy and hold" is to allocate investment capital on the basis of justifiable and cautious premises, valid logic and hard evidence – and then reap the long-term benefits that are likely to accrue from this process. It entails the purchase of sound businesses (or parts thereof) at prices which analysis concludes are bargain prices; it also involves the expectation that these holdings as long as these businesses remain solid and their prices sensible. This definition is a necessary condition – indeed, it's virtually a synonym – of investment; and its disavowal is a – and perhaps the – basis of speculation. To buy and hold does NOT entail the purchase of "blue chips"² on the basis of popularity and without regard to quality and price. Nor is it a matter of "set and forget." Above all, this definition doesn't mean that the investor never sells. There are, however, fundamental differences between the investor's and the speculator's sale. An investor worthy of the name sells when

- the investment no longer meets the criteria that initially prompted its purchase;
- a superior opportunity arises; or
- the investment becomes so overvalued (on the basis of one's analysis) that it offers a compelling opportunity to sell.

Plus Ça Change, Plus C'est La Même Chose

Pick an interval of financial market history during the past century. Then go to the library, borrow a good book about it and study it.³ What becomes evident? Market participants often convince themselves not just that there's something new under the sun – but also that this "something" allegedly nullifies (or renders inoperable) principles of investment. In the 1920s it was the "New Era" whose prosperity would last forever; in

² "A blue-chip stock," says [Investopedia](#), "is the stock of a large, well-established and financially sound company that has operated for many years. A blue-chip stock typically has a market capitalization in the billions, is generally the market leader or among the top three companies in its sector, and is more often than not a household name."

³ Books authored by James Grant are invaluable in this regard. See, for example, *Bernard M. Baruch: The Adventures of a Wall Street Legend* (1983; repr. Axios, 2012); *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* (Farrar, Straus and Giroux, 1994); *Minding Mister Market: Ten Years on Wall Street with Grant's Interest Rate Observer* (Three Rivers Press, 1996); *The Trouble with Prosperity: A Contrarian's Tale of Boom, Bust, and Speculation* (Crown Business, 1998); and *Mr. Market Miscalculates: The Bubble Years and Beyond* (Axios, 2008).

the 1930s was the Great Depression that might never end. The “Go-Go” years of the 1960s and the Dot Com mania of the 1990s were milder repetitions of the 1920s – and the 1970s and years since 2009 hangovers after the preceding booms. Hence Graham’s injunction:

To invest intelligently in securities one should be forearmed with an adequate knowledge of how the various types of bonds and stocks have actually behaved under varying conditions – some of which, at least, one is likely to meet again in one’s own experience. No statement is [truer] and better applicable to Wall Street than the famous warning of Santayana: “those who do not remember the past are condemned to repeat it.”

Similarly, go to a major library’s archives and peruse the daily financial press from virtually any year. What does one learn? *Something is always* the matter: that is, uncertainty borne by mostly trivial, transitory or imaginary events, both at home and overseas – and babble regarding this ambiguity – typically pervaded the press of yesteryear (and today’s electronic media). Referring to himself in the third person, Graham wrote:

When the young [Graham] entered Wall Street in June 1914 no one had any inkling of what the next half-century had in store. (The stock market did not even suspect that a world war was to break out in two months, and close down the New York Stock Exchange.) Now, in 1972, we find ourselves the richest and most powerful country on earth, but beset by all sorts of major problems and more apprehensive than confident of the future. Yet if we confine our attention to American investment experience, there is some comfort to be gleaned from the last 57 years. Through all their vicissitudes and casualties, as earthshaking as they were unforeseen, it remained true that sound investment principles produced generally sound results. We must act on the assumption that they will continue to do so.

Figure 1 provides an example. It plots the index of global economic policy uncertainty compiled by Scott Baker, Nick Bloom and Steven Davis (for full details, go to www.policyuncertainty.com). Before the Global Financial Crisis, this measure of policy uncertainty trended mildly downward; since then, however, it’s trended resolutely higher – and reached its maximum in December 2018. If something is always the matter, then since the GFC ever more has seemingly been amiss. Figure 2, which plots Baker et al.’s index of economic policy uncertainty in the U.S., corroborates this result. Between 1900 and the height of the Great Depression, uncertainty waxed; from then until ca. 1960, it waned; and since 1960 it’s trended higher (the maximum reading, 351, occurred in August 2011 – the month that the U.S. Government lost its AAA-rating).

Figure 1:
Global Economic Policy Uncertainty, Monthly Observations, January 1997-July 2019

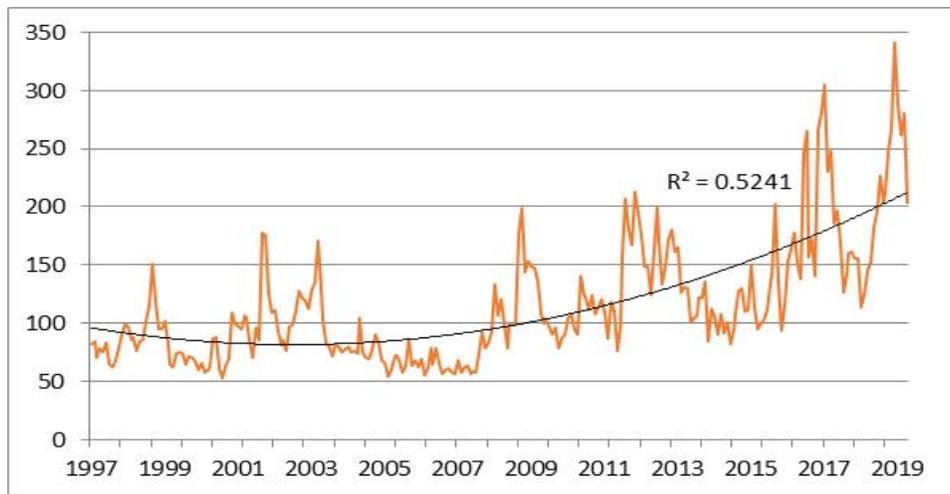
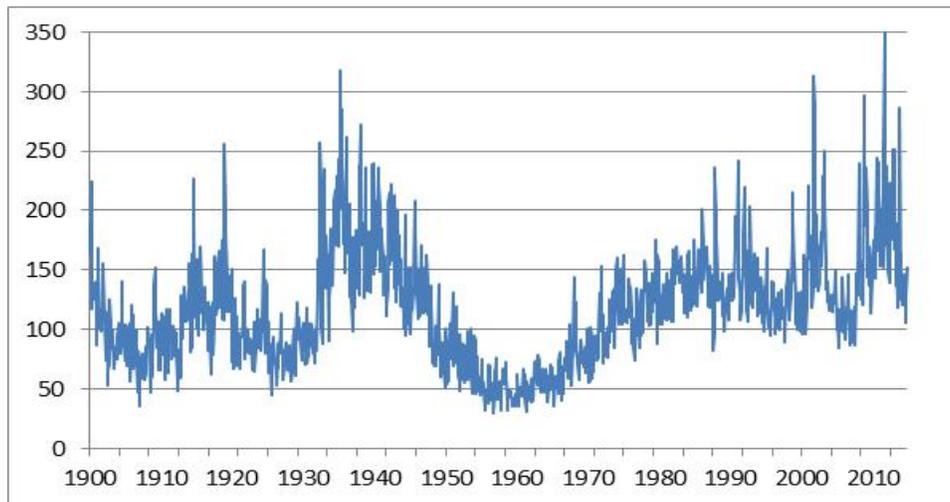


Figure 2:
Economic Policy Uncertainty in the U.S., Monthly Observations, Jan 1900-Dec 2014



Yet just as no son is ever as laudable as his mother proclaims or as deplorable as his father complains, in economic and financial terms few things are ever as upbeat – or as gloomy – as they seem to contemporaries. Unexpectedly steep declines of the prices of securities – and consequent feelings of consternation and disorientation – accompany many bull markets. And sharp short-but-sharp updraughts are part-and-parcel of most bear markets. More importantly, bull markets cause bear markets. In Graham’s words,

The extent [of] the market's shrinkage in 1969-70 should have served to dispel an illusion that had been gaining ground during the past two decades. This [illusion] was that leading common stocks could be bought at any time and at any price, with the assurance not only of ultimate profit but also that any intervening loss would soon be recouped by a renewed advance of the market to new high levels. That was too good to be true. At long last the stock market has "returned to normal," in the sense that both speculators and investors must again be prepared to experience significant and perhaps protracted falls as well as rises in the value of their holdings.

Thirdly, and whatever the era, the boom that eventually begets the bust causes most market participants – including major institutional investors – to abandon sober investment and embrace frenzied speculation. As Graham put it,

In the area of many secondary and third-line common stocks, especially recently floated enterprises, the havoc wrought by the last market break was catastrophic. This was nothing new – it had happened to a similar degree in 1961-62 – but there was now a novel element in the fact that some of the investment funds had large commitments in highly speculative and obviously overvalued issues of this type. Evidently it is not only the tyro who needs to be warned that while enthusiasm may be necessary for great accomplishments elsewhere, in Wall Street it almost invariably leads to disaster.

Back to the Future: Reaffirming Buy and Hold

Do uncertainty and volatility impair or even destroy investment principles? Many market participants seem to think so. They use unexpected ructions of one kind or another as excuses to disavow buy and hold – and thus to abandon investment and embrace speculation. Graham, in sharp contrast, sought to justify and re-emphasise justifiable – even in the light of messy reality – axioms: "the underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate." There are at least three reasons why a buy and hold strategy (i.e., the purchase of part-ownership of good businesses at bargain prices, and the retention of these holdings as long as these businesses remain sound, thus achieving returns commensurate with their underlying business operations), despite the disapprobation occasionally heaped upon it over the years, has long been and today remains a far more sensible course of action than alternatives such as short-term trading (i.e., speculation).⁴

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Justification #1: Trading Is a Loser's Game

A *Losing Game* is unwinnable, i.e., intentionally rigged so that you cannot win consistently. Regardless of your actions, degree of skill, etc., over time you will tend to lose. Games of chance in casinos are perhaps the most prominent examples. The outcome of a *Loser's Game*, on the other hand, is determined by the loser's action(s), i.e., mistake(s). Amateur sport provides many examples; investing, contended Charles Ellis, has since the 1950s become another. He wrote in [The Loser's Game](#): "Unlike golf and tennis, investing is a Loser's Game for both professionals and amateurs. The secret to success in a Loser's Game is minimizing mistakes and for investors this means minimizing trading." Perhaps the major justification of buy and hold is that its antithesis, speculative trading, leads almost inevitably to tears. *The blunt truth is that the [vast majority of stock traders lose much of their money](#); and the fortunate few who don't lose heavily tend to gain very little.*⁵

Why do speculators mostly lose quickly and investors worthy of the name tend to win over time? *Speculators don't merely make poor decisions; they make far too many decisions.* In sharp contrast, investors don't act until the odds of success heavily favour them; as a result, they make a far smaller number of decisions – and their choices tend to be sensible. Warren Buffett has emphasised this point; predictably, the mainstream media has mostly ignored it. Since at least the 1990s, when visiting university campuses and speaking to students, [he has often said things such as](#)

I could improve your ultimate financial welfare by giving you a ticket with only twenty slots in it so that you had twenty punches – representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all. Under those rules, you'd really think carefully about what you did, and you'd be

⁴ See also [7 Reasons Buy and Hold Investing Beats Trend Trading](#) (*U.S. News & World Report*, 22 May 2019).

⁵ See also Brad Barber and Terence Odean, [The Behavior of Individual Investors](#). "With some exceptions (e.g., trading to harvest capital losses)," they write, "it is safe to assume that ... investors who trade actively in taxable accounts will earn lower after-tax returns than buy and hold investors." The key to successful speculation is the ability to anticipate the short-term direction of prices and the magnitudes of fluctuations around trends. If a person were omniscient and therefore able to predict short-term perfectly accurately, buying at a low price and selling shortly afterwards at a higher price, that person would clearly mint money. The trouble, of course, is that nobody is omniscient; more to the point, "predictions" of short-term fluctuations are at best mere random guesses. Yet many people greatly overestimate their (virtually non-existent) ability in this regard. The desire for quick, effortless and large trading profits – together with a high degree of overconfidence in the ability to divine the future – tempts so many people to speculate.

forced to load up on what you'd really thought about. So you'd do so much better.

Speculators – including the many within their ranks who mistakenly believe they're investors – scatter decisions (and money) as if it were grass seed. They say to themselves, "I'll throw a little here and a bit there, and then see what happens." Instead, Buffett advocates concentration and focus – that is, locating the richest soil that receives reliable rain, etc., and then allocating to it a substantial amount of the right kind of seed. This policy is simple to understand yet psychologically difficult to practice (for details, see Robert Hagstrom, *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy* (John Wiley & Sons, 1999).

Speculators regard a security (i.e., a stock, bond or title to real estate) as a mere piece of paper and consider its value and market price as synonyms. They focus almost exclusively upon "the market" and thereby ignore the economic and financial characteristics – to say nothing of the activities and results – of the business that underlies a security. And they believe that they can anticipate short-term trends and fluctuations of prices. The compelling evidence that nobody can reliably divine short-term fluctuations of price⁶ seemingly doesn't dissuade them; nor does their personal experience of repeated and often substantial financial loss. Hence they repeatedly do much the same thing; each time, they tend to lose; yet next time they expect different results. That's the definition of insanity commonly attributed to Albert Einstein. Investors, in contrast, distinguish sharply between a security's market price and value. They focus upon the economic and financial fundamentals of the business underlying a stock or bond, and pay attention to its price only to the extent that it enables them to buy from pessimists (and eventually sell to optimists). Speculators thus attempt – but almost always fail – to get rich quick by buying and selling in rapid succession; investors, in contrast, tend to become financially independent gradually by buying and holding – and only occasionally selling – for the long term (five years or more).

Justification #2: Reduced Costs of Transaction

Whether they're private individuals of modest means or institutions whose operations span the globe, few participants in financial markets can resist the temptation constantly to buy and sell securities. They have an incentive to "churn," i.e., to speculate – rather than patiently await attractive opportunities to buy and hold. From 1 January

⁶ For an extended analysis, see [Leithner Letter No. 213-214 \(26 July-26 August 2017\)](#).

to 9 August 2002, for example, ca. 4.4 billion shares of Telstra Corp. Ltd, which was then and is now Australia's biggest provider of telecoms services and one of its largest listed companies, changed hands. That's an annualised rate of 7.1 billion shares. The total number of shares at that time was ca. 12.9 billion. At that rate, 55% of Telstra's shares changed hands during 2002. The Commonwealth Parliament owned slightly more than 50% of Telstra's shares; hence churn (also known as "turnover") as a percentage of "free float" was closer to 110%. On an annualised basis, each privately-owned share of Telstra was exchanged ca. 1.1 times during 2002. In other words, a typical owner held her shares less than 11 months. *This typical owner (or the manager acting on her behalf and probably without her knowledge) was thus a speculator rather than an investor.*

It's hardly just Telstra or the stocks of major Australian corporations: over the years virtually all securities have been churned ever more rapidly. Why? Ultimately, I believe, it's because portfolio managers' time horizons have shortened. Let's define a portfolio's turnover as the ratio of the total value of all its transactions over a specified period of time to its average "mark to market" value during that period. This definition implies the concept "average holding period" – which is more meaningful than "average turnover rate." The holding period quantifies the length of time between a portfolio manager's purchase and sale of a security. Given an average rate of turnover, the average holding period is:

$$\text{Average Holding Period (in months)} = (12 \text{ months}) \div (\text{Average Annual Turnover Rate})$$

Turnover rates generate the average holding periods specified in Table 1.

**Table 1:
The Relationship between Turnover Rate and Holding Period**

Average Annual Turnover Rate	Average Holding Period
5%	20 Years
10%	10 Years
25%	4 Years
50%	2 Years
75%	16 Months
100%	12 months
125%	10 Months
150%	8 Months

A portfolio's rate of turnover at a given point in time quantifies the percentage of its securities that's been bought and sold during the previous 12 months. Consider as a hypothetical example that on 1 January a portfolio that comprised equal dollar amounts of 100 stocks. If by 31 December its owner had sold none of its holdings, then its churn rate was 0%; if she had sold 25, its turnover rate was 25%. This latter rate, if it continued, implies that the portfolio would be completely reconstituted after four years; a rate of 20% means that it would be reconstituted after five years, etc.

[John C. Bogle](#), the founder of The Vanguard Group, was one of the fathers of the funds management industry. Formed in 1974, today Vanguard manages approximately \$3.0 trillion of assets. It's one of the world's largest investment managers; specifically, it's the world's largest provider of mutual funds and the second-largest provider of exchange-traded funds (ETFs). Almost 15 years ago, in [The Mutual Fund Industry 60 Years Later: For Better or Worse?](#) Bogle wrote:

Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committee to portfolio manager had a profound impact on mutual fund investment strategies, most obviously in soaring portfolio turnover – as shown in [Figure 3]. In 1945, mutual fund managers did not talk about long-term investing. They simply did it. That's what trusteeship is all about. But over the next 60 years, that basic tenet was turned on its head and short-term speculation became the order of the day.

Figure 3:
Average Holding Period (Years), American Equity Fund Portfolios, 1945-2015

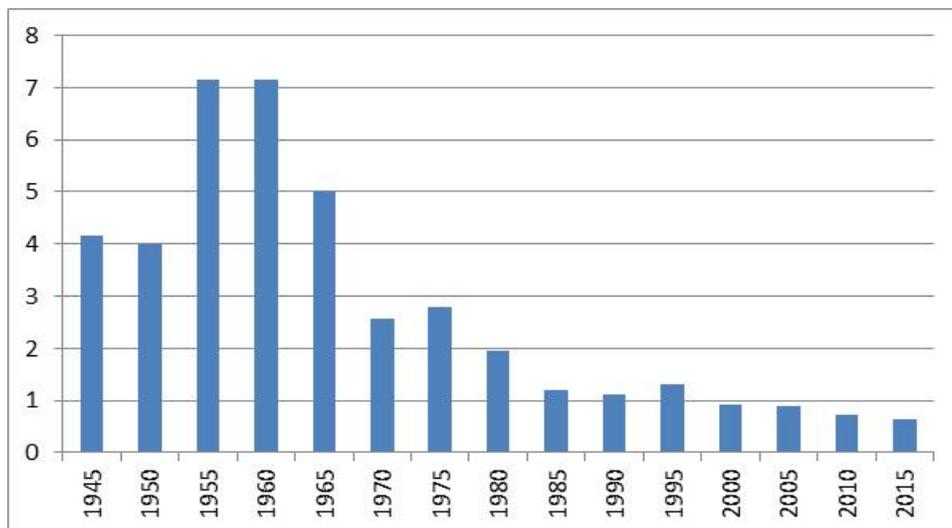


Figure 3, which plots data that Bogle compiled, shows that between 1945 and 1965 annual portfolio turnover in the U.S. averaged 17%; hence the average managed fund held its average stock for almost six years. But since 1960 – perhaps not co-incidentally, the time when Charles Ellis reckons that investment became a Loser’s Game – turnover has risen steadily: managers now “churn” their portfolios at an average rate of ca. 150% annually. As a result, the average manager now holds a stock for an average of only 8 months. Although virtually all managers loudly claim that they’re investors, the truth is that *it’s been more than 50 years since investment managers as a whole have actually been investors: since then they’ve really been speculative traders masquerading as “investors.” Even worse, their clients have taken them at their word – and suffered the consequences. No wonder managers’ results, considered as a whole, have long been so poor!*

Bogle elaborates:

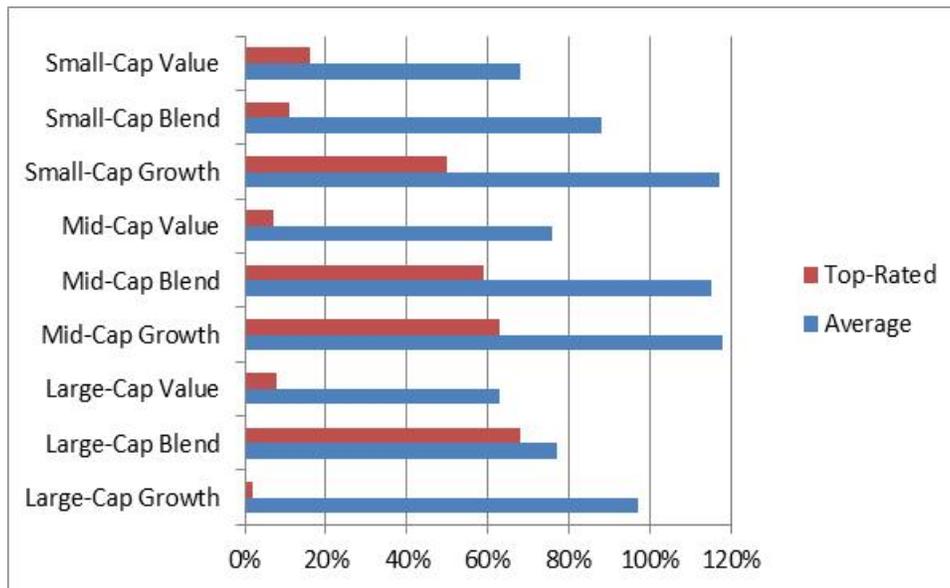
If a six-year holding period can be characterized as long-term investment, and if an 8-month holding period can be characterized as short-term speculation, mutual fund managers today are not investors. They are speculators. I do not use the word “speculation” lightly. Nearly 70 years ago, John Maynard Keynes contrasted speculation (“forecasting the psychology of the market”) with enterprise (“forecasting the prospective yield of an asset”) and predicted that the influence of speculation among professional investors would rise as they emulated the uninformed public—that is, seeking to anticipate changes in public opinion rather than focusing on earnings, dividends, and book values.

In my 1951 [Princeton undergraduate] thesis on the mutual fund industry, I was bold enough to disagree with Keynes’ baleful prediction. As funds grew, I opined, they would move away from speculation and move toward enterprise by focusing, not on the momentary, short-term price of the share, but on the long-term intrinsic value of the corporation. As a result, I concluded, fund managers would supply the stock market “with a demand for securities that is steady, sophisticated, enlightened, and analytic.” *I could not have been more wrong* [italics added].

Figure 3, it’s important to emphasise, describes managed funds. Over the years these funds have owned a steadily decreasing – and “hedge funds” and specialist vehicles a gradually increasing – percentage of all stocks. These days, ever more hedge funds are “high-frequency traders.” These HFTs, in turn, make the managers of mutual funds look like paragons of ultra-long-term investing. According to *The Daily Telegraph* ([How Long Does the Average Share Holding Last? Just 22 Seconds](#), 18 January 2012),

The average holding is less than a minute thanks to computer driven “high frequency” trading. ... A former Wall Street economist ... who also helped establish the world’s first sovereign debt fund recently said: “Take any stock in the United States. The average time in which you hold a stock is – it’s gone up from 20 seconds to 22 seconds in the last year. ... The average foreign currency [speculation] is up now 30 seconds, up from 28 seconds last month.”

Figure 4:
Average Turnover Rates, Various Categories of U.S. Managed Funds, 2015



David John Marotta has analysed the recent turnover rates of various categories of managed fund⁷ (Figure 4). Each category’s average masks a very wide range of trading activity; churn varies from a minimum of ca. 5% to an astounding maximum of more than 1,000%. “Top-Rated” refers to the funds within each category that possesses the best 10-year annualised total return. Clearly, most investment managers buy and sell securities very frequently: the average churn rate across the nine categories in Figure 4 is 91%. Recall that a rate of 100% means the fund replaces the entire portfolio within 12 months. Annual turnover rates among the most active stratum of managers ranged from 215% to an astounding 972% and averaged 320%. These rates imply holding periods of 5-24 weeks and an average of 16 weeks. *Yet top-rated funds churn at only one-third*

⁷ See [What Is the Relationship between Number of Holdings and Returns?](#) (Marotta on Money, 16 June 2015) and [What Is the Relationship between Turnover Rate and Number of Holdings?](#) (Marotta on Money, 2 June 2015).

of the average rate. Their average is 32%; that implies an average holding period of ca. 3 years.

Managed funds, then, generate turnover ratios of ca. 60-100% per year – and in recent years a significant minority has churned at the rate of 100%-200% per year. Yet as Marotta’s results show starkly, churning is costly. On both sides of each transaction, brokers extract a commission. Almost 20 years ago, Warren Buffett estimated the total commissions, etc., generated by churning. In [Mr. Buffett on the Stock Market](#) (*Fortune*, 22 November 1999) he stated:

My estimate is that investors in American stocks pay out well over \$100 billion a year – say, \$130 billion – to move around on those chairs or to buy advice as to whether they should! Perhaps \$100 billion of that relates to the FORTUNE 500. In other words, investors are dissipating almost a third of everything that the FORTUNE 500 is earning for them by handing it over to various types of chair-changing and chair-advisory “helpers” ... In my view, that’s slim pickings.

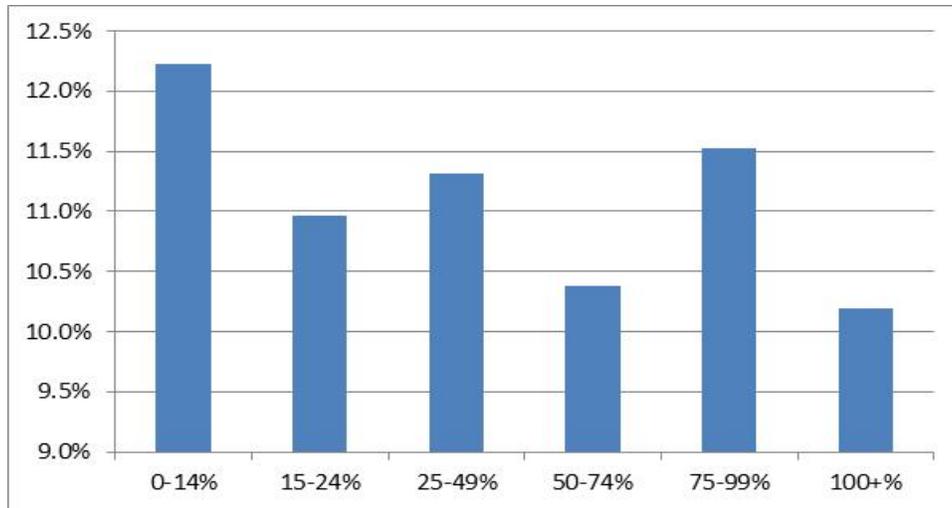
Buffett’s and Marotta’s conclusions are widely applicable, so don’t let anybody tell you otherwise: [the more frequently you \(or your manager\) trades, the poorer will be your results](#). This result applies as much to major institutions as one-man traders. Clearly, the greater is the frequency of trading the greater are the commissions to brokers. *More fundamentally, the more frequently one trades, the more profitable one’s trades must be in order to counteract the drag imposed by commissions, capital gains taxes (see the next section), etc.* Other things equal, the higher is a portfolio’s turnover rate the lower will be its rate of return (see Figure 5, which disaggregates figures from the first three categories of Figure 4).⁸ Accordingly, and just as the tortoise beat the hare, the “lazy” investor usually beats the energetic speculator. “The reason why,” according to Härje Ronngard ([Why the Lazy Investor Always Wins](#), *Money Morning*, 31 July 2017), “comes down to two factors:”

First, holding undervalued stocks for longer periods [as acolytes of Buffett and Graham tend to do] should give them more time to appreciate. Second, fund managers who had lower turnover rates — those who traded less —

⁸ A large academic literature corroborates and elaborates this fundamental point. See, for example, the research of Terrance Odean: [Just How Much Do Investors Lose by Trading?](#) *Review of Financial Studies*, 2009, vol. 22, no. 2 (2009), pp. 609-632; [Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors](#), *Journal of Finance*, vol. 60, no. 2 (April 2000), pp. 773-806; and [Do Investors Trade Too Much?](#) *American Economic Review*, vol. 89, no. 4 (December 1999), pp. 1279-1298.

likely made fewer mistakes. Thus, the lazy manager [who sat] on his investments beat the most active manager trying to optimise his portfolio.

Figure 5:
Effect of Turnover Rate (Horizontal Axis) upon
Five-Year Performance (Vertical Axis),
U.S. Small-Cap Funds, 2015



The startling – to the conventional wisdom – truth is that activity per se doesn't beget higher returns. *To many people – and, it seems, most managers – it's counterintuitive but it's nonetheless true: jumping from "low-growth" into "high-growth" stocks doesn't improve one's results. Indeed, the opposite is more often true.* In 1996, Warren Buffett [wrote to Berkshire's shareholders](#):

Inactivity strikes us as intelligent behaviour. Neither we nor most business managers would dream of feverishly trading subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market. Why, then, should we behave differently with our minority positions in wonderful businesses? ... The art of investing in public companies successfully is little different from the art of successfully acquiring subsidiaries. In each case you simply want to acquire, at a sensible price, a business with excellent economics and able, honest management. Thereafter, you need only monitor whether these qualities are being preserved.

It's important to ask a final question: WHY do most managers churn their portfolios so rapidly? *It's a simple matter of incentive: although turnover doesn't serve clients' interest, it does advance the typical manager's.* "Imagine," writes Ronngard,

I gave you \$50,000 to invest. But there's a catch. Each quarter I would review your performance. If you didn't beat your benchmark [for example, the S&P/ASX 200 Index] then I would take \$10,000 away from you. What would your strategy be? Would you try to buy undervalued stocks that might take a year or more to appreciate? Or would you jump in and out of "hot" stocks, trying to capture short-term gains? You'd probably lean towards the latter, right? It makes more sense to try and ride the "hot" stocks in the short-run, to beat your benchmark for the quarter.

The typical investment manager thus faces a dilemma. He must speculate in stocks rather than invest in businesses; in particular, he strives to pick stocks whose prices will appreciate quickly – that is, within a few weeks or months, and certainly within a year. For if they don't, he confronts "career risk," i.e., the distinct possibility that his "investors" (they're actually speculators, too) will shift their funds to the "hot" manager who achieved impressive results in the previous quarter. *Given this dilemma, the typical manager's short-term self-interest overrides his investors' long-term financial interest; for this reason, and given their intense focus upon the here and now, mainstream funds' "churn rate" is typically very high.*

Half a century ago, most managers abandoned "buy and hold" and embraced "buy and trade." As a result, and although most would vehemently deny it, they ceased to be "investment managers" and became "speculation managers." They churn their portfolios heavily; turnover, in turn, generates transactions costs; for this reason, among others (see below), most managers fail to meet their benchmarks. More fundamentally, the problem is that, because the cost of the typical manager's frequent trading is deducted from the fund's assets and not the manager's fee, there's little incentive for most managers to change their frenetic ways.⁹

Justification #3: Enhanced After-Tax Results

⁹ In diametric contrast, Leithner & Co.'s costs are deducted from its total cash EPS – which is the source of the dividends it pays on both ordinary and Redeemable Preference Shares. *Just as the typical funds manager has little incentive to restrain his "churn," Directors of Leithner & Co. have a strong incentive to do so. This, we believe, is a major reason why [our results have outperformed both the All Ordinaries Accumulation Index and the vast majority of other managers.](#)*

A buy and hold approach possesses another important advantage. It postpones the payment of capital gains tax (CGT); thereby, and other things equal, it augments the investor's return. When a stock's price appreciates above the investor's purchase price and the investor retains rather than sells it, she enjoys an "unrealised" capital gain. No CGT is payable until she "realises" the gain, i.e., sells the stock. "So long as Wesco [a subsidiary of Berkshire Hathaway] does not ... sell any appreciated securities," wrote Charlie Munger in [Wesco Financial Corp.'s Annual Report 2000](#) (p. 6), "it has, in effect, an interest free 'loan' from the government equal to its deferred taxes on the unrealized gains ..." During the early-1990s, for example, Berkshire spent ca. \$1.3 billion to buy shares of Coca-Cola Inc. By 2010, the valuation of this investment (based upon the market price of Coke's shares) had risen to ca. \$9.1 billion; by the end of 2018 it approached \$19 billion. This "paper" gain of ca. \$7.8 billion (2010) and \$17.6 billion (2018) isn't taxable until Berkshire sells these shares – which in 2019 it still hasn't. Clearly, the larger is the unrealised gain, the bigger is the imputed loan; and the longer you hold appreciated securities, the longer you defer taxes. That's one reason why, as Buffett stated in [Berkshire's 1988 Annual Report](#), "our favorite holding period is forever."

Except in the case of non-taxable accounts, taxes typically rank among investors' biggest expenses; accordingly, to defer them is to boost one's return. To see this, consider a Buffett-inspired (from its [1989 Annual Report](#)) thought experiment. Assume that (1) you possess \$100 and invest it in a security whose price compounds 15% per year; (2) capital gains tax (CGT) is payable at a rate of 30%; (3) there are no brokerage fees; the security's initial purchase price is \$1 per share; and (4) we purchase 100 shares. If we sold the shares one year after we bought then then we we'd realise an after-tax gain of \$10.50 and the market valuation of our investment (post-CGT) would increase to \$110.50 (Table 2). If we used this capital to repurchase 96.09 shares (for simplicity, let's assume that we can buy fractions of shares) at \$1.15 per share, held them for a year, sold them at \$1.32 per share, paid CGT, and repurchased them, etc., then after 10 years we'd accumulate 67.09 shares, pay CGT of \$73.46, pocket \$271.41 (i.e., our initial investment of \$100 plus the post-CGT capital gain of \$171.41) and earn a compound rate of return of 10.5% per annum.

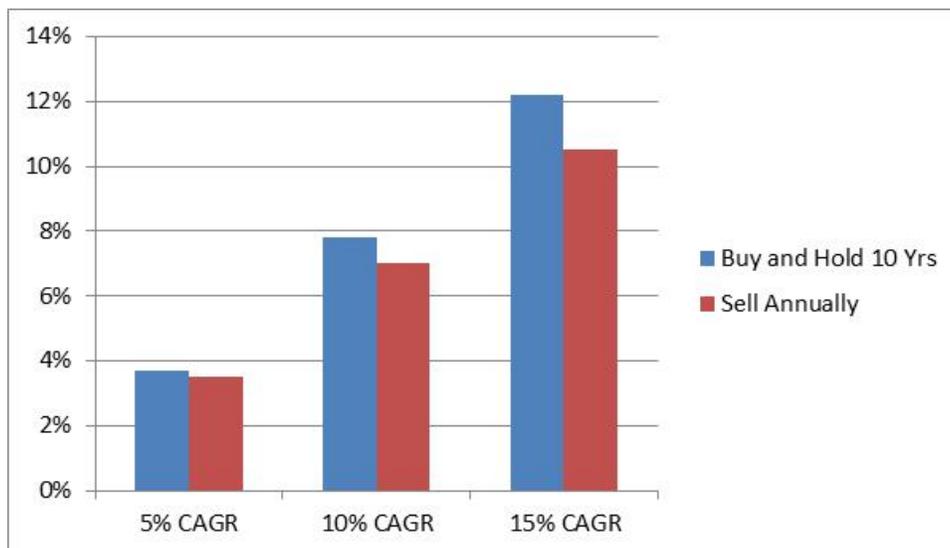
If, on the other hand, we purchase 100 shares at \$1.00 per share, hold them for 10 years (thereby delaying the payment of CGT) and sell them (at \$4.05 per share) at the end of the tenth year, we'd pay more (\$91.50) CGT – but also pocket much more cash (our initial \$100 plus post-CGT capital gain of \$313.50 = \$413.50). *That latter amount is more than 25% greater than what we'd receive in Table 2; it thereby increases the compound rate of return to 12.2% per annum.* It's ironic: traders crave the increase of stock prices; yet these very increases crimp their returns! Notice that each successive year, CGT leaks from the trader's account and the price of the shares rises; as a result, the trader owns slightly less capital (compared to the buy and hold investor's unrealised and hence untaxed

capital gain; further, given the rise of the stock's price, with this slightly lower base of capital the trader is able to buy fewer and fewer shares: by the end of year 10 he owns fewer than 70 whereas the buy and hold investor continues to own 100. This result generalises. It applies when of the compound annual growth rate (CAGR) of the shares is 5%, 10 or 15% – indeed, it applies regardless of the CAGR. But as the CAGR rises, so too does the advantage of buy and hold versus buy and trade (Figure 6).

**Table 2:
Buffett's Thought Experiment Using Chris' Assumptions**

Yr	Share Price (Start of Yr)	Investment (SOY)	No. Shares Purchased	Share Price (EOY)	Realised Cap Gain (pre-CGT)	CGT	Revestment (EOY, net of CGT)	Shares Re-purchased
1	\$1.00	\$100.00	100.00	\$1.15	\$15.00	\$4.50	\$110.50	96.09
2	\$1.15	\$110.50	96.09	\$1.32	\$16.58	\$4.97	\$122.10	92.33
3	\$1.32	\$122.10	92.33	\$1.52	\$18.32	\$5.49	\$134.92	88.71
4	\$1.52	\$134.92	88.71	\$1.75	\$20.24	\$6.07	\$149.09	85.24
5	\$1.75	\$149.09	85.24	\$2.01	\$22.36	\$6.71	\$164.74	81.91
6	\$2.01	\$164.74	81.91	\$2.31	\$24.71	\$7.41	\$182.04	78.70
7	\$2.31	\$182.04	78.70	\$2.66	\$27.31	\$8.19	\$201.16	75.62
8	\$2.66	\$201.16	75.62	\$3.06	\$30.17	\$9.05	\$222.28	72.66
9	\$3.06	\$222.28	72.66	\$3.52	\$33.34	\$10.00	\$245.62	69.82
10	\$3.52	\$245.62	69.82	\$4.05	\$36.84	\$11.05	\$271.41	67.09

**Figure 6:
Returns from Buy and Hold vs. Buy and Trade, Three CAGRs**



Conclusion: Buying and Holding in the 21st Century

A buy and hold strategy entails the acquisition of sound businesses at bargain prices, and the intention to retain these holdings as long as these businesses' operations and prospects remain solid. During the past 20 years it has served Leithner & Co. well; accordingly, it remains one of the pillars of our investment operations – which, it's vital to note and despite its very large weighting towards cash and equivalents, have "outperformed" the All Ordinaries Accumulation Index. Participants in markets cannot consistently "time" their purchases successfully; hence we must conclude that poor results – and potentially large losses – are a virtually inevitable consequence of speculation. Even ignoring brokerage and other costs of transactions, the results a buy and hold strategy exceed the results of buy and trade; taking into consideration brokerage and other costs, the advantages of buy and hold become even more evident.

Leithner & Co. has neither the ability nor the disposition to churn securities in anticipation of favourable short-term movements of market prices. Instead, and given the benefits of the buy and hold approach, properly defined, it devotes considerable amounts of time and energy to the identification of the securities of sound enterprises. Further, and given the costs of "churn," it makes sense to regard occasional sharp downdraughts of market prices not as signals to trade but as opportunities to acquire part-ownership of sound businesses at bargain prices. Accordingly, with respect to the frequency of buying and selling – as opposed to the intensity of research – lethargy bordering upon sloth forms a cornerstone of a sensible approach to investment.

Above all, and notwithstanding longstanding – and utterly misguided – criticisms of buy and hold, in its 20th year Leithner & Co. keeps uppermost in mind Graham's admonition:

The one principle that applies to nearly all these so-called "technical approaches" is that one should buy *because* a stock or the market has gone up and one should sell *because* it has declined. This is the exact opposite of sound business sense everywhere else, and it is most unlikely that it can lead to lasting success on Wall Street. In our experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by "following the market." We do not hesitate to declare that this approach is as fallacious as it is popular.

Chris Leithner