

The Ultimate Buy-and-Hold Strategy: 2012 update

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In this update to one of the most important items in our article library, Merriman shows how a series of simple but powerful concepts can benefit patient, thoughtful investors. This 2012 revision updates all reported returns to include the year 2011.

If you are a serious investor, this article could be one of the most important things you'll ever read. I'm going to show you the buy-and-hold strategy with rebalancing that's very close, though not quite identical, to the way we manage the majority of the money we invest for our clients.

We have been recommending this sample strategy since 1992. After all these years, we still like it so much that we call it the Ultimate Buy-and-Hold Strategy, as the title of this article indicates.

We don't use that word "ultimate" casually. I don't claim this is the best investment strategy in the world – but it's the best we have found.

I believe almost every long-term investor can use it to advantage.

As we shall see, compared with the U.S. stock market as measured by the Standard & Poor's 500 Index, the Ultimate Buy-and-Hold Strategy has historically increased returns and reduced risk.

The strategy I'm going to describe is suitable for do-it-yourself investors as well as those who use professional investment advisors. It works in small portfolios as well as large portfolios. It's easy to understand and easy to apply using exchange-traded funds (ETFs) and/or low-cost no-load mutual funds.

We did not invent this strategy. It has evolved from the work of many prominent academics over a long period, including some winners of the Nobel Prize in economics.

Setting a high standard

In theory, a perfect investment strategy would be cheap, easy and risk-free. It would make you fabulously rich in about a week. Tax-free, of course. We haven't found that combination, and we don't expect to find it. But in the real world, the strategy I'm about to describe is the best substitute we know.

Over the long run, the Ultimate Buy-and-Hold Strategy has produced higher returns than the investments that many people hold. It did so at lower risk, with minimal transaction costs. It's mechanical, so it doesn't require you to pore over newsletters, pick stocks, find a guru or understand the economy.



This is the best
investment
strategy we
have found.

This strategy in a nutshell

Even though this strategy is based on academic research, it's really fairly simple. If I had to reduce it to just one sentence, here's what I would say: The Ultimate Buy-and-Hold Strategy creates a sophisticated portfolio with worldwide stock diversification by adding value stocks, small company stocks and real estate funds to a traditional large-cap growth stock portfolio.

This strategy is really fairly simple.

If you think you already know what that means and you're tempted to skip the rest of this article, I hope you'll resist that temptation. I have some compelling evidence to show you. If you apply this diligently, doing so could make a big difference in your future and your family's future.

If there is a "catch" to this strategy, it's availability. You cannot buy it in a single ETF or mutual fund. You can put together most of it using Vanguard's low-cost index funds; but Vanguard doesn't offer every piece of it. If you use more than one fund family and include ETFs, you can get each individual piece; but in order to do that you may have to open more than a single account.

In our view, the ultimate way to implement this strategy is to hire a professional money manager who has access to the institutional asset-class funds offered by Dimensional Fund Advisors. (More on that later.)

What really matters

The Ultimate Buy-and-Hold Strategy is based on more than 50 years of research into a deceptively simple question: What really makes a difference to investment results?

Some of the answers may surprise you. The people behind this research include Harry Markowitz, a 1990 Nobel laureate; Rex A. Siquel, who started the first index fund; and Eugene F. Fama, Robert R. McCormick Distinguished Service Professor of Finance at the University of Chicago Booth School of Business.

Their expertise is pooled in a company that Siquel and David Booth started in 1981 in order to give institutional investors a practical way to take advantage of their research. Today, that company, Dimensional Fund Advisors, manages more than \$213 billion of investments for pension funds, large corporations and a family of terrific mutual funds that are available to the public through a select group of investment advisors.

It is based on more than 50 years of research.

Not for everybody

Before we get into the meat of this strategy, there are a few things you should know. Every investment and every investment strategy involves risks, both short-term and long-term. That means investors can always lose money. The Ultimate Buy-and-Hold Strategy is not suitable for every investment need. It won't necessarily do well every week, every month, every quarter or every year. As investors learned the hard way in 2007 and 2008, there will be times when it loses money. You have been warned.

Like most worthwhile ways to invest, this strategy requires investors to make a commitment. If you are the sort of investor who dabbles in a strategy to check it out for a quarter or two, don't even bother with this. You will be disappointed, and you'll be relying entirely on luck for such short-term results.

I am often asked how this strategy did last year or how it's doing so far this year. Some people tell me they think investors should be in some particular kind of asset over the next few months or the next year. Almost always, this is the result of something they have read or heard without checking it out thoroughly on their own. These people aren't likely to succeed with this ultimate strategy because they are focused on the short term.

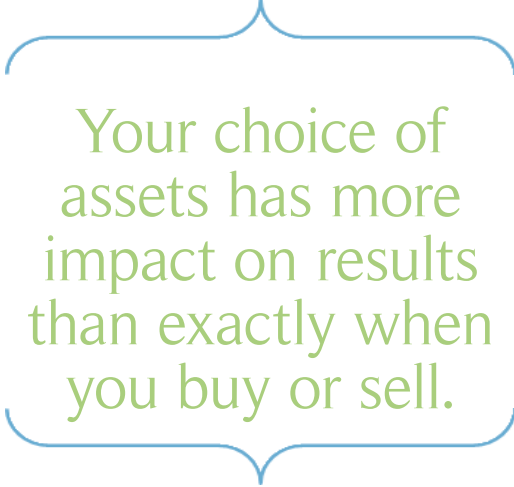
The Ultimate Buy-and-Hold Strategy is not based on anything that happened last year or last quarter. It's not based on anything that is expected to happen next quarter or next year. It makes absolutely no attempt to identify what investments will be "hot" in the near future. If that's what you want, you should look elsewhere, because you won't find it here.

This strategy is designed to produce very-long-term results without requiring much maintenance once the pieces are in place. If that is what you want, I hope you'll keep reading.

It's the assets that make the difference

The most important building block of this strategy is your choice of assets. Many investors think success lies in buying and selling at exactly the right times, in finding the right gurus or managers, the right stocks or mutual funds. But being at the right place at the right time depends on luck, and luck can work against you just as much as for you.

Here's the truth: Your choice of asset classes has far more impact on your results than any other investment decision you will make. I know this flies in the face of a lot of conventional wisdom and almost all the marketing hype on Wall Street, so I want to repeat it. Your choice of the right assets is far more important than exactly when you buy or sell those assets. And it's much more important than finding the very "best" stocks, bonds or mutual funds.



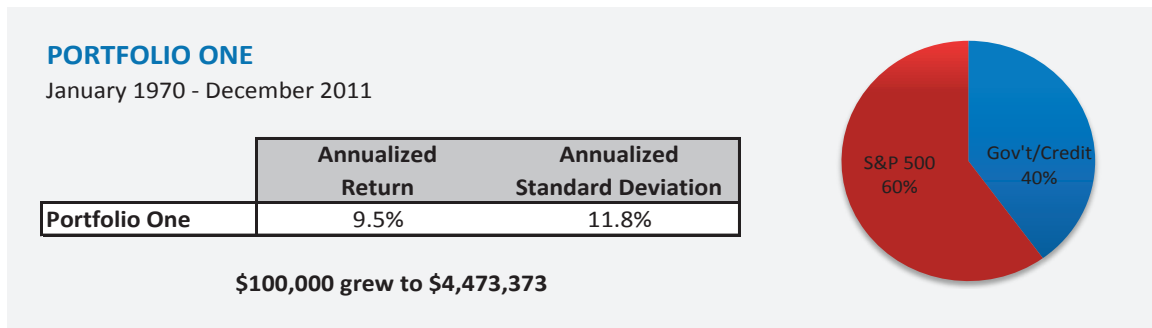
Your choice of assets has more impact on results than exactly when you buy or sell.

A 1986 study, largely confirmed by a follow-up study five years later and often cited by investment managers, tracked the investments of 91 large pension funds from 1974 to 1983. The researchers concluded that more than 93% of the variation in returns could be attributed to the kinds of assets in the portfolio. Most of the remaining variation was due to stock picking and the timing of purchases and sales.

Basic building blocks

So how do you choose the right asset classes? I'll show you how, starting with Portfolio 1, a very basic investment mix. Assume the whole pie represents all the money you have invested. This version of the pie has only two slices, one for bonds (Barclay's Government Credit Index) and one for stocks (Standard & Poor's 500 Index).

The returns cited throughout this article are not those of our managed strategy and do not reflect any potential transaction costs, fees or expenses that investors must inevitably pay. These figures represent the returns of asset classes, not specific investments.



Portfolio 1's 60/40 split between stocks and bonds

is the way that pension funds, insurance companies and other large institutional investors have traditionally allocated their assets. The stocks provide long-term growth while the bonds provide stability and income.

Let me say up front that we don't believe 60% stock and 40% bond is the right balance for all investors. Many young investors don't need any bonds in their portfolios. And many older folks may want 70% or more of their portfolios in bonds. However, the 60/40 ratio of Portfolio 1 is a good long-term investment mix. It's an industry standard, and I'll use it throughout this article to illustrate my points.

For 42 years, from January 1970 through December 2011, this portfolio produced a compound annual return of 9.5%. That's not bad, especially considering this period included four major bear markets. I believe that long-term return should be more than enough to let most investors achieve their long-term goals.

Therefore, for this discussion I will use a long-term annual return of 9.5% as a standard or benchmark against which to measure the strategy I'm presenting. You'll see this strategy unfold in a series of pie charts as we split the pie into thinner and thinner slices by adding asset classes.

Remember that we also must look at risk. Adding return while also increasing risk is certainly possible, but it's not what we're after here. We want risk to remain the same – or ideally, to decline. Therefore, another measure I'll use to gauge this strategy is standard deviation.

Ideally, we want risk to decline.

Standard deviation is a statistical way to measure risk. (If you want to understand this statistically, there are plenty of resources online that will tell you how it's defined and applied.) For our purposes here, what you need to know about standard deviation is that a lower number is better, indicating a portfolio that is more predictable and less volatile. The standard deviation of Portfolio 1 is 11.8%, so we'll use that as the benchmark.

Historically, millions of investors would have been better off with Portfolio 1 than they were with their actual portfolios, which included too little diversification and too much risk. If those investors did nothing more than adopt this simple mix of assets – which is easily duplicated using a couple of ETFs and/or no-load index funds, they would be more likely to achieve their long-term investment goals.

Because of that, and because it is used by institutional investors who must get the equation right for

the long term, Portfolio 1 is a relatively high standard from which to start. Anything worthy of being called an “ultimate” strategy must beat Portfolio 1 in two ways. It must be worthy of a reasonable expectation that it will produce a return higher than 9.5% and at the same time have a standard deviation of 11.8% or less.

Most of the Ultimate Buy-and-Hold Strategy is concerned with the 60% stock side of the pie. That’s where the main focus will be in this article. But it’s very important to get the bond part of this strategy right.

Most people include bond funds in a portfolio in order to provide stability, which can be measured by standard deviation. Many investors also expect bond funds to produce income, which of course is part of any investor’s total return. The higher the percentage of bonds that make up a total portfolio, the more stability that portfolio is likely to have – and the less long-term growth it is likely to produce.

Getting bonds right

Whether your portfolio is heavy or light on bonds, it matters what kind of bonds you own. In general, longer bond maturities go together with higher yields and higher volatility (higher standard deviation, in other words). However, as you extend maturities beyond intermediate-term bonds, the added volatility (risk) rises much faster than the additional return.

Our recommended bond portfolio is exclusively in government bond funds and is comprised of 50% intermediate-term funds, 30% short-term funds and 20% in TIPS funds for inflation protection. (TIPS funds invest in U.S. Treasury inflation-protected securities, which automatically adjust their values and interest payments to changes in the Consumer Price Index.)

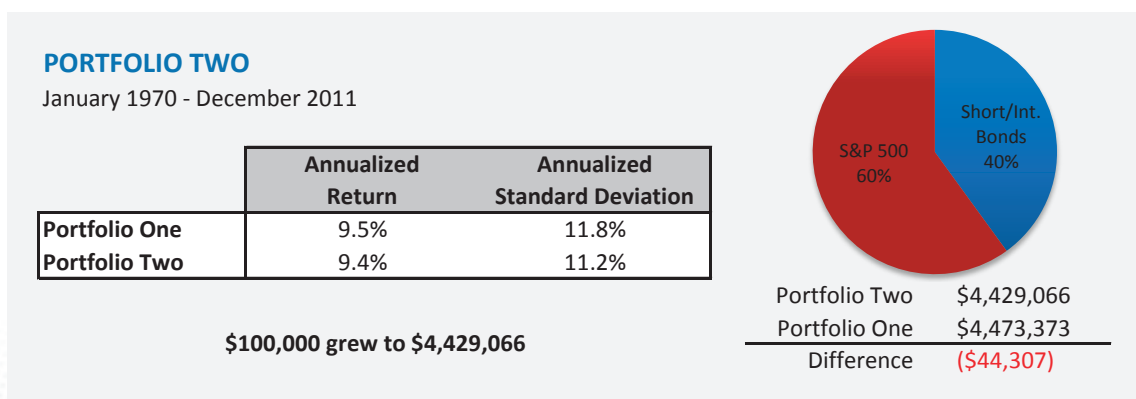
Why do we exclude corporate bond funds? In a nutshell, because they entail some risk of default – a risk that tends to increase at the very times when we want stability the most. We believe in taking calculated risks on the stock side of the portfolio and being very conservative on the bond side. U.S. Treasury securities are the safest in the world and virtually eliminate the risk of default.

It’s important to get the bond part of this strategy right.

Making these changes gives us Portfolio 2. From 1970 through 2011, this combination had an annualized return of 9.4% and a standard deviation of 11.2%. This change gives the portfolio more stability (less risk)

with slightly lower return.

The change from Portfolio 1 is modest. But there’s much more to come as we tackle the 60% of the portfolio devoted to stocks.



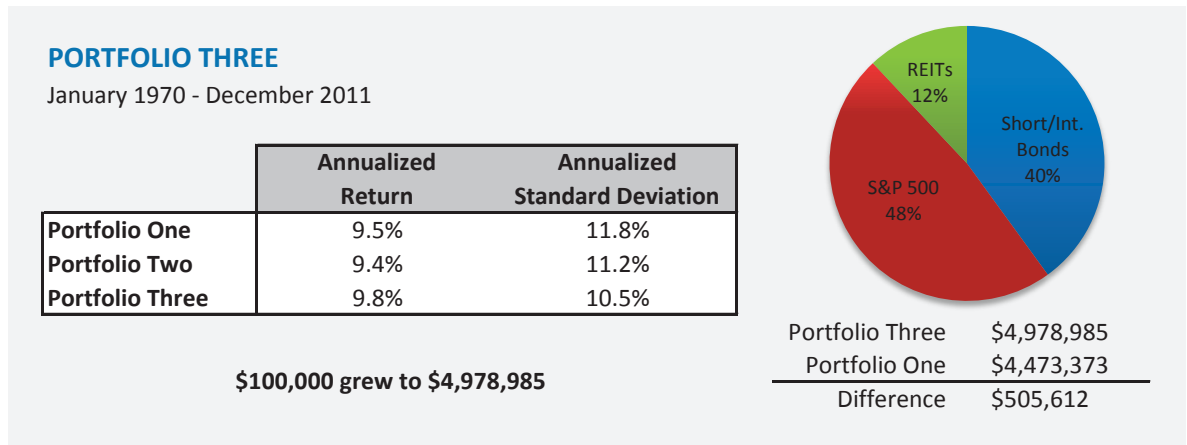
Getting stocks right: adding real estate

Despite recent history, investors are familiar with the long-term attraction of owning real estate. When this asset class is owned through professionally managed real estate investment trusts known as REITs, it can reduce risk and increase return.

From 1975 through 2011, REITs compounded at 13.9%, outpacing the Standard & Poor's 500 Index (which returned 11.5% over that same period). This was an unusually productive period for REITs, and academic researchers expect the future returns of real estate and of the S&P 500 Index to be similar to each other – though not as high as they were during this period.

As you will see in Portfolio 3, when REITs made up one-fifth of the stock part of this portfolio, the annual return rose slightly to 9.8%; more important for our purposes, the standard deviation (risk) fell to 10.5%. At this

point we have accomplished our objective of adding return and reducing risk. Over this long period, the bottom line is an additional \$505,612 in cumulative return.



This is an excellent start, but the best is yet to come.

Getting stocks right: size matters

The standard pension fund's stock portfolio, shown here in Portfolios 1 and 2, consists mostly of the stocks of the 500 largest U.S. companies. These include many familiar names like ExxonMobil, General Electric, Johnson & Johnson, Microsoft, Pfizer and Proctor & Gamble. Each of these was once a small company going through rapid growth that paid off in a big way for early investors. Microsoft was a classic case in the 1980s and 1990s.

Because small companies can grow much faster than huge ones, a fundamental way to diversify a stock portfolio is to invest some of your money in stocks of small companies.

To accomplish this, the next step in building the Ultimate Buy-and-Hold Strategy is to add small-cap stocks to the stock part of the portfolio. To represent small-cap stocks, we have used the returns of the Dimensional Fund Advisors U.S. Micro Cap Fund, which invests in the smallest 5% of U.S. companies.

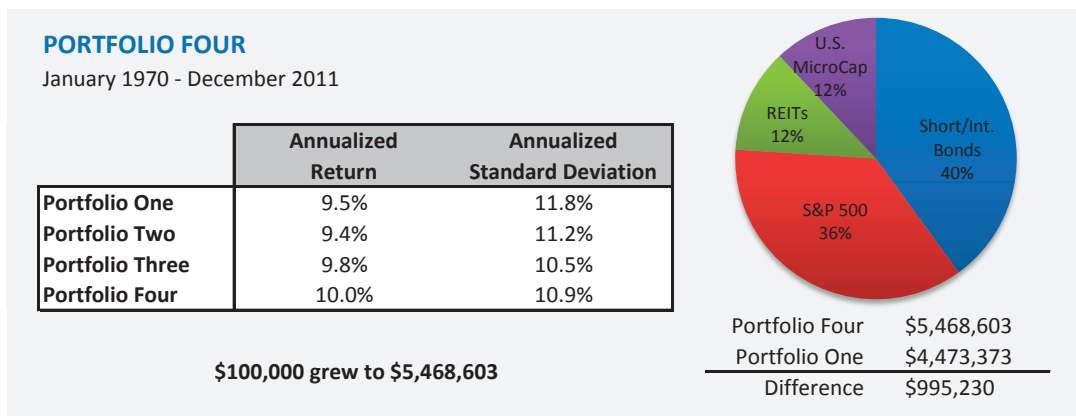
The result is Portfolio 4, a pie that now has four slices and which from 1970 through 2011 produced an annualized return of 10.0%, with a standard deviation of 10.9%. With these three changes, we added about \$995,230 to the cumulative return, an increase of 22.2%.

I think that is very impressive, and I'd like you to pause for a moment and think about that.

The additional return is more than nine times the entire initial investment of \$100,000.

How much work did

it take to capture that extra return? I'm betting you could set this up with less than 20 hours of your time. But let's be conservative and say that it took you 40 hours, a full standard work week. Divide the extra return by those hours and the payoff amounts to nearly \$25,000 per hour. I don't know anywhere else you can get paid that much for your time. Could I now interest you in doubling that extra return, and doing so within the same allotted 40 hours of the calculation above?



Getting stocks right: adding value

The next step is to differentiate between what are known as growth stocks and value stocks. Typical growth investors look for companies with rising sales and profits, companies that either dominate their markets or seem to be on the brink of doing so. These companies are typical of those in the S&P 500 Index of Portfolio 1.

Value investors, on the other hand, look for companies that for one reason or another may be temporary bargains. They may be out of favor with big investors because of things like poor management, weak finances, new competition or problems with unions, government agencies and defective products.

Value stocks are regarded as bargains that are expected to return to their supposedly "normal" levels when the market perceives their prospects more positively. Some well-known examples, taken from the largest holdings of the Vanguard Value Index Fund in December 2011, include Exxon Mobil, General Electric, Proctor & Gamble, AT&T and Johnson & Johnson.

Historically,
value stocks
outperform
growth stocks.

The Ultimate Buy-and-Hold Strategy uses a purely mechanical approach to identify value companies. This approach starts by identifying the largest 50% of stocks traded on the New York Stock Exchange and then including all other public companies of similar size. These companies are then sorted by the ratio of their price per share to their book value per share. The top 30% of this list, the companies with the highest price-to-book ratios, are classified as large-cap growth companies. The bottom 30% are classified as large-cap value companies. The process is the same for small-cap stocks.

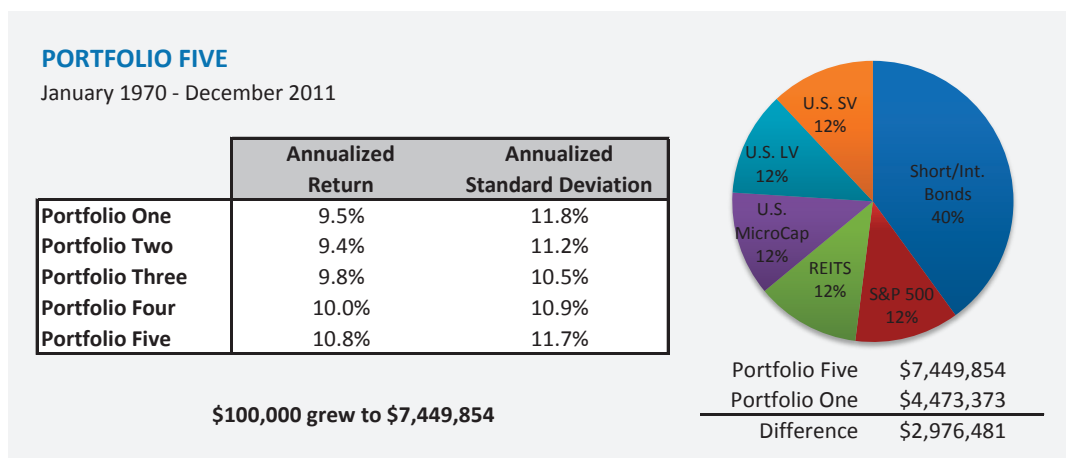
Although the most popular stocks are growth stocks, much research shows that historically, unpopular (value) stocks outperform popular (growth) stocks. This is true of large-cap stocks and small-cap

stocks, and it's true of international stocks as well. From 1927 through 2011, an index of large U.S. growth stocks produced an annualized return of 7.6%; large U.S. value stocks, by contrast, had a comparable return of 10.47%. Among small-cap stocks over the same period, growth stocks returned 8.11%, and value stocks returned 12.99%.

Therefore, we create Portfolio 5 by adding slices of large-cap value and small-cap value so that the stock side of the portfolio is divided equally five ways.

This boosts the portfolio's historic return to 10.8%, still with a slightly lower standard deviation than Portfolio 1. And notice how much this adds to the 42-year cumulative return: nearly \$3 million. That is more than three times the "added value" that came from Portfolio 4.

To recap, we started with a standard industry portfolio mix, re-fined the bond portion and added real estate, small and value stocks to the stock portion. The



result is an increase of nearly 14% in annualized return (and of about 67% in cumulative return) at essentially the same level of risk.

Now there is one more very important step in creating the Ultimate Buy-and-Hold Strategy.

Getting stocks right globally

The final step toward Portfolio 6 takes us beyond the borders of the United States to invest in international stocks. U.S. and international stocks both go up and down, but often they do so at different times and different speeds. Because of this, international stocks are diversifiers that can reduce volatility. However, U.S. and international stocks can decline at the same time, as we saw in 2008.

Like U.S. stocks, international stocks have a long-term upward bias. Yet when the shorter-term movements of U.S. and international stock markets offset each other, as they often do, the combination has a smoother long-term upward curve than either one by itself.

There are two major reasons that international stocks help diversify U.S. stocks. First, they trade and operate in different economic environments with different growth rates and monetary policies. Second, currency fluctuations affect their prices when translated into U.S. dollars.

The virtues of small-cap stocks and value stocks apply equally to international stocks as to U.S. stocks. Portfolio 6 slices the stock portion equally 10 ways, adding international large, international large value, international small, international small value and emerging markets.

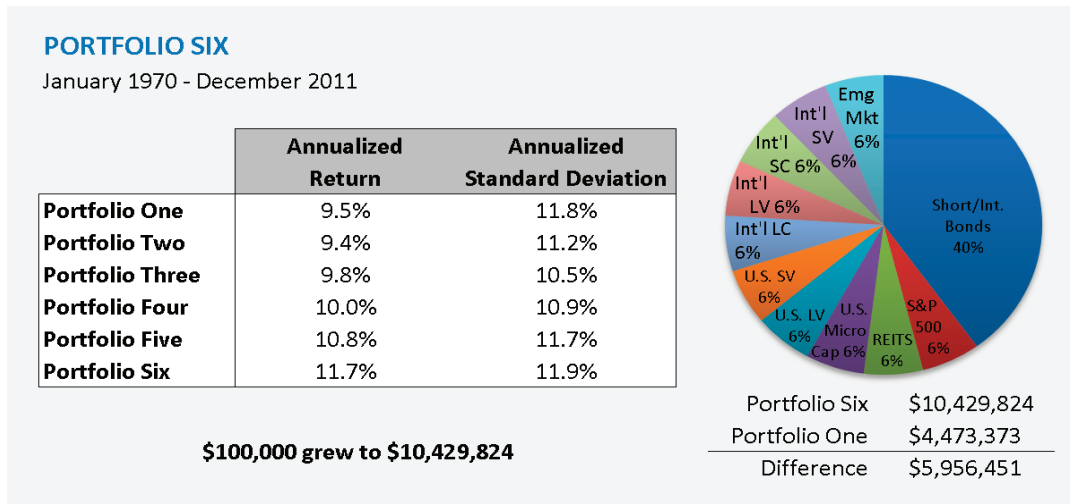
Emerging markets stocks have outperformed the Standard & Poor's 500 Index over long periods of

time. They represent countries that are growing rapidly, and they have become an increasingly important part of the world's total market capital.

As you can see, the annualized return of Portfolio 6 jumps to 11.7% and the standard deviation is 11.9%. Cumulatively over 42 years, this portfolio grew to \$10.4 million, more than twice as much as Portfolio 1. If you go back to the premise that you could implement this strategy in a total of 40 hours,

the added-value return works out to about \$149,000 per hour for your time. (Too bad you can't do that for a whole career!)

This completes the basic makeup of the Ultimate Buy-and-Hold Strategy, which over this time period increased annu-



alized return by 23% without really increasing volatility. This investment strategy is not complicated, and it's based on solid research, not hocus-pocus. It doesn't require a guru. It doesn't require investors to figure out the economic landscape or make predictions about the future.

With 2008 and early 2009 fresh in our minds, let me say a few things about risk. While the standard deviation of Portfolio 6 is about the same as that of Portfolio 1, I think the real risk was much lower. Consider that Portfolio 1 contained only about 500 stocks. Now consider all the stocks held by all the funds in Portfolio 6. At the end of September 2011, according to Dimensional Fund Advisors, those funds owned a total of 12,411 stocks. Portfolio 6 entails ownership in many thousands of stocks, not just 500. To my way of thinking, that much diversification is very worthwhile in terms of peace of mind.

Putting this strategy to work

The trickiest part of the Ultimate Buy-and-Hold Strategy is getting the level of risk right for each individual investor. The most important asset-class decision an investor makes is how much to have in bond and how much in stocks. In these illustrations we have used a 60/40 mix. That is an industry standard, and I believe that over a long period of time many investors can use it to accomplish their goals at reasonable levels of risk.

But this may not be right for you. For help in applying risk-vs.-reward to your own situation, I suggest you read one of our most important articles, "[Fine tuning your asset allocation.](#)"

A note on using this strategy in taxable accounts

This combination of asset classes works best in tax-sheltered accounts such as IRAs and company retirement plans. In taxable accounts, we recommend leaving out the REIT fund and dividing that portion of the portfolio equally among the other four U.S. stock classes. I say this because real estate

funds produce much of their total return in the form of income dividends that do not qualify for the favorable tax treatment afforded to most other dividends.

Many investors implement this strategy in taxable accounts to supplement their employee retirement plans in order to capture asset classes not available in those plans. Investors who take this approach, which we favor, should hold REIT funds in their tax-sheltered accounts.

What's wrong with this strategy?

Even though this is the best buy-and-hold strategy we know for serious long-term investors, it isn't flawless. Investment markets are not highly predictable, and this strategy might not work as well in the future as well as it did in the past.

The stock side of this portfolio is overweighted to value stocks. Yet it is quite possible that value stocks will underperform growth stocks over the next five, 10, 15 or 20 years. The portfolio also contains lots of small-cap stocks. But it's possible that large-cap stocks will do better than small ones in the future. This portfolio contains more exposure to international stocks than most advisors recommend. International stocks could underperform U.S. stocks in the future. Likewise, it's possible that bond funds, which make up a minority of this portfolio, could do better than stocks in the future.

All this uncertainty is simply inevitable. Still, I believe the Ultimate Buy-and-Hold Strategy deals very well with it. If you own this portfolio, you aren't dependent on any particular asset class. You have them all. And no matter which ones are doing well, you will own them.

To my mind, this is the best an investor can do. And when you have done your best, it's time to turn your attention to something else. A very good "something else" is to make sure you are living your life the way you want to.

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Merriman is an investment advisory firm registered with the Securities and Exchange Commission. Based in Seattle, we manage more than \$1 billion in investments for clients all across the country.

Since Merriman was founded in 1983, we have maintained a commitment to empowering people, whether they become our clients or not.

We give advice on everything from investment basics to college funding and retirement distributions, taking the time to educate our clients along the way so they can feel comfortable with their money management strategy.

Our services are specifically structured to help reduce the level of emotional decision making that can derail the best of plans. Your advisor will work with you to create a detailed investment plan and then will work on your behalf, making sure it gets implemented and keeping your portfolio appropriately structured over time.

We give you the time and freedom to focus on the more enjoyable aspects of life.

For additional information about our programs, services and investment philosophy, or to request a one-on-one consultation with one of our financial advisors, please visit us on the web.

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Invest Wisely. Live Fully.

Disclosure

This document contains hypothetical results. Although we have done our best to present this information fairly, hypothetical performance is still potentially misleading. Hypothetical data does not represent actual performance and should not be interpreted as an indication of actual performance. This data is based on transactions that were not made. Instead, the trades were simulated, based on knowledge that was available only after the fact and thus with the benefit of hindsight. Results do not include the impact of taxes, if any. Past returns are not indicative of future results.

Data sources:

The following data sources were used to develop the tables and figures in this workshop. Note that many of our return series rely on academic simulations gathered and developed by Dimensional Fund Advisors (DFA). All performance data are total returns including interest and dividends. Simulated data subtracts the current expense ratio for the comparable fund, except for the S&P 500 Index.

Stocks:

Emerging Markets	DFEMX to May 1994, DFA simulation back to Jan 1987.
Emerging Market Core	DFCEX from May 2005.
Emerging Market Small Cap	DEMSX back to 1999, DFA simulation back to Jan. 1987.
Emerging Market Value	DFEVX back to 1999, DFA simulation back to Jan. 1987.
International Large Cap	DFALX back to 1992, MSCI EAFE back to 1970.
International Large Cap Value	DFIVX back to Mar 1994, DFA simulation back to 1975.
International Small Cap	DFISX back to Oct. 1996, DFA simulation back to 1970.
International Small Value	DISVX back to 1995.
Large Cap	DFUSX starting 5/2010, DFLCX from 1/1991 - 4/2010, S&P 500 from 1970 - 1990.
Large Value	DFLVX back to 1994, simulation back to 1970.
Large Value Index	DFA simulation back to 1927.
Micro Cap (or Small Cap)	DFSCX back to 1983, Dimensional US Micro Cap Index to 1970.
Real Estate Investment Trusts	DFREX back to Jan. 1993, Don Keim REIT Index 1975-1992, NAREIT 1972-1974.
S&P 500	S&P 500 Index, provided by Standard & Poor's Index Services Group, through DFA.
Small Value	DFSVX back to 1994, DFA simulation back to 1970.
Small Value Index	DFA simulation back to 1927.

Bonds:

Barclays Government Credit Index	50% long-term corp., 50% long-term government for 1970-1972 (from DFA Matrix 2004), Barclays Government/Credit Bond Index from 1973 to present, through DFA.
Barclays U.S. TIPs	Back to March 1997 to June 2000, Morningstar.
DFA TIPs	DIPSX starting January 2007.
DFA Intermediate Government Bonds	DFIGX, Morningstar.
Vanguard Short-Term Treasuries	VFISX, Morningstar.
Vanguard Intermediate-Term Treasuries	VFITX, Morningstar.
Vanguard Inflation Protected Securities	VIPSX, Morningstar from July 2000 to December 2006.

Portfolios 1-6:

- Yearly rebalancing
- U.S. Stock Allocation: 20% each in LC, LCV, SC, SCV, and REITs
- International Stock Allocations:
 - 1970-1974: 50% Int. LC, 50% Int. SC
 - 1975-1986: 25% Int. LC, 25% Int. LCV, 50% Int. SC
 - 1987-1994: 20% Int. LC, 20% Int. LCV, 10% EM, 5% EMS, 5% EMV, 40% Int. SC
 - 1995-2005: 20% Int. LC, 20% Int. LCV, 10% EM, 5% EMS, 5% EMV, 20% Int. SC, 20% Int. SCV
 - 2006 - 2011: 20% each in Int. LC, Int. LCV, Int. SC, Int. SCV, and EM Core
- Bond Allocation is:
 - 1970 - 1996: 30% Short-Term Treasury, 70% Intermediate-Term Government
 - 1997 - 2011: 30% Short-Term Treasury, 50% Intermediate-Term Government, 20% TIPs.