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Smart Investing Conference Call
Is Buy and Hold Investing Dead?

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Is Buy and Hold Dead?

- After the S&P 500 fell 37% in 2008, claims that long-term buy and hold investing no longer works began to proliferate
- One example:

  "A down trend can be neutralized and even turned into a profit opportunity, by adding short or leveraged short ETFs. If the market decides to move up, extra returns can be squeezed out with leveraged ETFs." (Simon Maierhofer on CNBC)
- It's clear how brokers benefit from this type of advice, but does this really work for individual investors?

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What is Buy and Hold?

- Long-term, fundamentally oriented investment strategy
- Look to the underlying strength of company cash flows
  - Accept short and intermediate term price volatility if current valuation is reasonable
- Long-term, strategic allocation to stocks, bonds, real estate and other assets
  - Rebalancing around targets
  - Opportunity for moderate tactical shifts
- Key to success – buy at a reasonable price
  - Tech stocks in 1999 – 100X Earnings
  - Core real estate in 2006 – 4% cap rates
  - Long term treasuries in 2008 - 2.2% yield
  - Stocks in 2007 – 18x Earnings
    - Not a “bubble” valuation

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What are the Options to Buy and Hold?

- Market timing
  - While everyone can participate in the long term returns of the financial markets, market timing is a zero-sum game
  - Depends on someone to buy stocks from you at the top and sell them to you at the bottom
  - Most market timing strategies use some combination of technical and macroeconomic analysis and they ignore the systemic implications of what happens when enough participants in the market use similar strategies
  - The financial markets exist primarily to allocate long term capital to businesses and a pervasive short-term casino mentality threatens the underlying stability of the overall economy
  - Infrequent and large “bets”
    - Must time both exit and reentry points correctly to add value
- A “black box”
  - i.e. Madoff or Renaissance
    - Renaissance is legitimate and the most successful hedge fund ever – annualized net returns of 35%+ per year for decades
    - Distinguishing one from the other can be difficult
    - Why bet your livelihood on one person’s acumen?

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Is Diversification Dead Too?

- All risky assets became correlated in 2008
- Even if underlying fundamentals were unaffected, many investors were forced sellers due to leverage and liquidity needs
- Risk vs. Uncertainty
  - Risk can be quantified
    - i.e. blackjack odds, mortality tables, sports betting
  - Uncertainty cannot be quantified
    - Whether stocks will outperform bonds
    - Future levels of inflation or economic growth
    - Which companies will survive or go out of business due to some new competitor
- Failure of badly designed risk models
- Basic rationale for diversification – we cannot know the future

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Profit Maximizing vs. Maximizing Odds of Survival

- Losses cause more pain than gains bring pleasure
- Many hedge fund models based upon getting paid for assuming a small risk of a catastrophic blowup
  - Leveraged arbitrage strategies
    - Sowood, Amaranth, LTCM, Granite
- Other examples of profit maximizing that assume survival risks
  - Leveraging personal assets
  - Extreme versions of "Yale-model" portfolios
    - Very few endowments went into 2008 with more than 10% in cash & fixed income
  - Trying to always beat benchmarks
    - During speculative periods this requires owning large concentrations of the most risky and overpriced securities within that benchmark
- Brittle vs. Robust portfolios
  - Leverage, poor diversification, liquidity mismatches will all tend to make "brittle" portfolios that will collapse in a downturn
  - Reduction in price vs. destruction of value

What is Required for the Long-Term Buy and Hold Investor to Succeed?

- Reasonable valuations
- Liberal economic system
- Rule of law / enforcement of property rights
- Even then, 5-7 years of cash flow requirements in high quality cash and fixed income is advisable

Buy and Hold is the Worst Possible Investment Strategy … Except for all the Others

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- A strategically allocated, diversified portfolio that matches liquidity needs remains the only serious investment strategy
- While the prices of stocks, real estate and other risky assets are volatile, holding these assets provides exposure to the overall productive activity of the economy
- The aftermath of this financial panic will likely limit economic growth for several years
- Public finances throughout the developed world face serious challenges by the recent explosion of deficit spending and the looming insolvency of entitlement programs due to aging populations
- However productivity, enabled by technology and globalization, has continued to grow
- Technology continues to offer a path to continued, and likely accelerating, increases in output and per capita GDP

Contact Information

Paul Comstock Partners ®
Two Riverway, Suite 1000
Houston, TX 77056

Main (713) 977 2694
Fax (713) 877 1363

www.paulcomstockpartners.com