



THE HARBOR OAK GROUP AT MORGAN STANLEY

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“Know when to hold ‘em, Know when to fold ‘em”

In 2010, three college professors from UCLA wrote a research paper entitled “Overconfidence, Under-reaction, and Warren Buffett’s Investments.” While reviewing the quarterly SEC filing for Berkshire Hathaway from 1980-2006, they uncovered that the median hold period for a stock in Buffett’s portfolio was just one year. Only 20% of the stocks were held more than 2 years, and approximately 30% of the stocks were held less than 6 months. Perhaps Mr. Buffett is more of an active trader than he leads people to believe* ...

Over the years, many successful investors have come to the realization that “buy and hold” can often be a very expensive exercise as not all good companies are good forever. Take for example, Cisco Systems, the stock was trading in the upper \$70s in 2000 and after 16 ½ years the stock is still under \$30. How about the Bank stocks? Bank of America was trading in the high \$50s in 2007 and after seven years it is still trading under \$15 a share. Citigroup was also trading in the \$50 range in 2007 and if you adjust for the 10 to 1 reverse split it is still trading below \$5 dollars a share. Not to mention all the companies that have filed Chapter 11 or sold for pennies on the dollar. So what happens when you find yourself with what you think is a good company and the stock starts going down? I think Kenny Rogers said it best - *you’ve got to know when to hold ‘em , know when to fold ‘em, know when to walk away, know when to run.***

In analyzing data from the Dalbar study conducted from 1995-2014 (see chart below), it was found that the average investor underperformed the broad equity market by over 7% per year. Therefore it’s relatively safe to assume the majority of investors are not following Kenny’s sage advice. It’s difficult for humans to be unemotional and admit they are wrong. Selling a stock for a loss can feel akin to a failure or personal mistake. It’s very natural to sell the winners too soon and hang onto the losers for way too long. The great investor Peter Lynch once said, “stocks will go up 20-30% and people get rid of it while they hold on to the dogs, it’s sort of like watering the weeds and cutting out the flowers.”***

A key component to successful investing is to always manage risk and have a plan for when a stock starts going south. Similar to professional golfers, it’s impossible to hit every shot perfectly during a tournament. It’s the magnitude of the bad shots and how you recover that separates the winners from the field. Financial commentator, Art Cashin, has said many times, “You do not survive in this business for 50 years if you don’t find out where the exit signs are the minute you enter the room.”

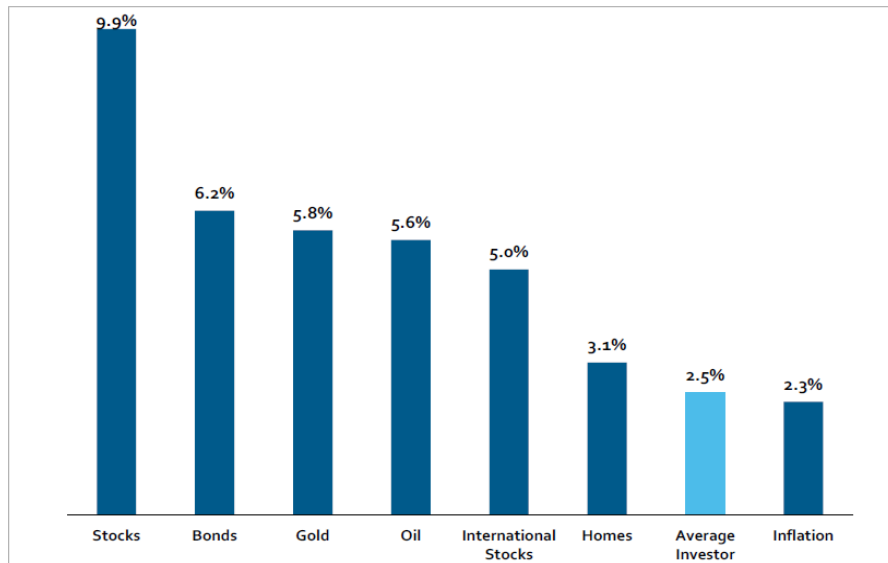
That said, utilization of technical analysis as a risk mitigation tool can help determine when to hold and when to sell. Often the fundamentals don’t change until the stock has already dropped considerably. Of course, it’s still extremely important to understand the fundamentals – but at the end of the day you have to respect what the chart is saying. Technical analysis is simply measuring the relationship between supply and demand. Like everything in life, stocks are only worth what the next buyer is willing to pay for it.

Kenny Rogers says it best -*the secret to survivin’ is knowin’ what to throw away and knowing what to keep.*



The Average Investor Underperforms

20-Year Annualized Returns by Asset Class (1995-2014)
As of December 31, 2014



Source: Morgan Stanley Wealth Management GIC, Bloomberg, Dalbar. Past performance is no guarantee of future results. It is not possible to directly invest in an index. Oil is represented by the change in price of the NYMEX Light Sweet Crude Future contract. Contract size is 1,000 barrels with a contract price quoted in US Dollars and Cents per barrel. Delivery dates take place every month of the year. Gold is represented by the change in the spot price of gold in USD per ounce. Homes are represented by the National Association of Realtors' (NAR) Existing One Family Home Sales Median Price Index. Stocks are represented by the S&P 500 Index, an unmanaged index that consists of the common stocks of 500 large-capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. Bonds are represented by the Barclays US Aggregate Bond Index, an unmanaged market-weighted index that consists of investment-grade corporate bonds (rated BBB or better), mortgages and US Treasury and government agency issues with at least 1 year to maturity. International stocks are represented by the MSCI EAFE Index, a broad-based measure of international stock performance. Inflation is represented by the Consumer Price Index. Average Investor is represented by Dalbar's average asset allocation investor return, which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/14, to match Dalbar's most recent analysis.

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*Social Science Research Network, July 5, 2010

** Thomas Reuters, July 6, 2016

*** Morgan Stanley Wealth Management GIC, Bloomberg, Debar 12/31/2014

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