Active Management Leads To More Consistent Returns, Study Shows

By Gary Case

Market averages are under pressure and they have not endured a major correction since late 2002, over five years ago. There is plenty of advice for investors to stay fully invested and not to try to "time" the market. One argument is: what if you miss some of those very good days because you are out of the market?

A study by Hepburn Capital Management, LLC says missing the best days of the market really doesn't matter, if investors also miss the bad days.

According to the chart below, the unlucky investors who miss strong days over the past 25-years would receive much lower returns. Will Hepburn, president of Hepburn Capital Management, says, "Clearly it doesn't pay to be unlucky."

The luckiest person around might miss the worst days in the market, instead, and boost their average returns. But how likely to actually happen is either of these scenarios? Not very. Statistically, missing just the best or worst days of the market is virtually impossible. History shows that the best days tend to closely follow the worst days. Sometimes they occur back to back. So if an investor misses one, chances are he will miss the other, as well.

What happens to an investor's returns if one were to sit out for both the worst days and the best days? Remarkably, average annual returns actually increase *and* become more consistent at the same time.

S&P 500 – 25 Years Ending Dec. 31, 2007 – Average Annual Return 10.28%			
	Miss the Best	**Miss the Worst**	**Miss Both Best and Worst**
10 days	7.43%	12.87%	10.56%
20 days	5.84%	14.64%	10.63%
40 days	3.07%	17.53%	10.56%

Source: Hepburn Capital Management 2007 Study

The worst days in the stock market tend to be much worse than the good days are good. Additionally, the worst days of the market rarely occur in isolation, but rather follow steadily deteriorating market values.

The Hepburn Capital study illustrates the point that investments actively managed for risk reduction may provide added potential benefits compared to a passive buy-and-hold approach, including more consistent returns and lower principal fluctuations.

Before you make up your mind whether or not it makes sense to actively manage your assets, you have to look at both sides of the argument. And you have to realize that any trading system isn't going to be perfect. But the good news is you don't have to be. Reduce your losses and you don't need eye-popping gains to exceed a buy-and-hold position. A buy-and-hold philosophy may overlook this point.

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