HEPBURN CAPITAL

Investments that Adapt to Changing Markets®

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Study: Active Management Delivers More Dependable Returns

Summary: The risk of selling and moving out of the stock market often focuses on missing good days and hurting overall returns. However, investors have an equal chance of missing a bad day and increasing returns. Since the best days often follow the worst days, back to back, it is statistically more likely that if an investor missed one he will miss the other. This expanded study looks at the outcome of missing both the best and worst days.

Prescott, AZ - Moving into 2014, stock market is basking in the afterglow of two years without a significant correction. It is difficult for investors to know what to do, including those that actively trade their holdings.

Investors looking for a better way will see articles and commentary telling them to stay fully invested and not to try to "time" the market. After all, runs the most common theme . . . What if you miss some of those very good days because you are out of the market?

The 2013 update to an ongoing an ongoing study by Hepburn Capital Management, LLC confirms that missing the best days of the market really doesn't matter if investors also miss the worst days.

The S&P 500 stock index averaged 7.63% annual return (dividends reinvested) for the period January, 3 1950 through December 31, 2013, the HCM study shows.

If you happen to be the unluckiest investor on earth, and you miss just the 10 strongest days over that, your return would have dropped to 6.39%. Move out of the market and miss the 20 best days and you end up with only 5.58% gains, and miss the 40 best days and your average gain drops to 4.18% per year, explained Will Hepburn, president of Hepburn Capital Management. “Clearly it doesn’t pay to be unlucky.”

The luckiest person around might miss the 10 worst days in the market instead and boost their average returns to 9.23%. If you are on a roll and miss only the 20 worst days your returns jump to 10.3%, and if you are lottery-winning kind of lucky and your streak has you out of the market for the 40 worst days your returns will soar to 11.96% annually, Hepburn explained.

But how likely is either of these scenarios? Not very. Statistically, missing only 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?” asks Hepburn. “Remarkably, average annual returns become more consistent and may actually increase at the same time. Our study shows that if one were to miss both the 10 worst and 10 best days the resulting average returns are 7.99%. Miss both the 20 worst and best, and annual returns become 8.22% and dodging the 40 worst and best days creates returns of 8.38%.”

S&P 500 – Jan 3, 1950 - Dec. 31, 2012– Average Annual Return 7.63%			
	Miss the Best	**Miss the Worst**	**Miss Both Best and Worst**
10 days	6.39%	9.23%	7.99%
20 days	5.58%	10.30%	8.22%
40 days	4.18%	11.96%	8.38%

Source: Hepburn Capital Management 2014 Study. Dividends reinvested.

Missing the 40 best and worst days produces increase in return over buy and hold of .75%. That may not sound like much, but that is a 9.84% earnings increase, and when compounded for long-term investors that makes a huge difference in the end results.

This increased earnings compounded over the life of the study results in a hypothetical $1,000 investment growing to $172,633 for the actively managed portfolio versus $110,655 for buy and hold.

As Novel Laureate Paul Samuelson said, “The longer one invests, the greater the chances of encountering a major market upheaval. Risk does not go down with time, it goes up!" The risk reduction potential of active management as modeled in this study is what accounts for the significant out-performance of actively manage portfolios.

The reason that missing both best and worst days both increases one's returns and dramatically reduces volatility is that the worst days in the stock market tend to be much worse than the good days are good. Throw in the math of gains and losses and the case for risk management becomes clear.

If you lose 10% you must have an 11% gain to break even. A 50% loss requires a 100% gain to return to breakeven making it much more important to avoid a large loss than make a gain of the same amount.

Although past performance does not assure future results, 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.

Hepburn also points out that it's also much easier to deliberately miss the worst days of the market, because they rarely occur in isolation, but rather follow steadily deteriorating market values.

"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 no trading system is going to be perfect. But the good news is you don't have to be. Simply reduce losses and you don't need eye-popping gains to exceed a buy-and-hold position. That's what the buy-and-hold argument conveniently overlooks."

Will Hepburn is a private investment manager who specializes in active investment strategies. He is President of Hepburn Capital Management, LLC, a Registered Investment Advisor, and a Past President of NAAIM, the National Association of Active Investment Managers (www.NAAIM.org) He may be reached by emailing Will@HepburnCapital.com, by calling (800) 778-4610, by writing to 2069 Willow Creek Road, Suite A, Prescott, AZ 86301, or by visiting our web site at www.HepburnCapital.com

The returns provided above are historical and shown for purely illustrative purposes. The S&P 500 is an unmanaged index and individuals cannot invest directly in the index. No consideration is made of costs that would have been incurred to actively manage a portfolio of S&P 500 stocks. Past performance is not a guarantee of future returns.