

# The Week

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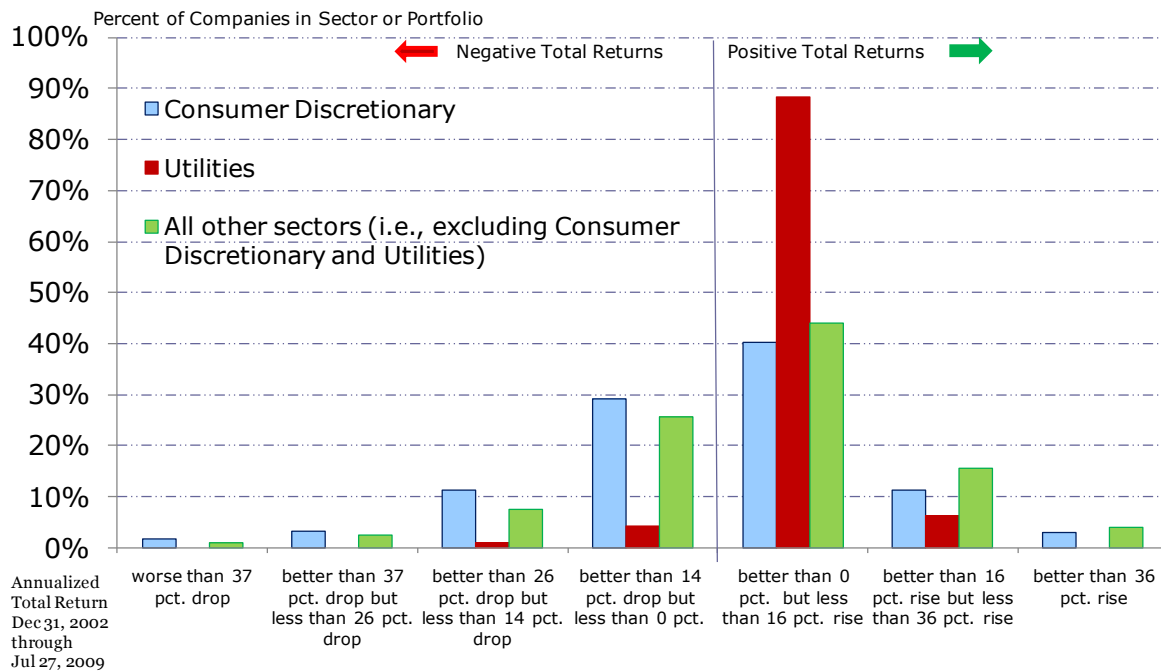
Tom McManus, Chief Investment Officer

## Updating Our "Buy & Hold" Analysis: Is It Really a Strategy "For the Birds"?

- The popular stock market indexes have broken through to new highs for 2009, fanning confidence in an eventual economic recovery. Meanwhile, we have heard a number of commentators claim that one of the important lessons that investors should take away from 2008 is they can no longer depend on a strategy of "buy and hold".
- For the most part, we disagree. While we concur that it always makes sense for equity portfolios to be closely monitored and managed, we believe there are strong businesses that many investors can comfortably own through the bad as well as good times. Investors like these probably realize that **one important key to success is to focus less on what they make during the good times, and more on what they keep over the long haul.**
- Berkshire Hathaway (NYSE: BRK/A, \$95,700) has risen +31.5% (+4.25%/year) since the end of 2002 — roughly, an equivalent time to the present in terms of the stock market cycle. While it is true that this return is only a little better than one might have received in the money markets, today's challenges are more grave than those we faced in the last recession, so that may portend more opportunity when conditions eventually improve.
- Years ago, Berkshire CEO Warren Buffett said that his preferred investment horizon is "forever." Earlier this year, he wrote "the investment world has gone from underpricing risk to overpricing it," and "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."
- It turns out that the Berkshire return is only a little lower than the median total return for a broad group (over 3100 companies) of stocks that were continuously listed in the US over the same timeframe. The Standard & Poor's 500 and Dow Jones Industrials provided positive returns (+2.7%/yr.) over this period, too, but lagged the average stock because of heavy concentration in some areas where the value destruction was greatest.
- The nature of an investor's portfolio is important to its success. Indexed portfolios have become increasingly popular since they first appeared in the 1980's, as more investors focused on efficiencies and costs. But some of the popular indexes may be too heavily weighted in the highest capitalization stocks, putting investors at the mercy of some nasty surprises like the collapse of technology stocks in 2000-2002 and the financial stock meltdown that began in 2007.
- When many observers refer to the "market," they are usually referencing the S&P 500 or the Dow. We have illustrated in a prior issue (see "The Week," February 2, 2009) how closely these two indexes have tracked each other. But we believe investors would be better informed if they instead considered the "market" to be a broad, equal-weighted index like the Value Line or perhaps the S&P 500 Equal Weighted index. In our opinion, investors should regard the "classic" S&P 500 as a specific portfolio with a heavy bias toward large-capitalization stocks. Sometimes, that bias can be a benefit ... but it can also be a detriment, as we saw in 2000 and 2008.
- Investors have come to recognize risk as the volatility of financial assets, or their tendency to bounce around a central path of value created over time. For any given rate of return, lower volatility is better, as holders feel more confident they can redeem (or invest more) at a fair price.

### Distribution of Historical Performance of a Wide Range of Stocks by Sector

Annualized total return from December 2002 through July 27, 2009



Total return includes reinvested dividends. There is no assurance companies will continue to pay, or increase their dividends. Analysis is based on the performance of all 3141 companies continuously US-listed throughout investment period. Past performance is not a guarantee of future results. Source: Company Reports, Standard & Poor's.

Our historical analysis allows a look into another kind of risk, called "dispersion risk," that can affect investors' portfolios in a meaningful way. About 63% of the 3141 stocks provided a positive return including dividends over the 6.5-year period; the median return was +33% (about +4.5% per year). The median returns by sector varied from a tiny gain of +0.25% per year for financial companies, all the way up to a gain of +13.5% per year for those in the energy sector.

It is important to realize that some of the stocks in existence at the start of the period are no longer listed, for various reasons. Some have been acquired, and may have provided their investors with better-than-average returns. Others may have been delisted for less fortunate reasons, perhaps bankruptcy and/or liquidation. Thus, our analysis has a "survivorship bias," which can cause returns to be overstated and risks understated.

In the chart above, we show the distribution of returns in the consumer discretionary and utilities sectors — and the 8 remaining sectors as a group. Note how the spread of the distribution (a.k.a. "dispersion") of returns in the consumer discretionary sector is wider than utilities, and the remaining sectors. Some sectors may have some very strong and exciting performers, but we have to be careful — as investors — not to presume that our big gainers will compensate for the inevitable disappointments.

Meanwhile, the utility stock returns are concentrated tightly around the median annual return of +9.1%. About 5% of the stocks fared significantly worse, but more exceeded the average return by a meaningful amount. While many investors consider utility stocks to be too conservative, results like these might change some minds.

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An index is not managed and is unavailable for direct investment.

Investments that are concentrated in a specific sector or industry may be subject to a higher degree of market risk than investments that are more diversified.

**Investment and Insurance Products: ►NOT FDIC Insured ►NO Bank Guarantee ►MAY Lose Value**

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