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The Market is Up (a Lot)… *Should That Change How We Invest?*

By Ian A. Post, CFA, CFP®

A new client recently suggested that since the market is at a top (her characterization) it may make sense to set up a more conservative portfolio allocation, her concern being that she might invest in equities right before the market falls apart. The problem with this line of reasoning is that we can only see market tops in hindsight.

The market has, in fact, had a long winning streak. The S&P 500 has produced a positive return every calendar year beginning in 2009 through 2016, and is up almost 12% in 2017[1]. The annualized return of 14.9% during this period significantly exceeds the 10% long run annualized return of the S&P 500 since 1926. An investment approach based on the idea that this streak must end badly at some point seems, at first, like it could have some merit.

Do market timing strategies have merit? The following three arguments and counter arguments refute the case for implementing a market timing strategy.

"The market has gone up for a long time, the bubble is going to burst" argument.

Since 1926, there have been two other periods of eight consecutive calendar year positive returns, 1982-1989 and 1991-1998. We can review the resulting one-year and five-year cumulative returns following those periods to get some perspective. Following the 1982-1989 period, the cumulative one and five-year returns were -3.1% and 51.7% respectively and following the 1991-1998 period, the one and five-year returns were 21.0% and -2.8% respectively. In the very limited history of this scenario we have ambiguous results. In one case, the following year was bad but the cumulative next five years were good and vice versa in the other.

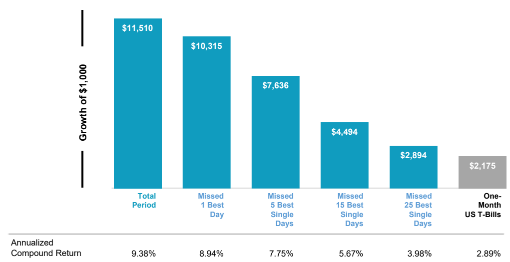
"The market is expensive, the bubble is going to burst" argument.

According to the Shiller CAPE P/E 10[2] valuation methodology, the current Price/Earnings ratio of the S&P 500 of 30 is roughly double the long-run average of 16.8 dating back to 1881. The Gordon Growth Model, a basic finance formula, can help us understand the implications of high market valuations. The formula relates the market price to current earnings, earnings growth and the required rate of return on stocks. Assuming an earnings growth rate consistent with the historical average of about 6% since 1960, a P/E of 30 is consistent with a required rate of return on stocks of 9%. At lower valuations, the required rate of return is higher, 12% in the case of the long run average P/E of 16.8. The idea is that high valuations don't **necessarily** translate into market meltdowns. Instead, they are mathematically consistent with lower expected returns (which still might be better than alternatives such as bonds or cash).

"The just don't invest in equities until after the market falls apart" argument.

If one were still interested in implementing a market timing strategy, it is useful to be aware of just how difficult a successful market timing strategy is to implement. The chart shows that in the 27-year period from October 1989 — December 2016, missing just a handful of the best trading days reduced equity returns dramatically. In fact, missing just the best 25 trading days during that period reduced equity returns to just a hair above ultra-safe one-month treasury bills.

Performance of the S&P 500 Index, October 1989 – December 2016



Despite the emotional response that long run positive market returns generate, there is little evidence that we can predict market meltdowns. There's even less evidence that we can produce the kind of precision necessary to implement a successful market timing strategy. Ultimately, discipline (by setting and sticking to a long term strategic asset allocation) is the primary determinant of investing success.

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[1] *As of 7/25/17* [2] *A well-known market valuation methodology developed by Robert Shiller, Professor of Economics at Yale University*

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