Second Quarter 2017 Knowledge College

Market at New High! Should I Care?

As equity markets continue to climb, investment news outlets are seemingly awash with headlines of markets reaching new highs. Whether implicit or explicit in the article, these headlines are serving as warning signals to investors. Like throwing a ball into the air, when it hits its "all-time high" it is bound to come down, right? We're skeptics of flashy headlines as fodder for good decision making so we decided to explore this concept. Does the market hitting a new all-time high signal a warning for investors that the market will drop?

We have used the S&P 500 Index for this evaluation because it is one of the most commonly known and cited equity indexes. On June 19, 2017 the S&P 500 Index reached an all-time new high of 2,453.46. Is this a meaningful data point for investors to consider? We looked back to the start of the year and found the S&P 500 Index has made 25 new all-time highs as shown in Figure 1. Admittedly, six months of data is a very limited time period so we expanded our look-back to five years ending June 30, 2017. In the last five years there have been 194 new all-time market highs followed by subsequent higher highs as shown in Figure 2. Thus far, reaching a new all-time high is not proving to be a strong data point to consider for investment allocations.

Figure 1

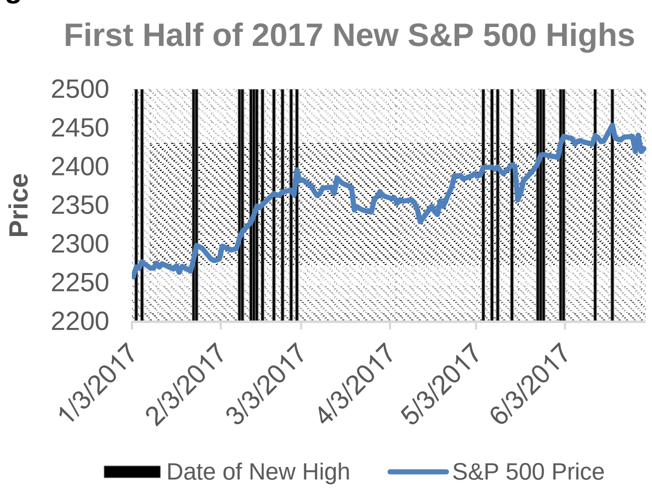
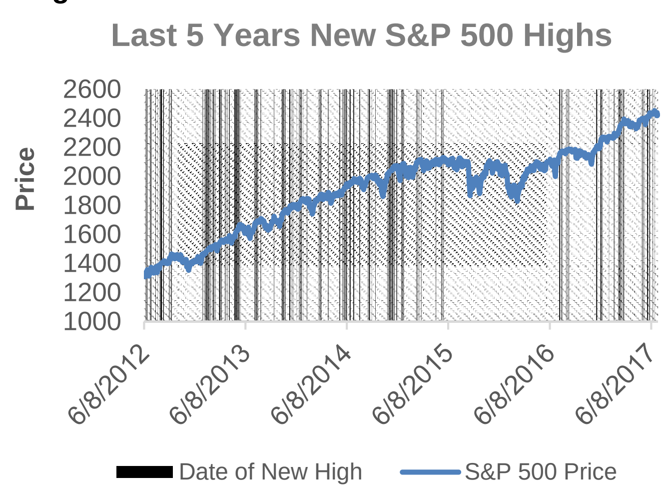


Figure 2



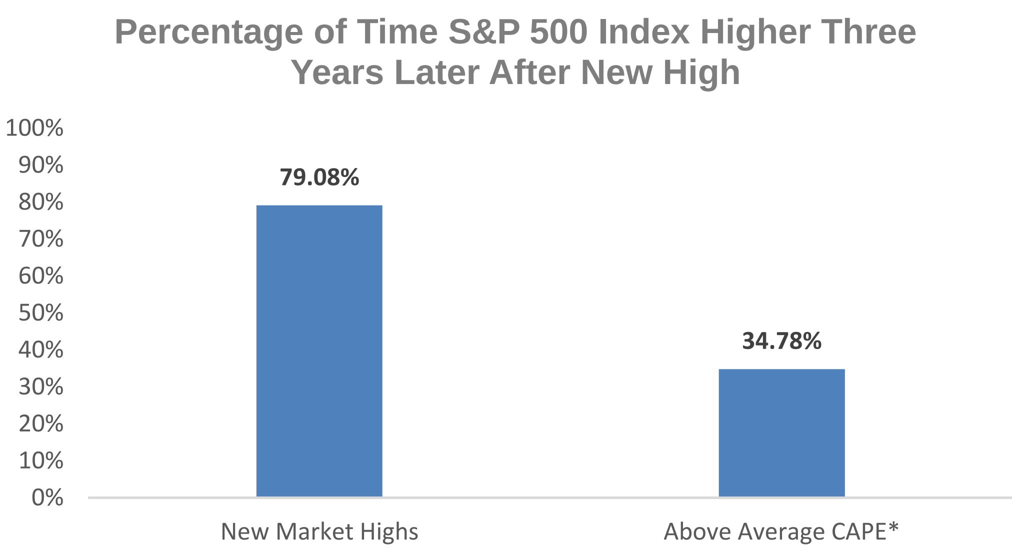
However, those of you that know us best realize five years of data is hardly the sample set we would consider meaningful. After all, we advocate our clients invest in 10 year increments leaning into opportunity and away from risk on a systematic basis. We also acknowledge that the last five years have been robust markets for equity investments. To further test the concept of new highs we modified the question slightly and lengthened the data set. Let's say we all agree that we are long-term investors, but we do not have infinite patience.

Therefore, we have decided that a three year snapshot is a good window to judge outcomes. The ultimate question we sought to answer is: "If we sold the S&P 500 Index at a new market high, would my portfolio be better or worse off three years later?". To address this question with a longer data set we have tested this question back to January 1926, the longest track record available for the S&P 500 Index.

This time period covers one depression, many recessions, a world war, inflationary, deflationary markets, and most markets in between. Despite the longer time frame, the data shows similar outcomes to the last five years. That is, future returns give little regard for new all-time highs. 79% of the time an investor sold on new highs they were worse off three years later. Said another way, that decision only pays off one out of every five times. So what went wrong?

Selling new highs *feels* like a natural and protective instinct. Much like our analogy of the ball at its apex, we can point to many other things in our lives that when they hit new highs we tell ourselves there is likely more room to fall. The problem here is a numerical new high, like the S&P 500 Index reaching 2,453.46, has no context to present day or history. The price of an index has grown over time, but so has the world around it. Earnings and revenue produced by companies have grown over time so without knowing the context of the price, you have no way of knowing how much you are buying for that price tag. Additionally, inflation changes the context of numbers throughout history. Think of a candy bar once costing 5 cents. This leaves data on new all-time highs far less meaningful than one would presume. Often, headlines are using new all-times highs as a shorthand for valuation, the notion of selling at high prices or conversely buying low is a defensible strategy.

Figure 3



Sources: Morningstar Direct
http://www.econ.yale.edu/~shiller/data.htm

To this end we agree valuation is important to consider, but we define valuation as Cyclically Adjusted Price-to-Earnings (CAPE) rather than new highs. CAPE is a commonly used valuation metric and addresses our concerns of relevance by considering price in context with the earnings of companies while adjusting them for inflation. Additionally, since CAPE is a relative metric we compare it to its average rather than all-time highs. Therefore, above average CAPE*, would be considered expensive rather than new highs. We reran our analysis with this in mind and asked the same questions; “If we sold the S&P 500 Index at above average valuation, would my portfolio be better or worse off three years later?”. As you can see from Figure 3, the results are meaningfully different. Modifying to valuation changes the results to being right far more often than wrong. This, albeit rudimentary, application of meaningful data made all the difference. While we still do not advocate for market timing nor to use CAPE as a sole data point, we continue to advise investors to question the flashy headline and apply a stayed and prudent approach to allocation. Long-term success is often built on avoiding the simple compelling mistakes like flashy headlines.