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The U.S. bull market: Is it time to get out?

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Snapshot

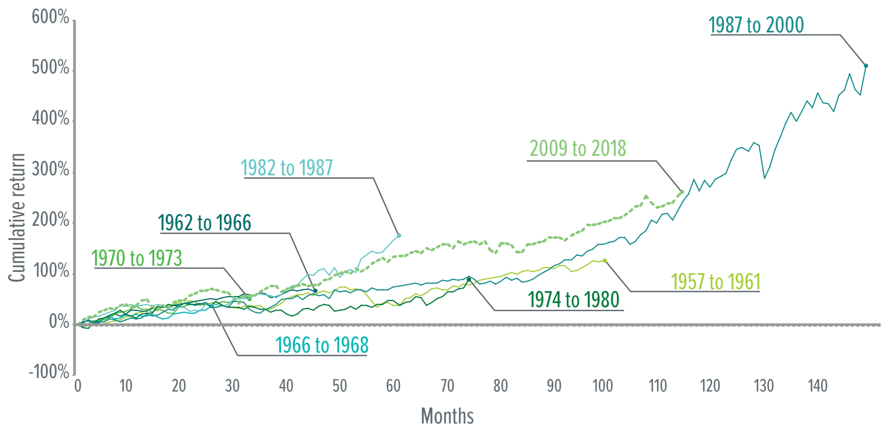
- The duration of the current U.S. bull market has some investors asking whether it's time to head for the exits.
- Trying to time market peaks and troughs is exceedingly difficult (if not impossible) and can be quite costly.
- Well-designed portfolios should already incorporate the possibility of bear markets in their underlying return assumptions.
- In portfolios with active management components, measures can be taken to reduce risk within a prescribed risk budget.

Many investors are concerned that the U.S. stock market may have recently peaked. This is one of the longest bull markets on record, with valuations appearing elevated by some measures and the U.S. economy having avoided recession for almost a decade. At SEI, we regularly receive questions like: "How much longer can this last?" "Are high valuations a warning sign?" "Can the economy keep going?" "Should I sell my stocks?" While these worries are certainly understandable, it's important to step back and assess them rationally.

Is the bull too long in the tooth?

Aside from the epic bull that ran from 1987 to 2000, the current bull market in U.S. stocks—as measured by the S&P 500 Index from the bottom of the preceding bear market in 2009—is the most significant on record in terms of both cumulative return and duration (Exhibit 1).

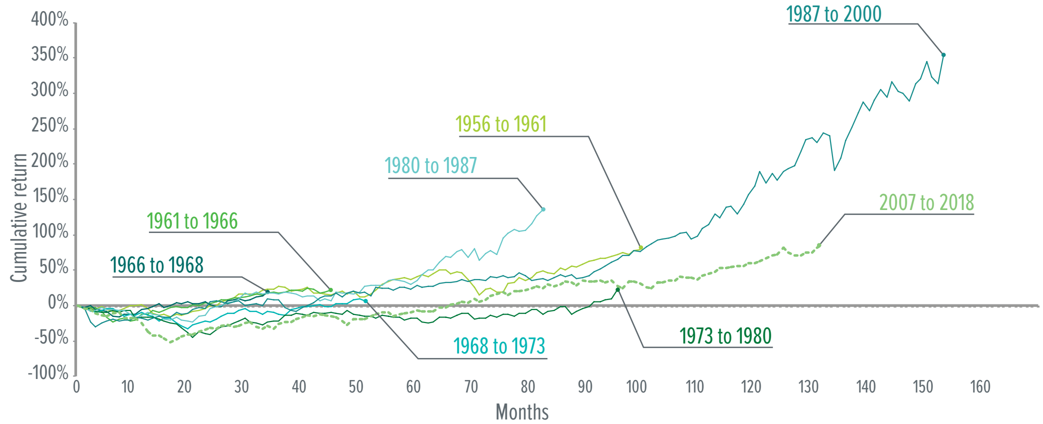
Exhibit 1: S&P 500 Index Bull Markets, Trough to Peak



Sources: Bloomberg, Yardeni Research, Inc., SEI.

However, when measured from the peak of the prior bull market (an approach that allows us to incorporate the relative severity of the most recent bear-market decline), it is still second in terms of duration but less impressive in terms of cumulative return (Exhibit 2).

Exhibit 2: S&P 500 Bull Markets, Peak to Peak



Sources: Bloomberg, Yardeni Research, Inc., SEI.

So, what do these findings tell us about the direction of the current environment? Standing on their own, not a whole lot. For one thing, the "peak to peak" approach in Exhibit 2 may be distorted by previous bull-market peaks that were driven by irrational investor exuberance and complacence. And most importantly, in our view, looking only at cumulative return and duration data constitutes a rather superficial analysis.

Bull markets don't die of old age

Jim Solloway, SEI's chief economist, has argued throughout the current cycle that bull markets are typically done in by misguided economic policies—not by old age. From that perspective, U.S. equities should continue to enjoy a tailwind from recent fiscal stimulus as well as monetary policy that is still fairly supportive despite the Federal Reserve remaining in steady-but-gradual tightening mode. Fundamentals—expectations of future cash flows and what their appropriate values are in the present—are the core elements in assessing whether a market is cheap, fairly priced, or expensive. While the U.S. market is a bit on the expensive side by those measures, it's not outlandishly so, and continues to be supported by low interest rates and still-solid sales and earnings growth.

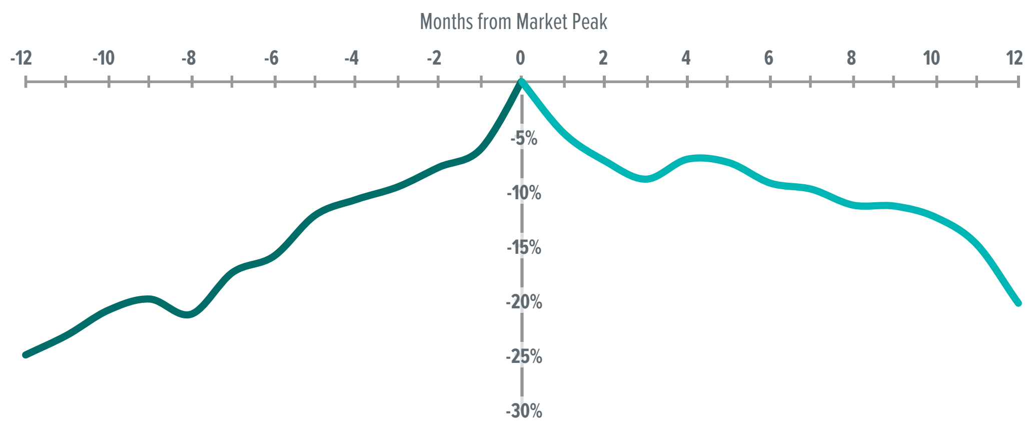
It's hard to outrun a bear

Of course this bull will not run forever. At some point, the bull market will end and we'll experience another bear market. When and how that happens is anyone's guess. In contemplating this inevitability, the question that springs to the minds of many investors is, "What should I do when the next bear market arrives?" Nobody likes losing money, even if it's just on paper. Research has found that humans tend to feel the pain associated with a loss far more than they feel pleasure resulting from a gain of similar magnitude. (We explain this in more detail in our paper, *Behavioral Finance: Loss and Regret Aversion, September 2014*.) For many, the knee-jerk reaction to any hint of significant market decline is all-out retreat. After all, investors would experience far less psychic discomfort if they could manage to outperform the market by substantially both avoiding the downside of a bear market and enjoying the upside of a bull market.

Unfortunately, that scenario is extremely unlikely for any investor. Timing the tops of bull markets and the bottoms of bear markets with any meaningful (much less consistent) degree of accuracy is essentially impossible. Using economic turning points—exiting risky investments prior to the start of recession, for example—is equally fruitless, in our view. Consider that it has historically taken economists at the National Bureau of Economic Research anywhere from 6 to 21 months to declare that a recession has already occurred. To the extent that markets are able to discount the future, investors would be well into a bear market, or even into the next bull market, before anyone knew for sure that a recession was underway.

Even more importantly, attempting to time market entries and exits comes with a cost: lost returns. And, judging by the historical behavior of markets around their peaks and troughs, as illustrated in Exhibits 3 and 4, those costs can be significant. The left side of Exhibit 3 shows the returns an investor would have foregone by trying to exit nine S&P 500 Index bull markets from 1957 to 2007 as they matured. If timed perfectly, the loss would have been zero, as depicted at the center of the graph. The right side of the graph shows the cost for getting out after the peak. For example, an investor who exited six months prior to the bull market peak would have missed an average subsequent return of 16%, while an investor who exited six months after the bull market peak would have incurred an average loss of 9%.

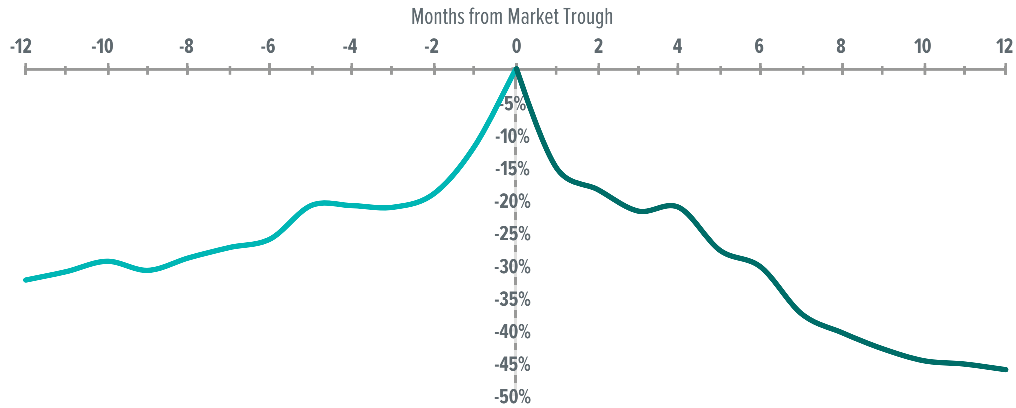
Exhibit 3: Average Cost of Mistiming a Peak



Sources: Bloomberg, Yardeni Research, Inc., SEI. Average of nine S&P 500 Index bull markets from 1957 through 2007, as identified by Yardeni Research, Inc.

Of course, an investor may be comfortable with selling a few months after a market peak; the line on the right side of Exhibit 3 shows that this would have at least preserved some capital. But this overlooks the dual nature—and dual risk—of market timing. Once an investor has exited the market, they have to decide when to reenter. And mistiming this decision can also be quite costly, as Exhibit 4 reveals. Again, perfect timing would cost nothing in terms of incurred losses or missed gains, as the center of the graph shows. But getting back in before the end of the bear market would naturally expose the investor to further losses, as the line on the left side of the chart depicts. And most importantly, as the line on the right side of the chart shows, getting back in after the next bull market has already begun can also be quite costly. In this example, a market-timing investor who reentered the market just six months prior to the bottom would have sustained an average loss of 26%, while one who reentered six months after the bottom would have foregone an average gain of just over 30%.

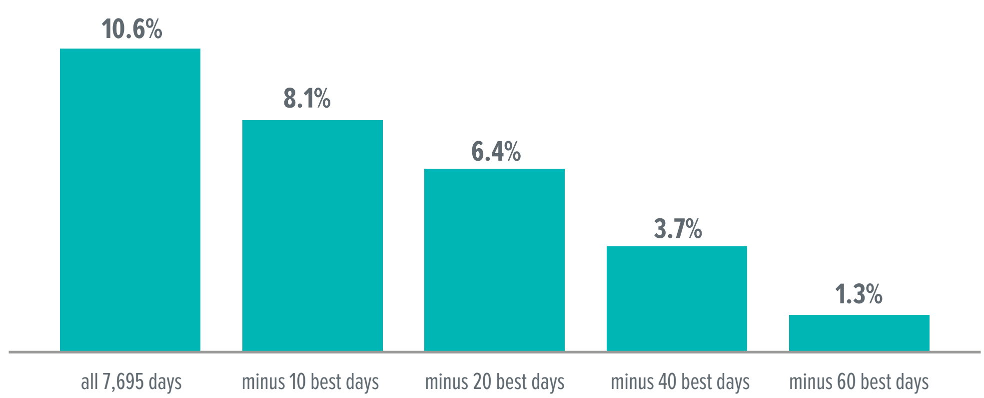
Exhibit 4: Average Cost of Mistiming a Trough



Sources: Bloomberg, Yardeni Research, Inc., SEI. Average of eight S&P 500 Index bear markets from 1957 through 2009 as identified by Yardeni Research, Inc.

The risk of missing out on the start of a new bull market is also illustrated in Exhibit 5. For example, missing out on just the 60 best days in the U.S. stock market over the past thirty years (as measured by the S&P 500 Index) would have surrendered almost all the returns earned by more disciplined, strategically minded investors who remained in the market.

Exhibit 5: Annualized S&P 500 Index Returns



Sources: Bloomberg, SEI. Annualized S&P 500 Index returns from January 1998 through June 2018.

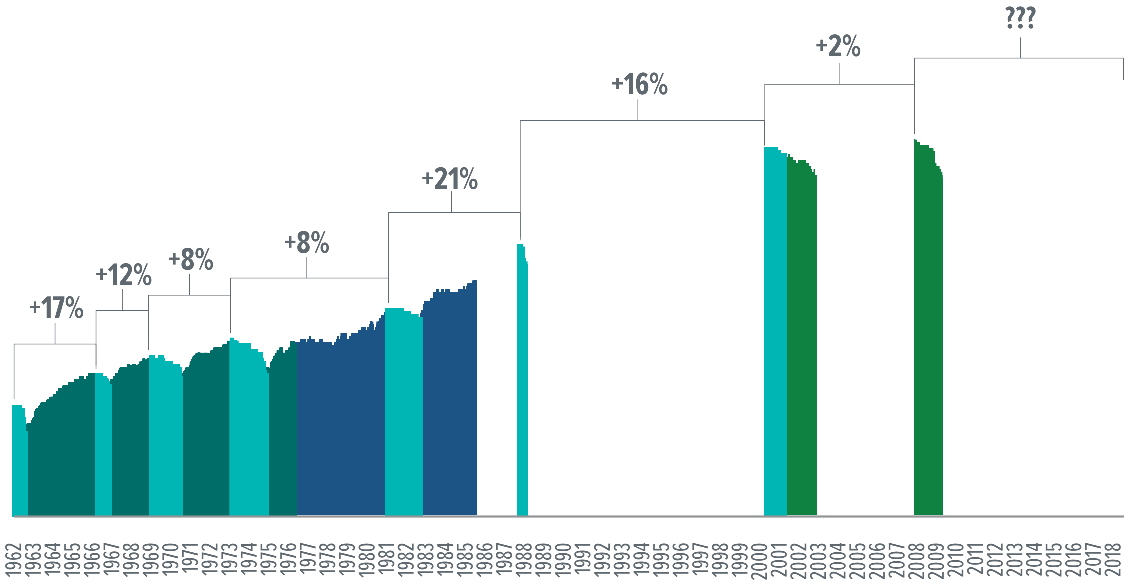
But even this analysis is imperfect, as it also assumes that an investor only makes two decisions: when to exit and when to reenter. In reality, nervous, impulsive investors who alternate between risk-seeking (greed-driven) and risk-averse (fear-driven) behavior could incur even steeper costs by attempting to time strategic exposures.

Is there nothing an investor can do?

There are two answers to this question. The first is to reorient investors' thinking when it comes to bull and bear markets (Exhibit 6 takes into account both bull and bear market performance). The second is to keep in mind that active management can be used—within a disciplined risk-budgeting framework—to take advantage of perceived opportunities in markets, including raising or lowering the amount of risk taken (Exhibit 7 provides examples of SEI's ability to actively manage risks).

The desire to avoid the pain of a bear market is a natural human response to our innate fear of loss. Meanwhile, a well-designed investment strategy already accounts for the fact that markets have return distributions that extend from negative to positive and, importantly, are centered above zero. In other words, equity markets have historically produced positive long-term returns, and the likelihood of both bull and bear markets should be fully reflected in the risk and return expectations used to build a portfolio.

Exhibit 6: Annualized S&P 500 Index returns including bulls and bears



Sources: Bloomberg, Yardeni Research, Inc., SEI.

Exhibit 7: Active Levers in SEI Strategies

Asset Class	Risk-Off	Risk-On
World Equity	Stability stocks, that is companies that have exhibited stable profits, lower price volatility, stronger balance sheets	Focus on higher-beta stocks and pro-cyclical areas of the market
Emerging-Market Equity	Countries/regions with lower geopolitical risk; high-quality businesses	Focus on idiosyncratic opportunities for higher growth
Investment-Grade Credit	Higher credit quality; tilts toward government bonds, diversifying sources of duration	Increase credit exposure; tilts toward non-Treasury, lower duration sectors
High-Yield Bonds	Higher credit quality and/or capital structure, e.g. bank loans	Seek higher yielding opportunities in more speculative credits
Emerging-Market Debt	Focus on higher-quality sovereign bonds denominated in “hard currencies” (less currency risk)	Tilt toward countries with attractive real yields; local currency exposure; corporate bonds
Multi-Asset or Dynamic Asset-Allocation Strategies	Risk-management-oriented tilts among asset classes; hedges against identifiable market risks	Return-enhancement-oriented tilts among asset classes, within a carefully controlled risk budget

A Better Way to Think About Bulls and Bears

Although this is one of the longest bull markets on record, it's not clear that it's "long in the tooth." Valuations do look a bit extended, but we think strong fundamentals should be supportive. While bear markets have often coincided with economic downturns, it's impossible to consistently and accurately predict when economic recessions and recoveries will occur and how markets will respond to these cycles. Most importantly, it's easy to overlook that trying to time market exits and entries is not free. Unless they are timed almost perfectly, there are potentially significant costs in terms of lost returns. In other words, it is exceedingly difficult to come out ahead when trying to time financial markets. It's also important to keep in mind that portfolios are designed using long-term return, volatility and correlation expectations for various asset classes. As long as these expectations are realistic (and adjusted when appropriate), they should account for bull-market returns, bear-market returns, and everything in between. Holding a thoughtfully designed, well-diversified portfolio should allow an investor to ride out the ups and downs of financial markets with the greatest probability of success. We believe that active management can play a meaningful role in positioning around valuation, economic, and other concerns—but should be done within a well-defined risk budget that still keeps a portfolio close to its strategic intentions.

Index Definitions

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held large-cap U.S. stocks.

Definitions

Beta: Beta is the quantitative measure of the Fund's volatility relative to the benchmark used. A beta above 1 indicates the Fund is more volatile than the overall market, while a beta below 1 indicates a Fund is less volatile.

Duration: Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.

Hard Currency: Hard currency debt is debt issued in the currency of a G7 country (group consisting of the finance ministers from the seven largest industrialized nations) and is mostly comprised of U.S. dollar, euro, sterling or Japanese yen.

Idiosyncratic Opportunity: An idiosyncratic opportunity relates to the potential for a particular asset, such as a single stock, to outperform.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. This information is for educational purposes only.

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Investing involves risk including possible loss of principal. Diversification may not protect against market risk. There is no assurance the goals of the strategies discussed will be met. Bonds and bond funds will decrease in value as interest rates rise. High-yield securities may be more volatile, be subject to greater levels of credit or default risk and may be less liquid and more difficult to sell at an advantageous time or price to value than higher-rated securities of similar maturity. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

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