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FACTORS IN FOCUS

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Managing Market Highs

by Eric D. Nelson, CFA

We are currently confronted with a good "problem." What should we do with our investment portfolios, if anything, in light of the fact that stocks in the US have recently hit all-time highs, and with international stocks not far behind?

Our Investment Policy Statements (IPS) provide us with a roadmap—not only for our intended asset allocation across stocks and bonds, US and foreign companies as well as large/small and growth/value asset classes, but also for how we intend to maintain that portfolio. **Rebalancing** is mentioned several times and we discuss it frequently, within the confines of each client's unique tax situation and in light of cash inflows (used to buy the underweighted asset classes) and outflows (funded by selling some of the overweighted asset classes).

But maybe this time is different? Maybe, just this time, we should take a little money off the table. As one client proposed: "Get out at Dow 18,000 and get back in around Dow 16,000? We'd be ahead by doing that, no?" Of course we would, if it were that simple. But a look at historical market behavior shows that it's not.

Table 1 looks at periodic stock returns since 1926. The first column measures how frequently the S&P 500 has been positive over *all* 1-, 3- and 5-year periods, and the average annualized gain when it was positive (second column). The third column looks at how frequently the S&P 500 gained in value only *after reaching an all-time high*. The fourth column measures its average gain during only these periods.

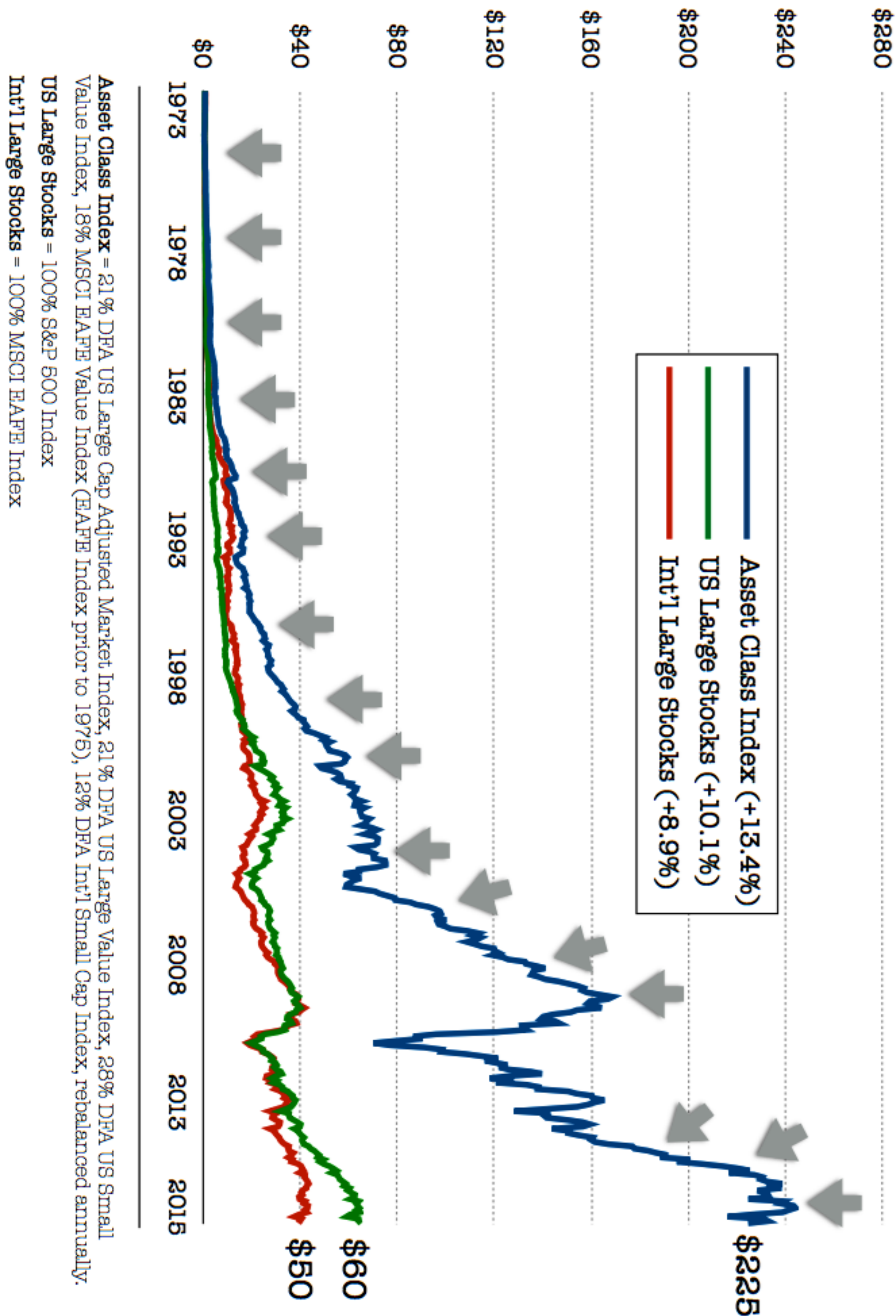
If you don't see a lot of difference between the two subsets of data, that's the point. Stocks are up most of the time over all periods, and this doesn't change after all-time highs. For example, over 1-year periods, stocks are up 75% of the time, and positive 80% of the time in the 12 months *after* they've hit an all time high. The gains average +21.2% and +19.8%, respectively.

The chart on the next page shows that stocks routinely set new highs, with only periodic setbacks. If we sold at Dow 18,000 and bought back at 16,000, we would profit. But markets don't decline often enough, even after reaching all-time highs, to reliably profit from. Portfolio adjustments might be needed when your goals change, but not because of common market milestones.

Table 1: S&P 500 Index Highs and Subsequent Returns (1926 to June 2016)

Look Ahead Period	% Positive Returns (S&P 500, ALL periods)	Average Annual Gain When S&P 500 Is Higher	% Positive Returns (S&P 500, AFTER all-time high)	Average Annual Gain When S&P 500 Is Higher
1 Year	75%	+21.2%	80%	+19.8%
3 Years	83%	+15.0%	83%	+14.9%
5 Years	87%	+13.1%	84%	+13.6%

source: Dimensional Fund Advisors



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