

FACTORS IN FOCUS

January 2018

Stock Prices Are Higher, Now What?



by Eric D. Nelson, CFA

Coming into 2018, a significant topic on investors' minds is the recent run-up in stock prices. After two lackluster years in 2014 and 2015, the S&P 500 gained 12% in 2016 and surged ahead more than 21% last year. Looking back over the last decade, we see only one down year—2008. The S&P 500 has gained value for nine consecutive years, which last happened between 1991 and 1999. The rising stock market has a lot of clients asking or at least thinking “now what?” So this month I will approach this question from a few different angles.

Are Stocks “Overvalued”?

Almost everyone thinks we are in an overvalued stock market, not just because stocks have earned above-average returns over the last few years, but because their valuations are above average. The most widely-cited metric comparing stock prices to valuations was created by Professor Robert Shiller in the 1980s, called the Cyclically-Adjusted Price-to-Earnings Ratio, or “Shiller CAPE.” The measure, which compares current stock prices to an average of the last ten years of earnings on the S&P 500, stood at 32.5 at year-end. Compared to the average annual CAPE ratio since 1926 (inception of S&P 500 data) of 18.1, stock prices relative to earnings today are almost twice as expensive as their long-term average.

If current prices are high, however, they've been that way for almost three decades. The average CAPE ratio from 1926-1989 was only 14.6; in the modern era since 1990 it's averaged 25.7, not far from where it is today. It's not clear whether we should expect relative stock prices to stay the same over time. What we do know is that banking on historical valuations and expecting a “reversion to the mean” can be costly. On a calendar year basis since 1990, the CAPE ratio has never returned to its 1926-1989 average of 14.6. If you were expecting that to happen, you've been waiting almost an entire investing lifetime! The S&P 500 has returned +9.8% per year since 1990, which is virtually identical to the +10.3% per year return from 1926-1989.

We've seen stock prices at these levels before, and not just at market peaks. The S&P 500 began 1998 with a CAPE ratio of 32.9—almost identical to today. Over the next ten years, a globally diversified asset class index portfolio returned +11.9% per year (+5.9% for the S&P 500), and +9.8% per year through 2017 (+7.2% for the S&P 500)! There were bumps along the road, most notably 2008, but long-term investors have profited handsomely from staying the course.

Have Returns Been Too High?

Since 2009, the S&P 500 has returned +15.3% annually, while US large value and small value stocks have done even better—+15.9% and +17.6% per year. International stocks, which have lagged, still produced returns of +9.3% to +13.7% per year. These results are well above the long-term averages seen on US stock asset classes since 1928 (international developed stock returns aren't available before 1970 but are expected to be similar) and we should not count on them continuing at these rates going forward.

Table 1: Historical Asset Class Returns

	1928-2017	2009-2017	2008-2017	2014-2017
S&P 500 Index	+9.9%	+15.3%	+8.5%	+12.0%
DFA US Large Value Index	+11.3%	+15.9%	+7.9%	+10.5%
DFA US Small Value Index	+13.4%	+17.6%	+10.5%	+8.7%
MSCI Int'l EAFE Index	n/a	+9.3%	+2.4%	+5.0%
DFA Int'l Large Value Index	n/a	+11.1%	+3.0%	+6.0%
DFA Int'l Small Value Index	n/a	+13.7%	+5.6%	+7.5%

Source: DFA Returns Web

But all return data is time dependent. If we start a year earlier, in 2008, returns are below average for every stock asset class and only US small value has double digit returns. Yet it's still about 3% per year *below* its long-term average.

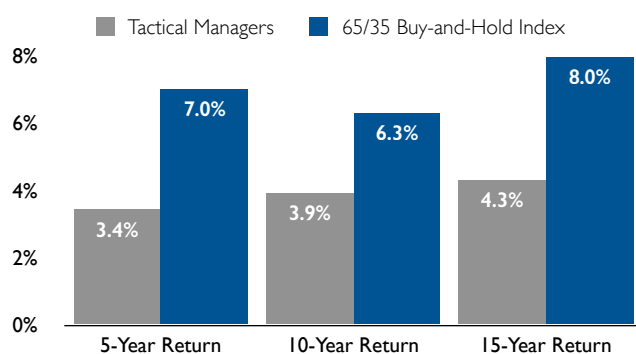
Continued...

Returns since 2014 are very lopsided: US large caps have been above average, thanks to the run-up in tech stocks like Amazon, Apple and others. US large value, small value and international stocks have all produced single-digit returns; reasonable but *below* average. Outside of US large stocks, (typically only about 20% of our diversified stock portfolios) it doesn't appear that stock returns have been too high.

Tempted To Try Tactical?

As investors, we always feel better taking action. Shifting the portfolio around more often would make me sound smarter and seem more proactive and might make you more satisfied. "Doing nothing" seems lazy and likely to cost us profitable opportunities. But a closer look at investors who try to time the market doesn't seem to validate these concerns.

Chart 1: Market Timing vs. Buy and Hold (8/2001 to 7/2016)



Source: Advisor Perspectives, "How Tactical Allocation Mutual Funds Have Fared" (8/2016)

Portfolio managers of "tactical allocation" funds trade in and out of asset classes trying to exploit perceived market inefficiencies. These are professional market timers. And their results aren't good. Morningstar tracks their returns as a category, illustrated in Chart 1 above. We can compare their results to a buy-and-hold index of 65% stocks and 35% bonds, rebalanced annually. Over the five-year period ending in mid-2016, their average return of +3.4% per year was only half of the +7.0% earned by the buy-and-hold index allocation. Going back ten years, their +3.9% annual return trailed the +6.3% performance of the 65/35 index mix by almost +2.5% per year. And over 15 years, a period that includes the 2002 and 2008 bear markets, we find the average tactical mutual fund returned only +4.3% per year compared to +8.0% for the 65/35 stock and bond mix. Buying and holding beat market timing by almost 100%!

How much sense does it make to subject your hard-earned wealth to an approach that has resulted in such horrendous relative returns over every reasonable period? **You are not paying us to squander your savings.**

What's Next?

This year isn't different from prior years as it relates to your investment plan. It was designed with your long-term objectives in mind and is expected to earn a return sufficient for you to achieve your lifetime financial goals without taking more short-term risk than you can handle. In general, if your goals have not changed, there is no reason to change your plan. That should sound familiar.

Some portfolios have done better than yours recently, primarily those heavily concentrated in US large cap stocks. But it's unlikely they will do better going forward. There will be a time, maybe sooner rather than later, when international stocks outperform US stocks (as they did last year), or smaller and more value-oriented stocks outperform larger and more growth-oriented shares. Historically, small cap and value stocks globally have delivered much higher returns than the S&P 500 (see Table 1), and I expect that to be the case in the future. On a relative basis, I believe that your portfolio will capitalize more than most. I also assume, thanks to DFA's expert asset class implementation, that you will benefit more from these trends compared to investors using exchange-traded-funds (ETFs) or Vanguard, regardless of small differences in expense ratios.

If you hold a balanced portfolio with an allocation to short-term bonds, you've also probably noticed that your returns have not matched the S&P 500 in recent years. You might feel at this point like bonds are superfluous. A little greed after years of good returns is natural. But when we experience a stock market correction or a bear market, those bonds may be the only element to hold their value. If you're drawing income from your portfolio, selling bond fund shares will hold you over until the stock market recovers and might make it easier for you to handle the emotional challenges of enduring a stock market plunge without bailing out.

As we enter 2018, I'd like you to reflect back on the last few years—the good ones and the not so good ones. More than likely, your investment portfolio sits well above previous levels, even if you've been drawing income. Our approach and your commitment to it have been working. We didn't know what these last few years would hold and we cannot know what will happen next. But through our partnership and commitment, I am confident that you will continue to experience the relative success that our plans have been designed to achieve. And I am grateful that you continue to choose Servo to guide you along the way.

65/35 Buy-and-Hold Index = 13.5% S&P 500, 13.5% DFA US Large Value Index, 18% DFA US Small Value Index, 12% DFA Int'l Value Index, 8% DFA Int'l Small Value Index, 35% Five-Year T-Notes; rebalanced annually.

Past performance is not a guarantee of future results. Diversification does not eliminate the risk of loss. Index and fund returns include the reinvestment of dividends but not expenses or additional advisory fees. This article is for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, product, or service. Servo is an investment advisor registered in the states of Oklahoma and Texas with clients nationwide. Unauthorized copying, reproducing, duplicating, or transmitting of this material is prohibited. For past *Factors In Focus* newsletters, please visit Servo's website at servowealth.com. **Edited by Kathy Walker.**

Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your personal financial situation.