INVESTMENT INSIGHTS

Analysis, Insights, and a Different Perspective

January 2024

KEY POINTS

- New all-time highs in the stock market have not historically been useful predictors of future returns.
- It is reasonable to assume that, in general, stock prices are at a level where the expected return is positive, regardless of whether major indices are reaching new highs.
- Based on historical data, the longer an investor stays invested in the stock market, the more likely their realized return will be positive.

IS IT A GOOD TIME TO INVEST?

There has been much discussion in the news lately about the stock market at near all-time highs. As an investor, this may raise questions—What is the expected return, given the current market level? And, more importantly, what would be a good strategy to gain a positive return? In this issue of Investment Insights, we will address these questions as we dive into the stock market.

EXPECTED RETURNS AFTER NEW MARKET HIGHS

When markets hit new highs, does that indicate that it's time for investors to cash out? Some investors may consider it a signal that the market is "overvalued." History tells us that a market index being at an all-time high generally does not provide actionable information for investors. We can look at the S&P 500 Index for the better part of the last century for evidence. The graph on pg. 2 shows that, between 1926 and 2022, the proportion of positive returns after a new monthly high has ranged between 82% and 84%, depending on the look-ahead period. This is very similar to the proportion of annual returns that have been positive during that entire time, regardless of whether the S&P 500 Index closed higher or lower for the month, which we call any monthly level. One reason for the similarity is that since 1926, almost a third of the monthly observations were new closing highs for the index.

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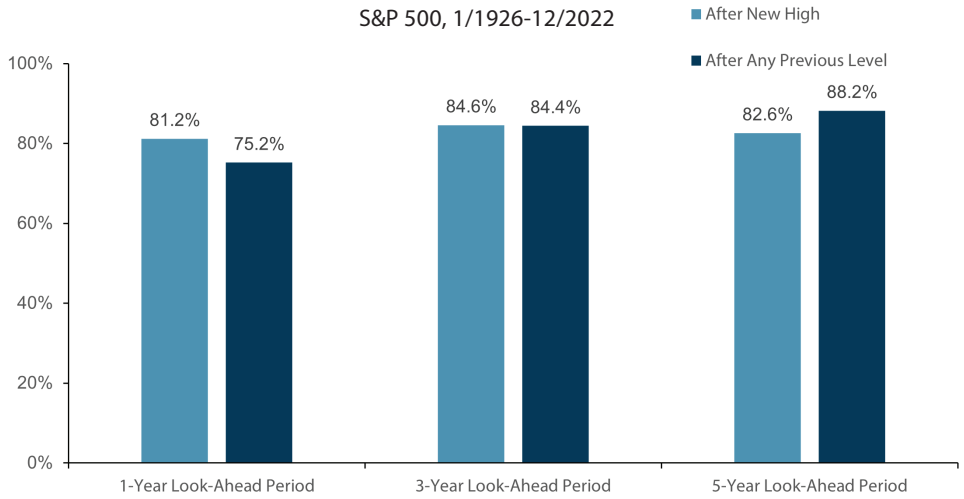
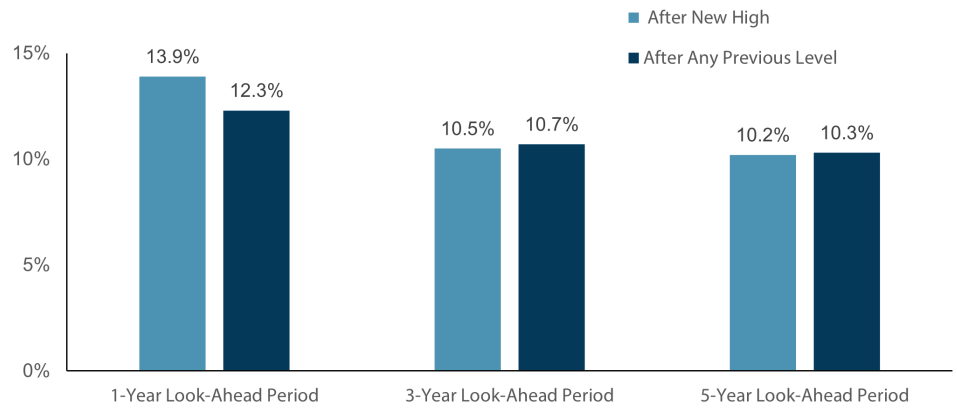
PERCENT OF CASES WHERE INDEX WAS HIGHER AFTER NEW MARKET HIGHS AND AFTER ANY MONTHLY LEVEL



Annualized compound returns are computed for the relevant time periods subsequent to new market highs and averaged across all new market highs observations. There were 1,163 observation months in the sample. January 1990–Present: S&P 500 Total Return Index, S&P data © 2023 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. January 1926–December 1989: S&P 500 Total Return Index, Stocks, Bonds, Bills and Inflation Yearbook™, Ibbotson Associates, Chicago. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

We can also look at the annual performance of the S&P 500 Index after a new market high versus performance after all other levels during that time. As illustrated in the next chart, the annual performance of market returns after new market highs are also similar to the returns after any monthly closing level. For example, historically, in a 5-year look-ahead period after a new market high, the stock market return was 10.2%, while the return after any monthly level was 10.3%.

AVERAGE ANNUALIZED RETURNS AFTER NEW MARKET HIGHS AND AFTER ANY MONTHLY LEVEL



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Looking at this data, it is clear that new index highs have historically not been useful predictors of future returns. Given that the level of an index alone does not seemingly have a bearing on future returns, a more fundamental question arises: What drives expected returns for stocks?

POSITIVE EXPECTED RETURNS

One way to compute the current value of an investment is to estimate the future cash flows the investment is expected to deliver and discount them to today's dollars. For an investment in a firm's stock, this type of valuation method allows expectations about a firm's future profits to be linked to its current stock price through a discount rate. The discount rate equals an investor's expected return, which is driven by its price and what its investors expect to receive.

The actions of many buyers and sellers determine stock prices. These buyers usually don't use negative discount rates (which would assume the value of future profits is more than today) when predicting the profits of the companies they invest in. Instead, investors use positive discount rates, which assume that future cash flows are worth less today. This means that stock prices usually reflect an expectation of positive returns in the future.

This concept can be a bit counterintuitive but is based on the principle that money received in the future is worth less than money received today, a key concept in finance known as the time value of money. The positive discount rate reflects the reduced value of future cash flows compared to current cash flows. Therefore, stock prices often represent the expectation of positive returns in the future, taking into account this principle that a dollar today is worth more than a dollar tomorrow, with the difference in value being quantified by the discount rate.

Even though investors can overestimate or underestimate future cash flows, there isn't much evidence that this happens consistently in the market. Generally, the market effectively sets prices that are not biased towards being too high or too low. So, it's fair to assume that the expected return, which influences stock prices, is not biased.

Consequently, the price of a stock, or a group of stocks like the S&P 500 Index, is likely set at a level where its expected return is positive. This holds true whether the price is at a record high or not. This explains why reaching new highs in the index doesn't usually lead to negative returns. In other words, the expected returns are generally positive whether the price is at a new high, low, or somewhere in between.

IT IS ALL ABOUT THE TIME HORIZON

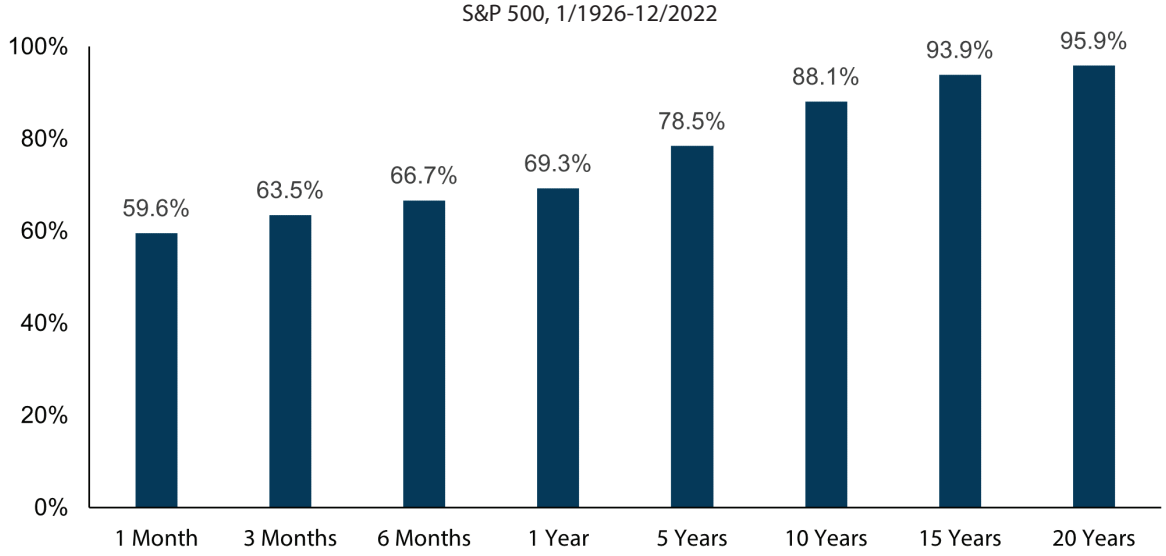
Today's prices depend on expected returns and expectations about future profits. If there is a shift in either, prices will adjust to reflect this new information. Changes in risk aversion, tastes, preferences, expectations about future profits, or the quantity of risk can all drive changes in expected returns. All else equal, an increase in expected returns is reflected through a drop in prices. A decrease in expected returns is reflected through a rise in prices. Thus, realized returns can differ from expected returns.

This means there is a probability that the realized return on any stock, an index like the S&P 500, or the market as a whole can be negative, even when expected returns are positive. But what can we say about the relationship between the probability of a negative realized return and an investor's holding horizon? According to our prior research, daily stock market returns over a long time period were positive only about 52% of the time.[1] Over very short time periods, stock returns are like a coin flip. Historically, the probability of positive equity returns increases over longer periods compared to shorter periods. The chart on pg. 4 shows the percentage of times the stock market was positive over different periods starting in 1926.

1 Between 1928 and 2020 using S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956. Source: Global Financial Data.

PERCENT OF TIME STOCKS EARNED A POSITIVE RETURN

S&P 500, 1/1926-12/2022



The author's calculations used the S&P 500 Index monthly rolling periods. Note that Price Returns were used, which exclude dividends. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

As the length of the time period increases, so does the chance of the equity returns being positive. To answer our previous question, a negative realized return probability decreases as an investor's holding period increases. This is why choosing a level of equity exposure that you can stay invested in over the long term is important.

YOUR INVESTMENTS

New all-time highs in stock markets have historically not been useful predictors of future returns. While positive realized returns are never guaranteed, equity investments have positive expected returns regardless of index levels or prior short-term market returns. In fact, the data shows that the returns after all-time highs versus after any other level are very similar. Historically speaking, the odds of positive realized stock returns increase as the time horizon increases, which is one reason investors should consider investing as a long-term commitment. Staying invested and not making changes based on short-term predictions increases your likelihood of success.