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January 2018 Investment Commentary

The optimism of 2017 has thus far continued into January 2018, with stocks off to a strong start. It's hard to believe that stocks had the worst start to the year ever just two years ago in January 2016. With most investment classes doing well recently, investors too easily forget the lessons of the past. When all investment classes no longer do well, how will you do? How will you react to investment declines when they happen? How can you position your portfolio today, so that you can continue to benefit from market gains, while protecting yourself from the most inflated stocks and investment bubbles, in order to keep your retirement plan on track(7)?

Any time investors have made easy money investing, it's tempting to forget the critical lessons of the past. The fact is that almost all investments have moved indiscriminately higher over the past fifteen months, and the pace of these returns cannot and will not continue indefinitely. With the average return on U.S. stocks equaling about 7% a year over the past 118 years, double-digit annual returns are simply not sustainable over the long term. We are not making a statement about where the market will move in the future. No one can do that, and an unfortunate amount of human talent and energy has been wasted on trying to guess market movements since stocks began trading(1).

Yet, while economic growth in the U.S. has improved recently, and financial pundits make frequent reference to "goldilocks" economic and financial conditions, it's important to realize what happened in the past following similar periods of positive economic sentiment, in order to prepare yourself for volatility to come. For example, the S&P 500 index has gone more than 400 days without a 5% pullback – did you know that's the longest such winning streak since 1929? We are in no way pointing to a great crash and depression, nor anything approaching that scenario. But we do believe it's important to be aware that things will change at some point(2).

Blind investment optimism is currently being driven by both individual and professional investors. Currently, optimism among professional investors sits at the highest level since April 1986. The following year, in October of 1987, the S&P fell 21% in one day. However, 1987 is also a crucial learning point for long-term investors, because despite the October drop, the S&P 500 actually closed <u>UP</u> for the year.

This speaks to the need to remain invested, even in the midst of tremendous market declines. As for individual investors, stock market optimism currently sits at the highest level it has since the year 2000, which preceded the bursting of the technology bubble[2][3].

Financial market extremes require great discipline from investors who want to succeed over the long term. With investments at all-time high levels, driven by blind optimism, a herd mentality of greed and envy causes investors to want to chase after the highest-returning investments. We don't know when a market correction will come, nor what form it will take, and neither does anyone else. What we do know is that the investments that have gone up the most, often without fundamental underpinnings, have historically fallen the most during corrections. We gave examples in past commentaries of auto and airline companies losing money for investors over the long-term. Warren Buffett cited over-enthusiasm for auto and airline stocks as one of the contributing factors to the Dow Jones Industrial Average Index returning nothing during the 1964 to 1981 time period. Similarly, over-enthusiasm for technology stocks contributed to the S&P 500 returning nothing over the 2000 to 2013 time period. Investors have a demonstrated track record of becoming overly enthusiastic about new industries, and it will happen again. Today, investors similarly pour money into industries such as cloud computing, social networking, and internet-based advertising, with large revenue potential but unproven long-term profit dynamics. It takes discipline, strength, and independence of mind to see people who aren't as prudent as you are temporarily make more money than you. But that's exactly what you must do to succeed over the long term when investors become overly excited[1][4].

So, sticking to investments with sound fundamental underpinnings, even when unproven and speculative investments temporarily make higher returns, is one quality needed for long-term investment success. The other quality needed is not panicking when markets do inevitably decline. The bull market that began in 2009 is currently the second-longest in history, exceeded in length by the 1990 to 2000 bull market. At some point, the optimism will change. While no one can predict how things will change, we can be certain of one thing: the downturn will be temporary. During the 38 years ended 2017, the S&P 500 experienced an intra-year decline from peak to bottom every year, with the average intra-year decline equaling 13.8%. Despite that average annual intra-year decline, stocks earned positive annual returns in 29 out of those 38 years. Over that 38-year time period, despite the 13.8% average intra-year decline, stocks returned about 10% annually, and the S&P 500 climbed 2,377%. And that's why it's a waste of time to try to pick the "top" and "bottom" of a market or stock. You'll make more than enough money remaining invested, and you will fail in trying to guess short term stock price movements. As a final argument to put to rest any attempt at market timing, consider a recent study reported by CNBC: buying stocks at the three worst times in the past thirty years still outperformed all other asset classes. If you bought and held the S&P 500 at the market top in 1987, you've made a 9.6% annualized return; if you bought at the top in 2000 and held, you've made a 5.7% annualized return; and if you bought at the top in October 2007 and held, you've made a 7.5% annualized return. According to the study, "at the worst times to buy in the last 30 years, the stock market has been the best generator of wealth than any asset class." Compare this data to DALBAR's Quantitative Analysis of Investor Behavior, which shows that for the 30-year period ended December 31, 2013, the average investor in a blend of equity and fixed-income mutual funds had garnered only a 1.9% net annualized rate of return. Over that time period, the S&P 500 returned about 10% per year annualized. Undoubtedly, much of that low 1.9% return resulted from attempting to time the market [3][5][6].

As investment markets stretch to new heights, we will continue to invest in conservatively managed companies with strong brands and proven, enduring products and services. We will not chase after what everyone else is overly excited about. We remain committed to achieving long-term growth of client accounts in order to help them achieve their financial goals, while protecting them from the most inflated investments.

Best Regards,

The Crescent Group
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Sources:

(1) S&P Dow Jones Indices LLC
(2) Business Insider
(3) CNBC
(4) The Snowball
(5) JP Morgan
(6) DALBAR
(7) Reuters

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