Life Is a Long Song

Why Equity Ownership Is Important for Long-Term Investment Success

Michael A. Tyler, CFA®, Chief Investment Officer

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The old rules are broken. Once upon a time, a widely followed investment rule of thumb was that people should invest "100 minus your age" in equities, and to withdraw about 4% from their portfolios in each year of retirement. A 70-year-old person with $500,000 should, by this rule, allocate $150,000 to stocks and withdraw $20,000 each year. Today, that way lies heartbreak; the world has changed. We are all living longer and healthier lives, and we are doing so in a very different investment environment. These changes are evident in several factors:

- When Social Security was enacted during the Depression, life expectancy for a 65-year-old man was about five more years. Today, a married couple at age 65 should expect that at least one spouse will live past 90. Planning for 25 years of retirement requires more emphasis on growth than planning for five years.

- Annual expenses in retirement are higher, too. Health care costs continue to rise faster than inflation, but we are also spending more money on active lifestyles (entertainment, travel, education, etc.).

- Interest rates are at near-record lows, and will likely remain low for a long time to come. Bond coupons are lower, and total returns likewise may be at lower levels than investors have enjoyed over the past three decades. The 4% rule could drain capital too quickly.

The implication is inescapable: Investors need to allocate more money to equities than the old rules suggest. There is simply no other way to generate growth, protect against inflation, and preserve capital for a longer period of time. Owning stocks still produces good current income in the form of dividends, and equities may no longer incur greater price risk than bonds. In short, as Jethro Tull songwriter Ian Anderson approaches his 70th birthday this summer, he might consider revising the band's 1976 hit ballad: Not only are you "never too old to rock-and-roll if you're too young to die," you're also never too old to own more stocks.

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Financial trauma leaves a scar no less permanent than any physical or mental trauma, and it can be just as debilitating to victims. Almost all of us were badly burned in the 2008 financial meltdown, and we all bear the scars today. I see it every time I am invited to speak at a local Rotary or Chamber of Commerce or one of our own client seminars. Someone will approach me after my talk, wondering whether it's really safe to be investing in the stock market these days. After all, prices are close to all-time highs, and we all remember the shock and trauma we suffered in 2008 when the stock market lost nearly half its value.

I can empathize with my interlocutor's pain; I lost plenty of money in 2008 too. But the real lesson of 2008 was the vital importance of staying fully invested through the pain of the moment. Markets are resilient and recover their vigor; stocks have more than doubled from their December 2007 prior bull market peak to today, even though they lost nearly half their value in 2008 and early 2009. With this in mind and with stocks indeed near their all-time highs, perhaps it's time for a quick refresher in six pictures.

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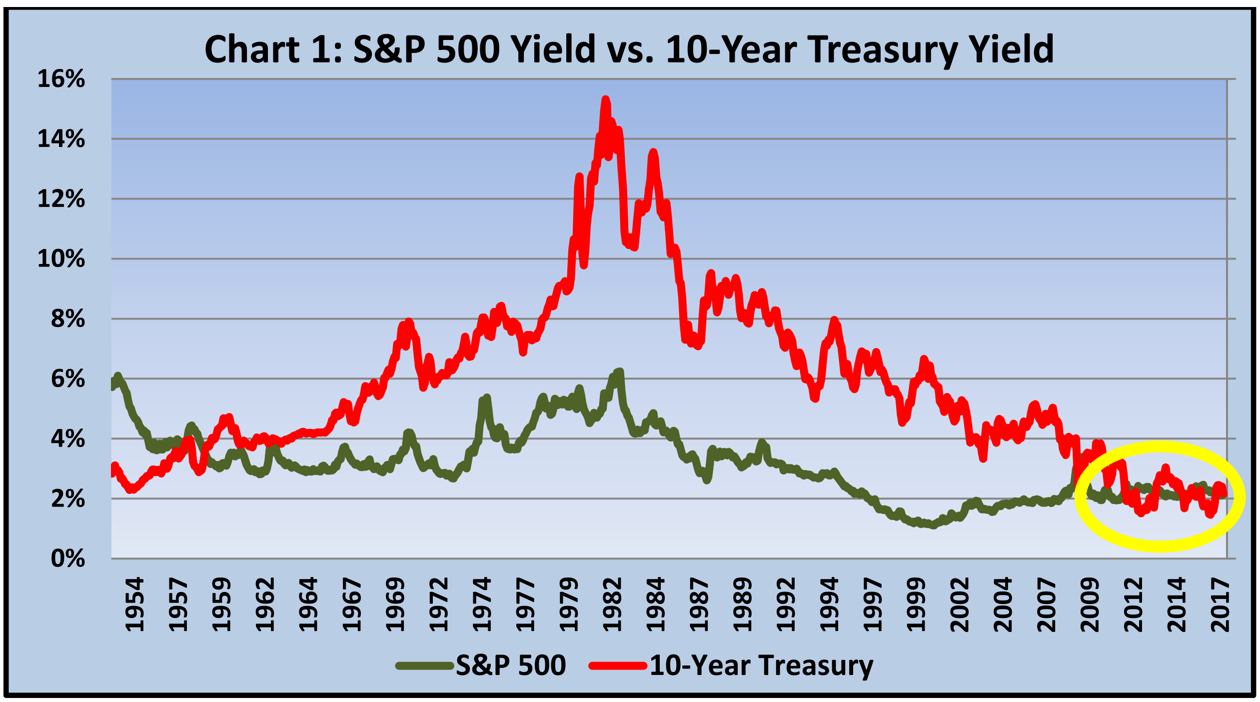
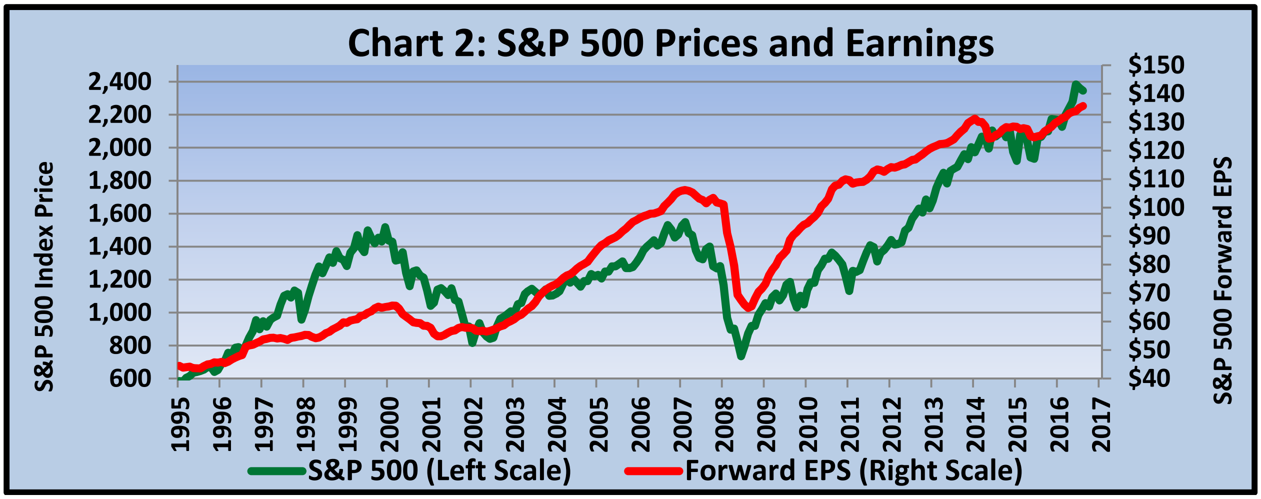
Let's look first at the relative value of stocks versus bonds. Chart 1 shows the dividend yield of the S&P 500 plotted against the current yield of a 10-year Treasury note. Historically, stock yields have almost always been considerably lower than bond yields. This makes sense, since stock dividends and prices grow over time while bond coupons are fixed. Yet since the financial crisis, stock dividends and the 10-year Treasury note have both been yielding about 2%, as highlighted on the chart. With comparable current income and superior inflation protection, stocks provide better value than bonds; not only that, but it's also entirely possible that longer-term bonds now carry more price risk than stocks.



Source: FactSet

Another way to evaluate risk is to look at the stock market's valuation over time, as measured by the price-to-earnings (P/E) ratio. Chart 2 shows the earnings per share (in red) and the price (in green) of the S&P 500 index over the past two decades. The chart is scaled so that the two lines would overlap at a P/E ratio of 16, which is the market's long-term average valuation. At a glance, it's easy to see when the market is expensive (the green line is higher than the red line) or cheap (the red line is above the green line). As the two lines grow farther apart, the market gets increasingly more expensive (as in 1998-2000) or cheaper (2009-2012).



Source: FactSet

Today, the stock market is slightly expensive by this measure. (Most other valuation metrics will lead to similar conclusions.) The S&P 500 is currently priced at about 17.5 times year-ahead earnings per share, a level it has seen and maintained many times in the past. If that feels expensive today, it's only because we're emerging from a seven-year period in which multiples were lower – thanks to the fear that stymied investors from buying stocks after the meltdown.

So if stocks aren't excessively expensive, and if they represent considerably better value than bonds, then why are most cash flows today still going into bond funds? One feature of financial trauma – like physical or mental trauma – is that it generates powerful emotions that can cloud judgment. We don't ever want to experience again the terror that accompanied the 2008 bear market. With stocks at all-time highs, isn't a bear market more likely now than when stocks were cheaper? Chart 3 provides the surprising answer: In fact, stock returns for any future period really aren't influenced by whether prices in the current period are at high levels.

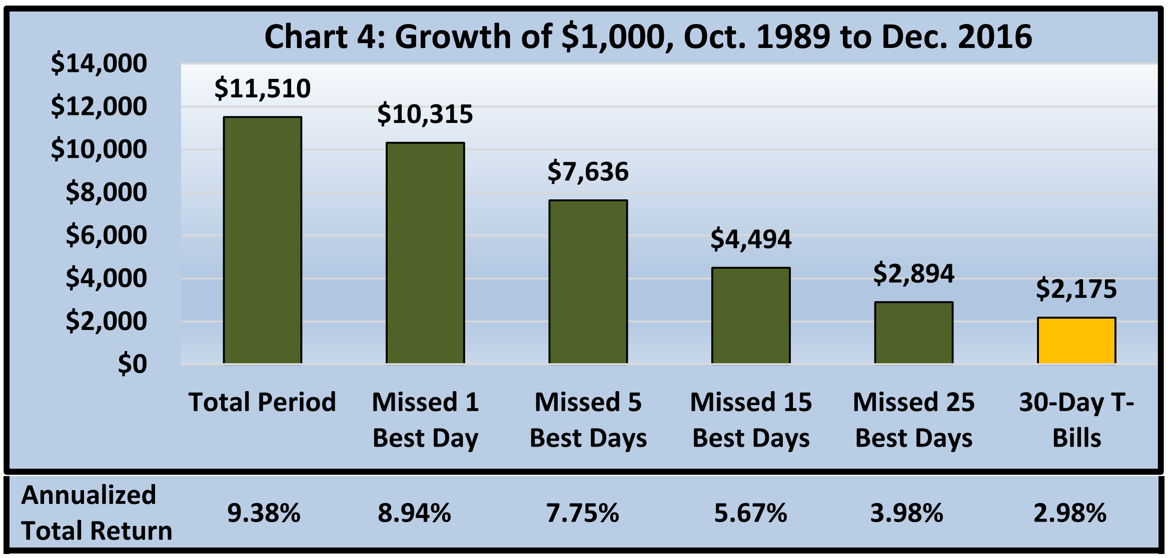
Chart 3: Stock Gains After Hitting New Highs				
	Periods with Rising Prices		**Average Return**	
	After New High	**After Other Months**	**After New High**	**After Other Months**
1 year	80.5%	74.7%	13.7%	12.2%
3 years	83.4%	83.3%	37.1%	39.7%
5 years	84.1%	87.4%	64.2%	71.0%

Source: Dimensional Fund Advisors

The data in Chart 3 cover 1,091 months from January 1926 through December 2016. The S&P 500 index hit an all-time high in 319 of them, or 29%. Chart 3 compares performance following those 391 months with performance following the other 772 months in this rather large data set. The left half of Chart 3 shows that stocks rose more than 80% of the time over 3- and 5-year periods regardless of whether the market had just set a record high. Surprisingly, the likelihood of future gains is unrelated to previous performance.

The right half of Chart 3 is perhaps even more surprising. Here, the numbers show *how much* the stock market rose in the same two types of situations (after an all-time high versus after any other month). Although returns weren't quite as robust following all-time highs, the difference is quite small; equities have produced healthy returns even when starting near all-time highs. The lesson from Chart 3 should be obvious: Don't "wait for the dip." Stay invested regardless of the current level of stock prices.

Chart 4 shows what can happen if we don't stay invested in stocks. The data show that missing even a few days can have powerful negative long-term effects:

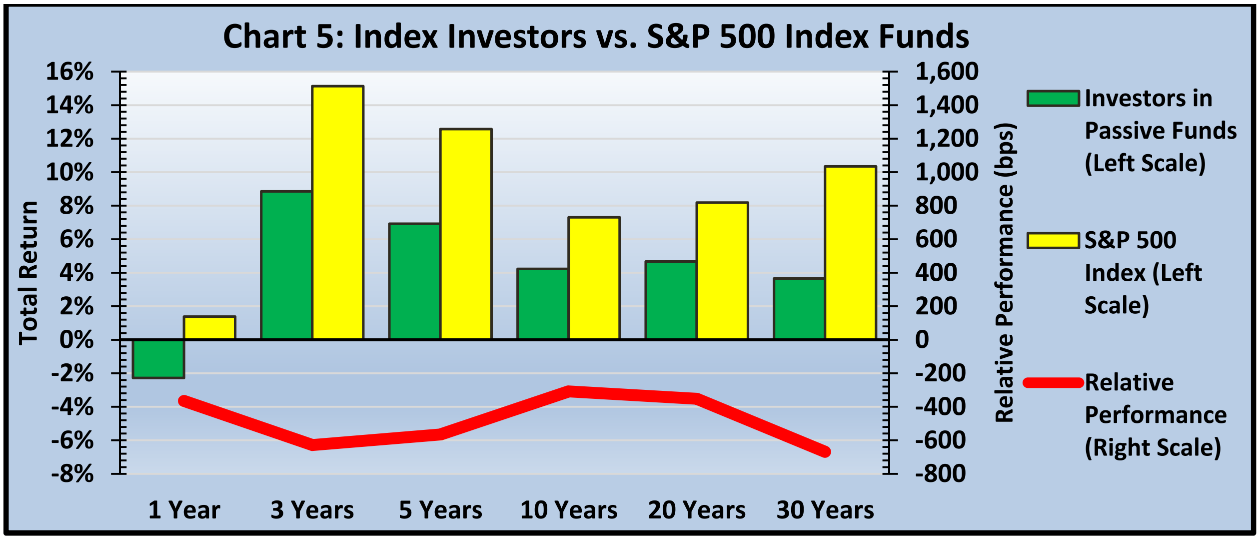


Source: Dimensional Fund Advisors

Investors who missed just five days in the past quarter-century could have seen a permanent 35% reduction in their accumulated value; missing the 25 best days would have cut the long-term return by 75%. Of course, these calculations assume that the missed days were the best over the entire period – but it's impossible to predict when such days occur. Fear of bear markets leads to certainty of missing bull markets.

The broader issue raised by Chart 4 is that of market timing. Many people think they can buy low and sell high, as the adage instructs. The evidence is not encouraging – in fact, it shows that do-it-yourself investors are consistently terrible at market timing.

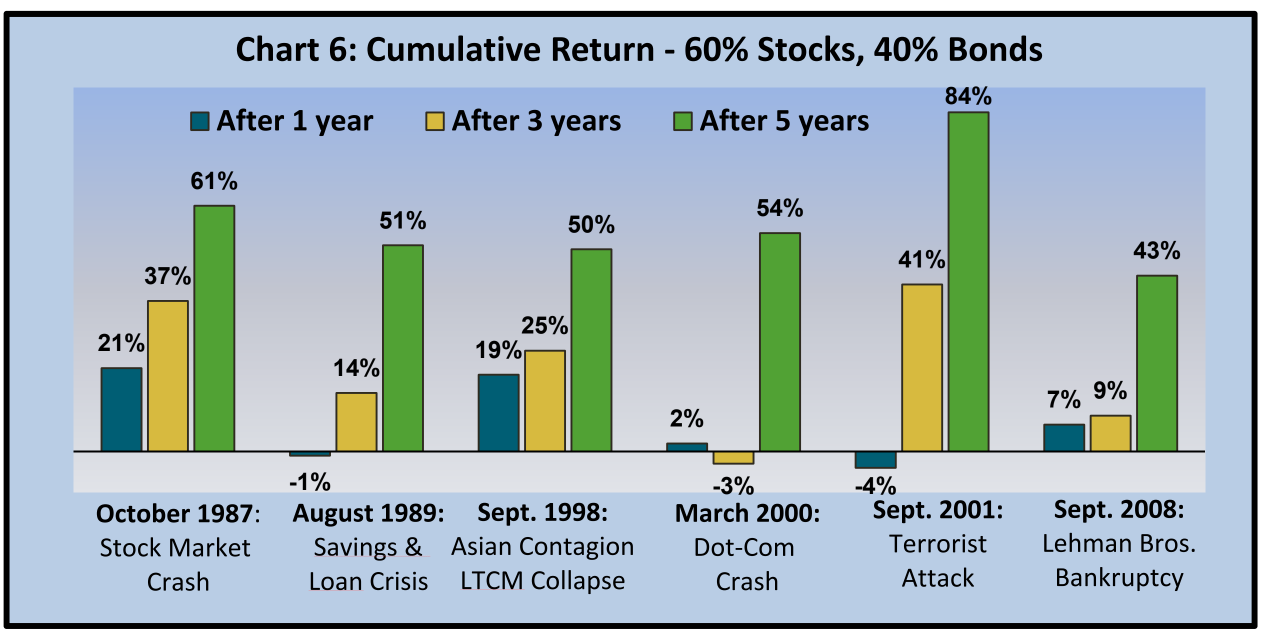
Chart 5 (overleaf) shows that market-timing investors have squandered capital for three decades. While the S&P 500 index funds have produced annualized total returns of over 10.3% since 1985, the average investor in these funds earned only 3.7% over the same time period. The difference between these two rates of returns, cumulated over 30 years, is staggering: Index fund investors earned 90% less than the index funds themselves. How can that be the case? Simply put, investors consistently buy high and sell low; they let their decisions be guided by emotion. Market timing simply doesn't work, but staying fully invested – even at high prices – does.



Source: Dalbar Inc.

The story that these charts tell is compelling: Investors need to include equities in their portfolios in order to provide growth, inflation protection, and current income. Over longer periods of time, equities produce superior returns regardless of when they are acquired and regardless of what prices do in intervening periods; but the only way to capture that superior return is to stay invested consistently.

Yet none of this contravenes the basic law of diversification: Owning multiple asset classes reduces volatility without sacrificing returns. Bonds are a necessary counterweight to stocks. While each investor's long-term allocation will depend on many factors, the large majority of our clients find the optimal strategic mix to include between 50% and 75% equities. This results in a remarkably resilient portfolio that recovers quickly from shocks. Chart 6 shows six crises in the stock market over the past 30 years, in all of which stocks fell at least 20% from prior highs:



Source: Dimensional Fund Advisors

In every case, the presence of bonds softened the bear market for stocks, resulting in more limited erosion of portfolios. Maintaining the asset allocation even when stocks were tumbling also enabled investors to profit when markets recovered. The power of Chart 6 is in its consistency: Without fail, investors had gained at least 40% over five years by holding firm to an asset allocation of at least 60% equities.

For investors who remain too worried to put money into stocks today, the message from this minstrel in your gallery is simple: Stand up and stop living in the past. Don't be thick as a brick when you can benefit from equities. Life is a long song; you're not too old to rock-and-roll, and you're not too timid to invest some of your portfolio in the stock market.