

First Quarter 2017 Commentary

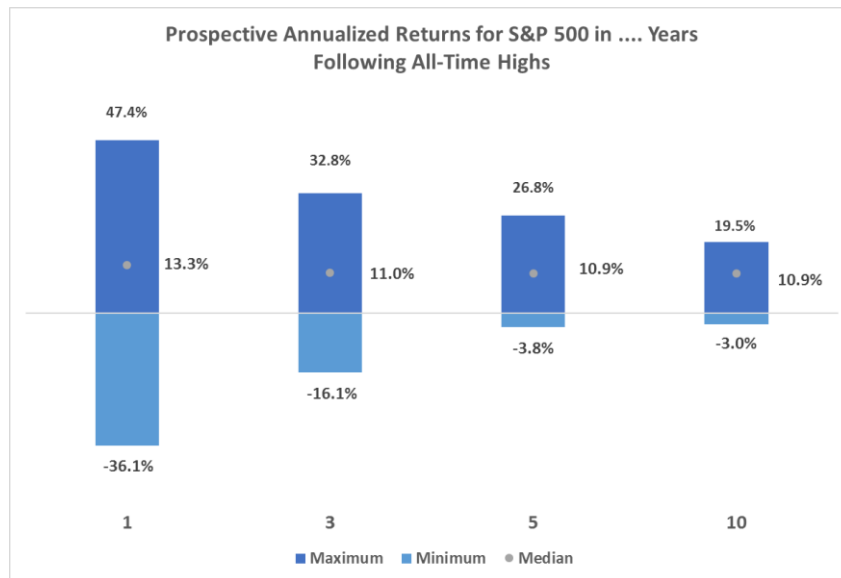
This year started the way last year ended, with the market continuing its ascent. In the first three months of the year, major market indexes climbed to record levels, with the Dow Jones Industrial Average closing over 20,000 for the first time ever in January, then quickly thereafter crossing the 21,000 mark. For the quarter the Dow returned 5.2%, while the S&P 500 posted a return of 6.1%.

March 2017 was the fifth consecutive month for which the U.S. stock market hit a new all-time high, and it was the twelfth time in the previous thirteen months. If you look back over the previous three-year period, about two-thirds of the months ended at all-time highs. Is this recent flurry of new highs an indication that we may finally be due for a correction? Rather than speculate on an answer, we'll allow the historical record to speak for itself.

What Follows All-Time Highs

We looked at the monthly data for the S&P 500 index's returns back to 1940, which was the year Congress passed the landmark Investment Company Act of 1940, capping off a series of laws intended to protect investors from similar events as 1929's great crash and ensuing decade-long depression.

The first new all-time high after 1940 came in January 1945, and there have been 867 months since then. In 295 of those 867 months, or 34%, a new all-time high was reached. Here is how the U.S. stock market performed following those 295 months:



source: Robert Shiller, Yahoo! Finance, MarketWatch, Inkwell analysis

There are four columns in the graph above. The leftmost column shows the returns in the first twelve months following an all-time high. The highest twelve-month return after an all-time high was 47.4%, which happened from January 1954 to January 1955. The lowest twelve-month return was -36.1% and is still a fresh memory for most of us as it occurred from October 2007 to



October 2008. Half of the twelve-month periods following an all-time high saw returns of at least 13.3%, which is shown by the gray dot indicating the median.

As the graph shows, the longer the time period, the lower the volatility for each metric. For example, the minimum annualized return for all the 3-year periods following an all-time high (-16.1%) is lower than the minimum for all the twelve-month periods (-36.1%), and the maximum annualized return for all the 5-year periods (+26.8%) is lower than the maximum for all the 3-year periods (+32.8%).

This implies that holding on for the long haul is the correct strategy for stocks, because the lowest return one would have experienced by buying at an all-time high and holding on for 10 years happened in March 1999. If an investor had bought into the market at that time, near the height of the Internet mania, and held on for 10 years, they would have found themselves in March 2009 at the very bottom of the recent Global Financial Crisis. Buying in at such an elevated level and holding on until such a depressed level still produced an annualized loss of just 3.0%.

In at least half the cases, buying at an all-time high and then holding on for 10 years would have produced a total annualized return of at least 10.9%. That's nearly tripling your money in a decade, and that comes after buying in at an all-time high. Not too shabby.

Let's look at one more stat related to these returns following all-time highs:

| | <u>1 Year</u> | <u>3 Years</u> | <u>5 Years</u> | <u>10 Years</u> |
|------------------|---------------|----------------|----------------|-----------------|
| Total Instances | 285 | 276 | 262 | 257 |
| Negative Returns | 55 | 36 | 21 | 10 |
| Negative % | 19% | 13% | 8% | 4% |

source: Robert Shiller, Yahoo! Finance, MarketWatch, Inkwell analysis

As we said earlier, there have been 295 months in which the S&P Total Return index hit a new high. Ten of those 295 have occurred in the last year, so we don't yet know how those one-year returns will pan out. That leaves 285 instances, and we know that 55 of those 285 saw negative returns in the following year. That means that an investor would have lost money 19% of the time in the twelve-month period following an all-time high.

As you can see, the odds of experiencing a negative return go down for each successively longer holding period, which means that stocks can be a pretty good place to be invested for long time frames, even when those time frames begin at what were—at the time—all-time highs.

What Follows Non-All-Time Highs

The preceding analysis is all well and good, but we have so far only described how the market performs following all-time highs. We should look also at the 1-, 3-, 5-, and 10-year periods following months that did not experience an all-time high. If those returns are appreciably higher than the ones we looked at above, then we should have an open-shut case against buying into the market at an all-time high.



Let's do our analysis in reverse order. First, we'll compare the numbers in the table immediately above to similar numbers for the months that did not see an all-time high:



source: Robert Shiller, Yahoo! Finance, MarketWatch, Inkwell analysis

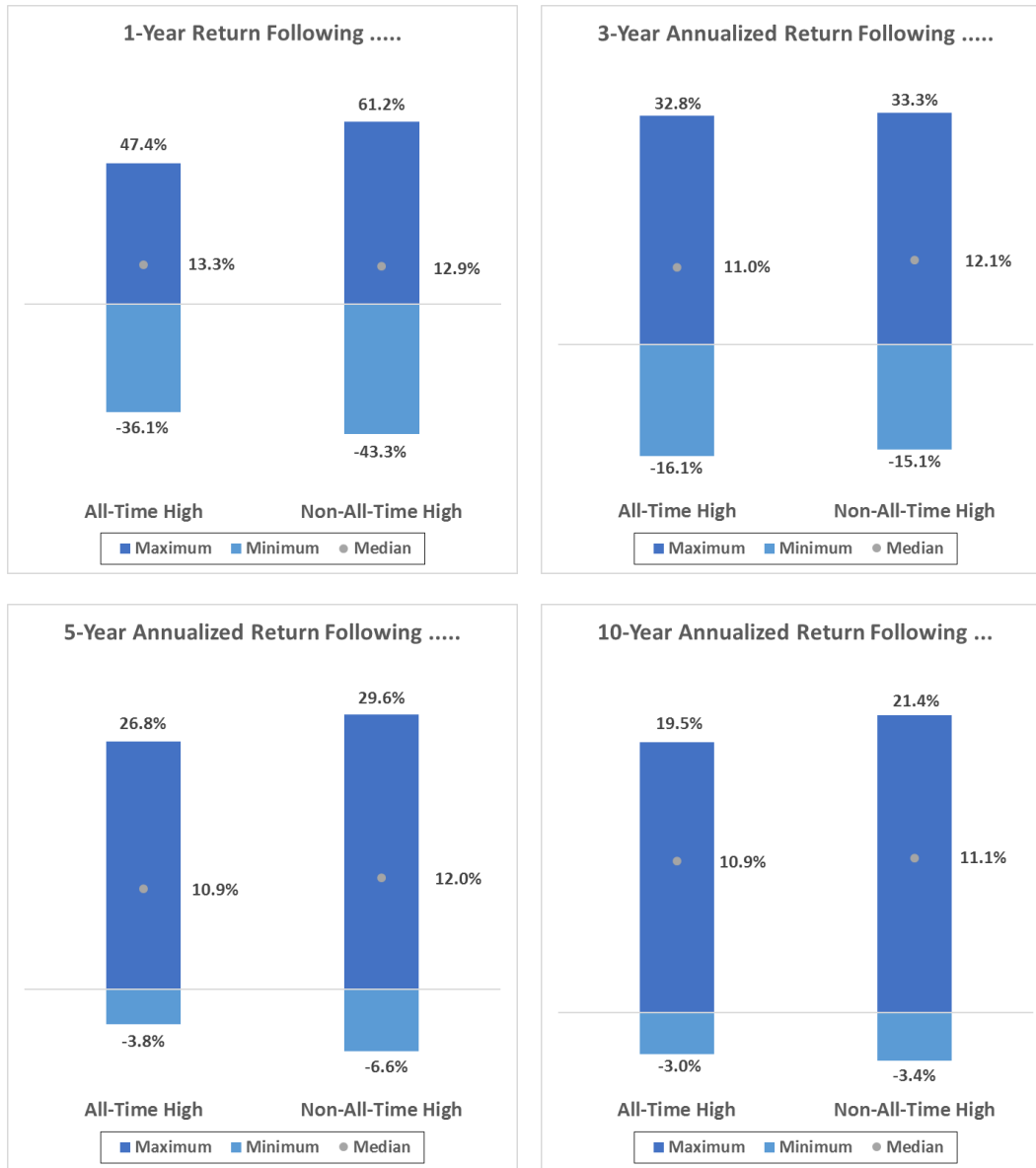
Two interesting points jump out from these four graphs. First, the percentage of non-all-time high months with negative returns is almost exactly the same as the percentage of all-time high months with negative returns. We confess that we would have expected the percentage to be much lower for the returns following non-all-time high months.



The second point is that the relationship does not hold across the board. While the 3-, 5-, and 10-year returns do have a lower chance of being negative, it's actually more likely to have a negative return over the twelve months following a non-all-time high.

All-Time Highs vs. Non-All-Time Highs

Now let's put the returns head-to-head. We'll compare the returns following an all-time high against the returns following a non-all-time high:



source: Robert Shiller, Yahoo! Finance, MarketWatch, Inkwel analysis

You'll notice that the left column in each of these four charts was taken directly from the first graph up above. In three of the four charts, the minimum negative return is actually lower (i.e.,



the loss was smaller) following all-time highs, and the median returns are nearly identical whether they follow all-time high months or non-all-time high months.

The bottom line conclusion we take away from these four charts is: the stock market has nearly the same risk at its all-time highs as it does at any other time.

What Now?

Now for the payoff: what should we expect following the latest all-time high in March 2017? Will 2017 finally be the year in which U.S. stocks experience a bear market (that is, decline by at least 20%)? We have no idea.

Could stocks go down 20% or more? Yes. They very easily could.

Could they go up 20% instead? Again, yes. That's possible, too.

And we really don't know what will happen.

What we can say is that the historical record seems to indicate that investing in the stock market does not appear to be any riskier at the times when the market is hitting all-time highs than it is at other times. This is a surprising conclusion, to say the least, but it's all right there in the data.

One important caveat, though: this analysis completely ignores every outside force acting on the stock market. Prevailing interest rates, expected GDP growth, valuation criteria, geopolitical activities, and many additional variables influence the stock market, and this analysis conveniently ignores all of them.

The market in 2017 is wholly unique in the condition of these external parameters, and therefore perhaps this analysis has no bearing whatsoever on what returns one may expect in the next decade. Which is why Inkwell is going to keep its head down and focus on things the way we always do: one stock at a time.

As ever, we thank you for your trust and support. We look forward to reporting to you again in three months.

Sincerely,



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