The Stock Market is Hitting Record Highs: Now What?

The U.S. stock market hit an all-time high last month. On May 13, the S&P 500 index closed at 1,897.45, up more than 3% year-to-date at that point if you include dividends. And this was after that same market index returned more than 32% in 2013. And *that* was following another banner year of 16% growth in 2012.

If your portfolio has had a significant exposure to the stock market these last few years, this has been good news for you. After all, a rising tide lifts all boats. However, after such heady recent gains, is it time to abandon ship?

Another Day, Another Record Stock Market Close

May 13, by the way, was not the only date on which the S&P 500 set a record this year. It was actually the tenth record close of 2014, following the previous record-high closes set on January 15, February 27, February 28, March 4, March 6, March 7, April 1, April 2, and May 12.

And these ten record-setting days came on the heels of an incredible performance in 2013: of the 252 days on which the stock market was open last year, the S&P 500 set new records on 45 of those days—nearly one-fifth of the total. In other words, the market set a new record high on average about once each week last year.

In our database, which has daily S&P 500 prices back through 1950, only 4 other years have had more than 45 record closes: 1964, 1987, 1995, and 1998. Two others (1955 and 1997) tied the mark. For each of those 6 previous instances, the market continued to advance in the next calendar year, but the five-year performance is a bit more spotty:

Year	Record Closes	Total Return in Following Year	Annualized Total Return in Five Following Years
1955	45	7.4%	9.2%
1964	65	12.4%	3.3%
1987	47	16.6%	15.9%
1995	77	23.0%	18.3%
1997	45	28.6%	-0.6%
1998	47	21.0%	-0.6%
2013	45	?	?

source: Yahoo!, Standard & Poors, Robert Shiller, Inkwell analysis

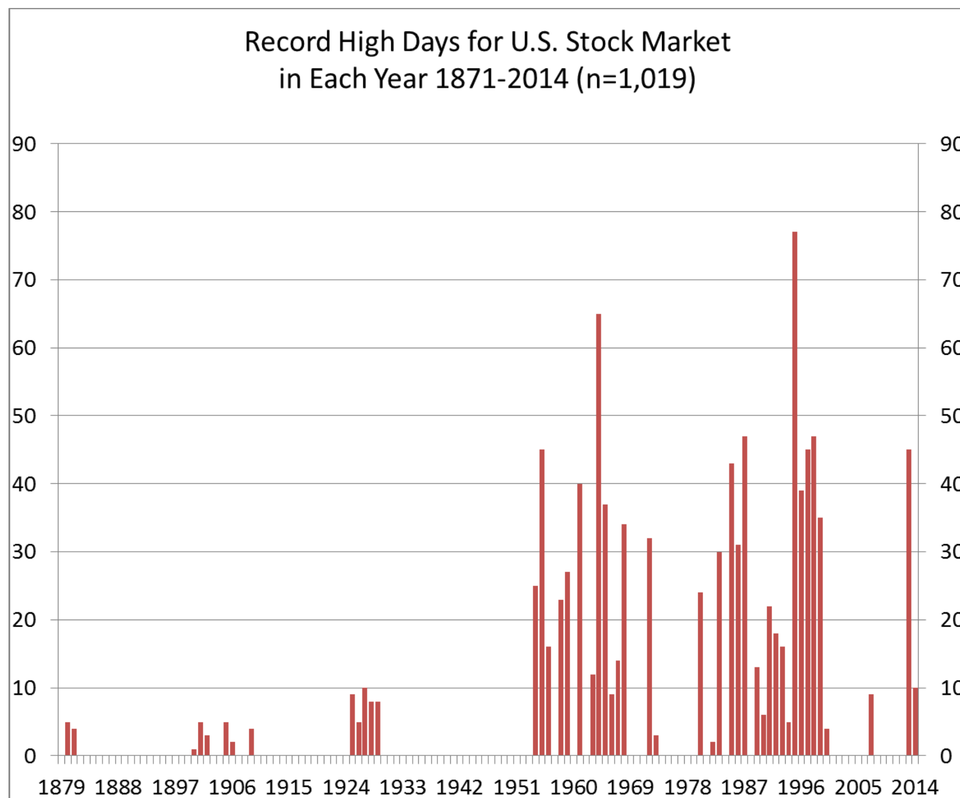
Widening the Lens

But seven data points is an incredibly small sample size, and we wouldn't want to go making any general pronouncements about things based only on that. What if we look at the bigger picture?

As we said, we have daily prices for the S&P 500 index going back to 1950, courtesy of Yahoo! Finance. Before that, courtesy of Nobel Prize winning Yale professor Bob Shiller, we have monthly data going back all the way to 1871. If we take all of those data points together, we then have a data set with 16,894 points, which is significantly more robust.

Of those 16,894 closing prices for the S&P 500, 1,019 of them set new records. That represents 6% of the total, and it means that the stock market reached a new record high on average every third week. The most important words in the previous sentence, of course, are *on average*. If the market had advanced in a generally smooth, somewhat linear fashion from 1871 through 2014, then yes we would have seen a new record high about once every three weeks.

However, as we all know, the market moves more erratically than that, with big crashes coming every few decades, bull markets lasting several years, and so on. Here is how the 1,019 new highs actually came in, which is rather lumpy:



source: Yahoo!, Robert Shiller, Inkwell analysis

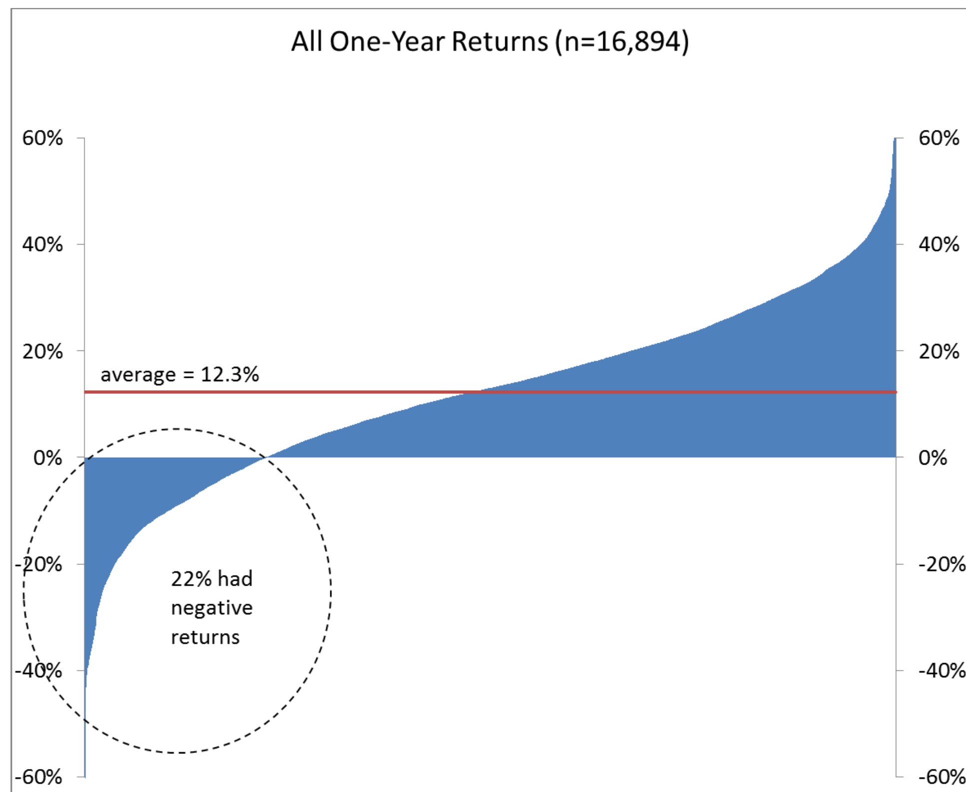
As the graph indicates, following the big crash in 1929, the market did not reach a new record high level again until 1954. Twenty-five years is a long while to wait for a market recovery.

Hang On For One More Year

For 980 of those 1,019 record highs, we know how the market performed in the one-year period following the record close. (That is, the remaining 39 days occurred less than one year ago, so we are still waiting to see exactly how it plays out.)

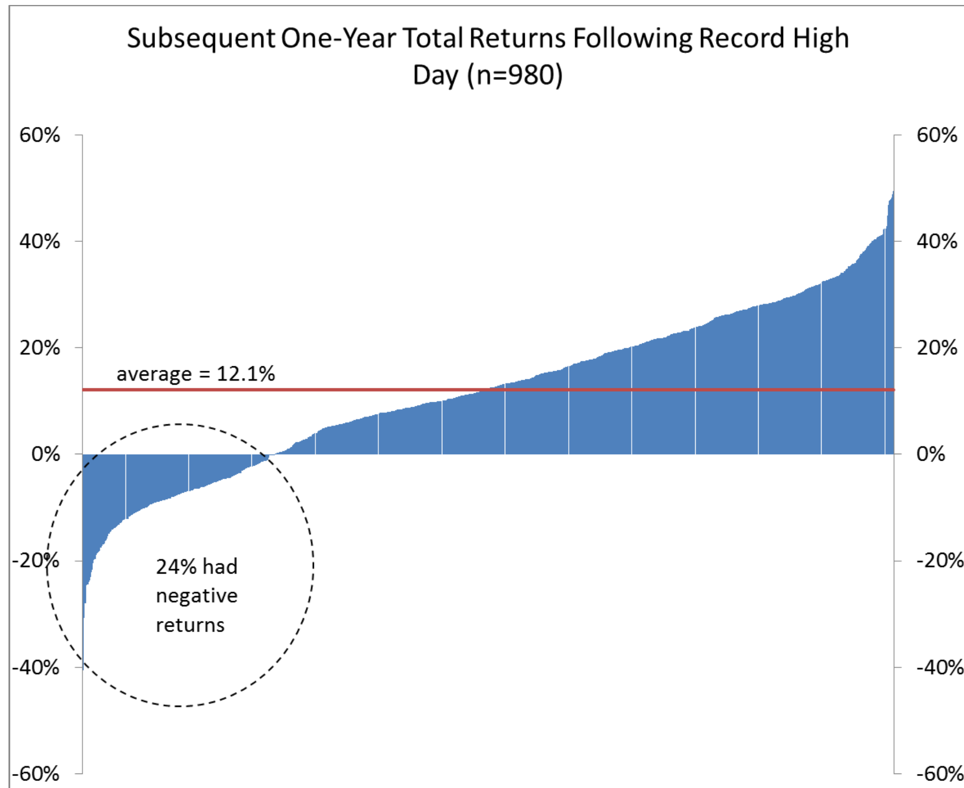
If we can compare the performance of the market after these days to the general performance of the market, then perhaps we can glean further insight into whether now would be a good time to get out of the market.

The blue columns in the following chart are all of the one-year returns the market has experienced for each one of our data points going back to 1871. The horizontal red line shows the average one-year return, which was 12.3%. The dashed circled shows that the market actually declined for any given one-year period approximately 22% of the time.



source: Yahoo!, Robert Shiller, Inkwell analysis

And now we see the same chart again, but this time instead of showing all 16,894 data points, we will look only at the one-year performance of the market following the 980 record highs. The blue columns again represent each of the results, and the red line shows the average, which is slightly lower at 12.1%. The dashed circle shows the results in which the market declined over the one-year period, which happened 24% of the time.



source: Yahoo!, Robert Shiller, Inkwell analysis

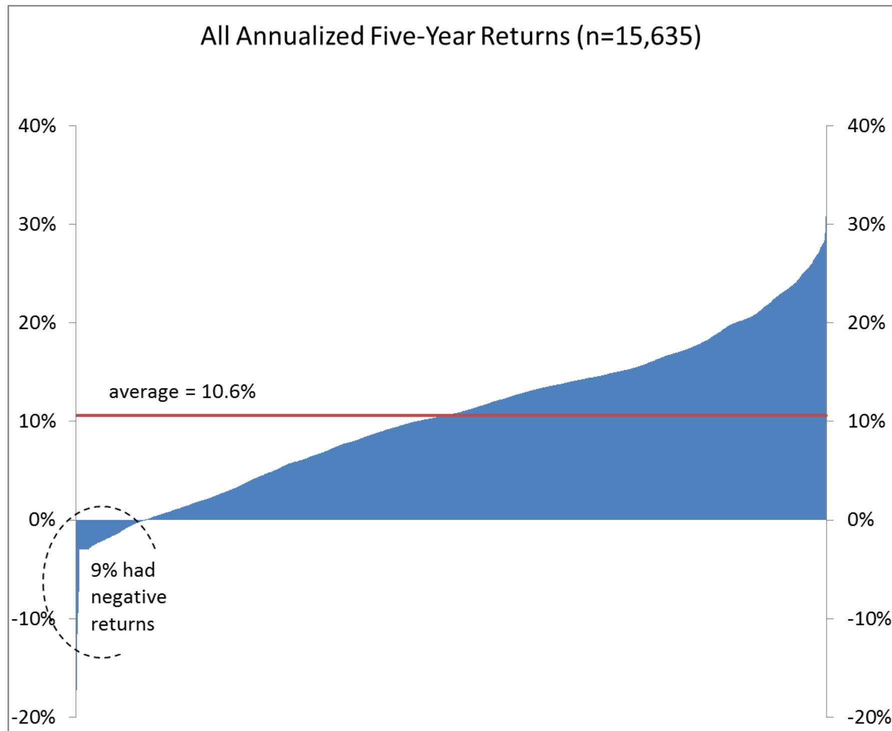
In other words, the one-year performance of the stock market following a record high is not significantly different from the one-year performance of the stock market in general. So is now a good time to get out? This particular set of data seems to indicate that may not be a great idea.

Hang On For Five More Years?

What if we expand our horizon a bit? That is, instead of looking at the subsequent one-year returns of the market after a new record high, what if we look at how the market does over the next five years? Will the results be any different?

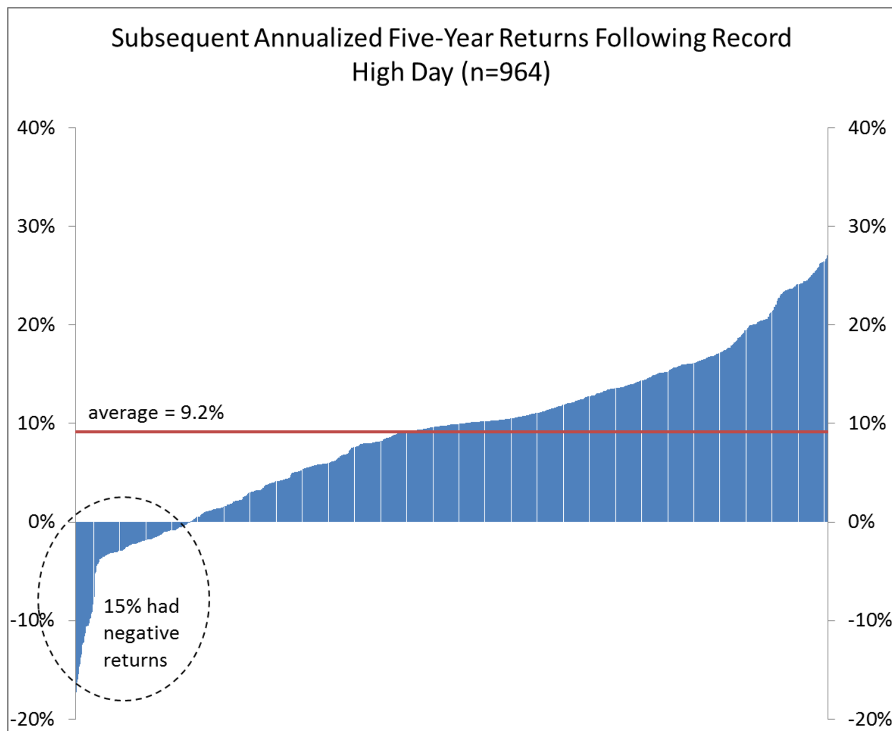
We know how the market performed in the ensuing five-year period for 964 of the 1,019 record closes. (In other words, 55 of the records have occurred in the last five years, so we are still waiting to see what happens.)

This first graph shows all of the instances we have of the market's performance over a consecutive five-year period since 1871. The annualized returns range anywhere from -17% to +34%, with the average coming in at 10.6%. If a hypothetical investor had been in the market constantly since 1871, we can say two things about him: (1) he would now be a very old man indeed, and (2) he would have lost money in approximately 9% of these five-year periods.



source: Yahoo!, Robert Shiller, Inkwell analysis

Now we will look only at the five-year performances of the stock market immediately following a new record close. The picture here is a bit different, with the average annual return coming in at only 9.2%, and with 15% of the data points seeing a cumulative loss during the 5-year period.



source: Yahoo!, Robert Shiller, Inkwell analysis

So is now a good time to get out of the market? If we based our conclusion solely on these graphs—and we ignore everything else we know about the current market environment and all of the past environments, including prevailing interest rates, P/E ratios, the political climate, etc, etc., etc.—then it seems to us to be only moderately more risky to be in the market following a record high than it is to be in the market at any other time.

Historically speaking, an investor could expect to make about 10.6% per year over any given five-year stretch, with the chance at losing money about 9% of the time. If the investor restricted himself to only investing in the market immediately following a record high, though, his expected return would be 9.2%, and his chance of loss over a five-year period would be 15%. To us, the differences between those numbers do not set off bright flashing red signals and clanging alarm bells of panic. Perhaps they indicate that an investor should have a moderately aroused sense of caution, but probably not any manic premonition of imminent doom.

Conclusion

But, of course, that is just about the most simplistic method of analysis one could perform. A prudent investor would never ignore the prevailing interest rates of the day. Or the level of P/E ratios of individual stocks, market sectors, or the market index overall. Or the political climate. To do so would be the height of foolishness. But if you are ever feeling so inclined, just remember this article and try to breathe a little easier knowing that new stock market highs do not necessarily mean that the end of the world is nigh.

Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC