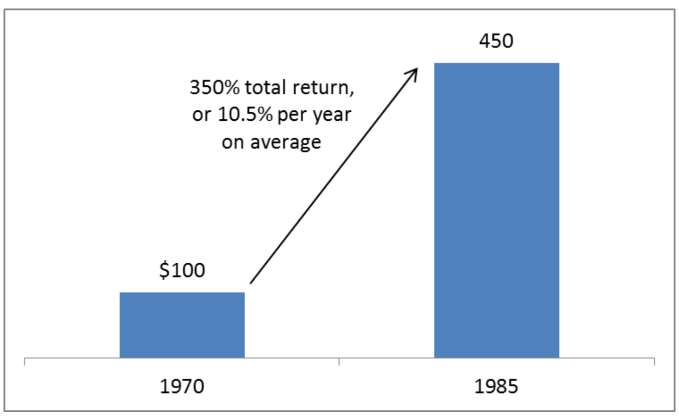
Que Sera, Sera

Do you remember that classic Hitchcock thriller "The Man Who Knew Too Much?" And how the famous song *Que Sera, Sera* figured into the climax in which Jimmy Stewart and Doris Day are re-united with their missing son? Perhaps in your head you are singing the chorus of the song now, with its poetic alternation between Spanish and English: "Que sera, sera. Whatever will be, will be. The future's not ours to see. Que sera, sera. What will be, will be."

Despite the wisdom of these words, stock market pundits never cease attempting to guess where we are headed in the near future. Usually such attempts are nothing more than fools' errands, but sometimes there is enough of a historical pattern for us to at least put future data points in the right ballpark.

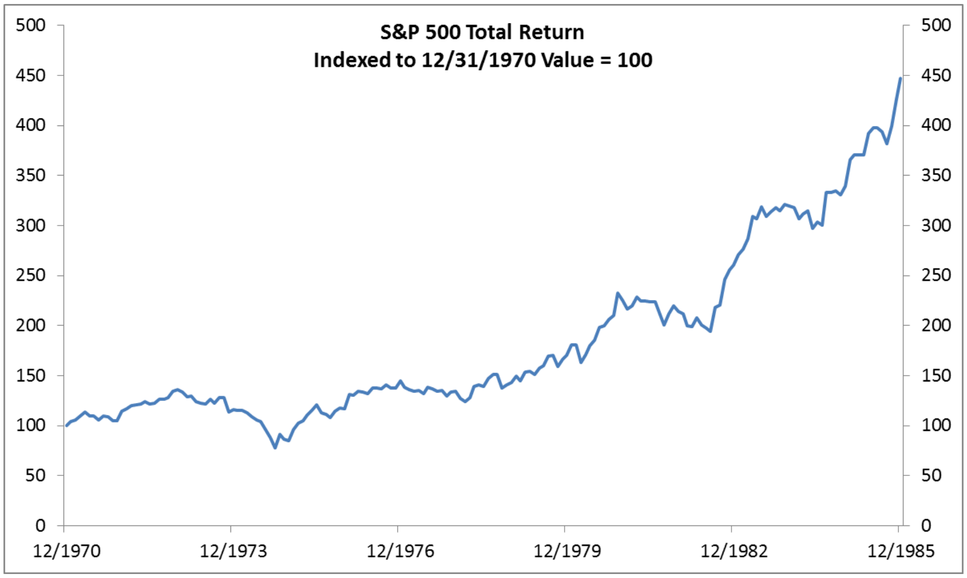
Consider the patterns of the annualized rolling 15-year returns for the S&P 500 index, which seem to exhibit a fairly uniform cycle of ups and downs. Before we look at those numbers, though, let's make sure we all understand what is meant by annualized rolling 15-year returns.

As an example, let's take the period from 1970 to 1985. If an investor had put a certain amount of money into the S&P 500 index at the end of 1970, and left it there for 15 years, never adding to or withdrawing from it, and having all the dividends which were issued re-invested in the index, then by the end of 1985 that investor would have had almost exactly four-and-a-half times his original outlay. That works out to a 350% increase over the course of that 15-year period, which—on average—works out to an annualized gain of 10.5%. That is, if you started with $100, then after the first year you would have $110.50. After two years, you would have $122.10. And so on until you had about $450 at the end of 15 years:



Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

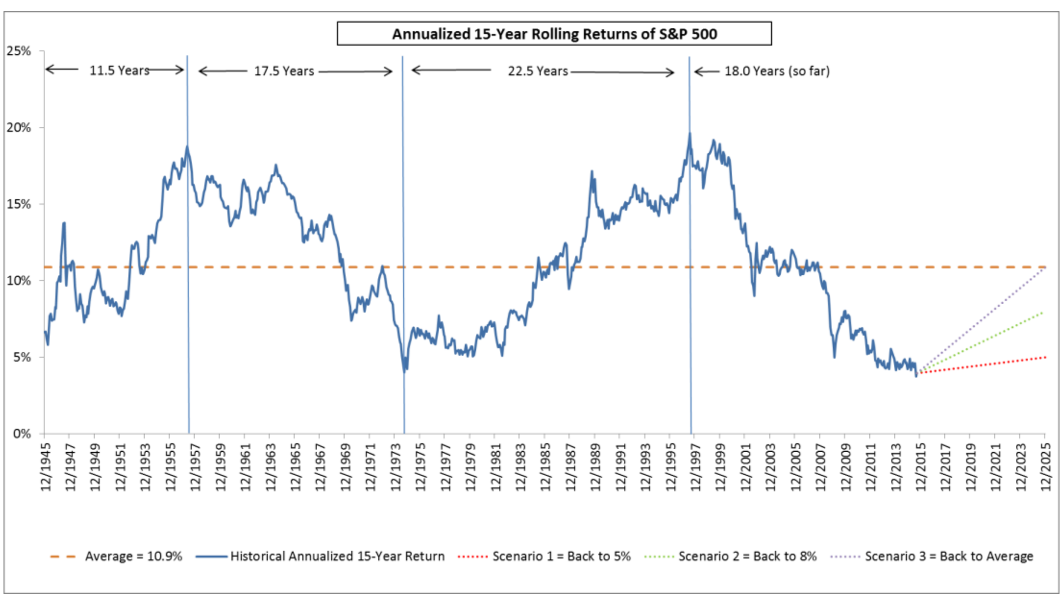
Of course, in actuality, the gains from 1970 through 1985 did not come in smooth returns of 10.5% each year. No, indeed. In 1974, our hypothetical investor would have lost more than a quarter of his overall portfolio, only to see it rise by more than a third in 1975 and then rise another quarter in 1976. No, the stock market does not deliver smooth returns. As the following chart shows, the annualized 10.5% return experienced from 1970 to 1985 was much more lumpy than it was smooth.



Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

Ups and Downs

Now that we understand what an annualized rolling 15-year return looks like, let's put them all together on a chart to see about that uniform cycle of ups and downs we mentioned earlier. The chart starts at the end of 1945, so the first point on the blue line represents the annualized return exhibited by the S&P 500 from 1931 through 1945, which was 6.6%. Over the next eleven-and-a-half years the line gradually moves up, in fits and starts, until it peaks out in mid-1957 at 18.8%. That is, the S&P 500 returned on average 18.8% per year from mid-1942 until mid-1957.



Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

Then the line gradually moves down, again in fits and starts, until it bottoms out in late 1974 at the pitiful figure of 4.0%. From late 1959 through late 1974, an investor in the S&P 500 would have averaged making just 4.0% per year. Can you imagine? That's the same return we were making on our FDIC-insured savings accounts just a decade ago!

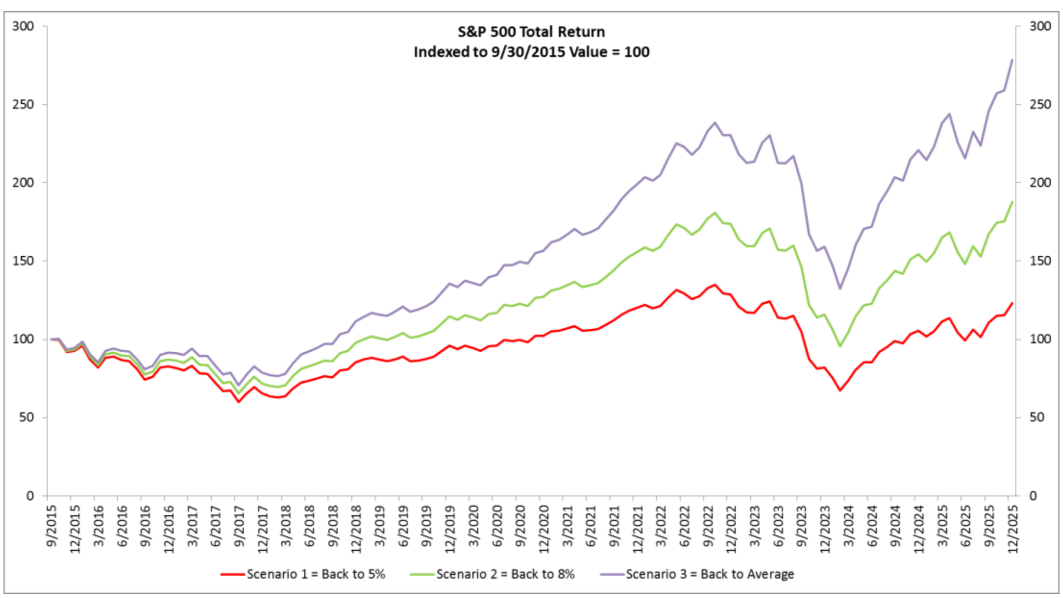
But then the cycle began again, with the line on the chart rising from the depths of 1974 to the heights of 1997, reaching a peak of 19.7%. Since then it has been gradually declining over the last 18 years, and it currently sits at 4.0%, coincidentally the same low point it reached in 1974.

But, gosh, that chart sure does look like it shows a clear cyclical pattern, doesn't it? Twice it peaked out at about 19% before turning down again. And, due to the fact that this chart shows rolling averages, we are fairly certain that the current low reading of 4.0% will turn out to be a trough in the graph just like 1974 was, since the 15-year average will soon be leaving behind the terrible returns experienced in 2000 and 2001.

The question now is, "Where are we headed? Where will this graph take us over the next few years?" And of course you now know us well enough to know that our answer is, "We don't know." We really don't. But we can think of a few different scenarios of what *could* happen, and we put them on the chart above. Scenario 1 (the dotted red line) assumes that we stay down on the lower part of the graph for the next decade, improving a little bit but not much to a 15-year annualized return of 5.0%.

Scenario 3 (the dotted purple line) shows what it would look like if we were to improve to our long-term historical average return of 10.9% per year (the dashed orange line), and Scenario 2 (the dotted green line) is halfway between the two, showing a gradual return to an annualized return of 8.0% per year.

But each of those three dotted Scenario lines seems awfully straight compared to the zigs and zags of the actual historical record. Let's try to translate those three straight lines into what they would imply for the stock market over the next decade:



Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

The graph immediately above shows what our three scenarios imply for the S&P 500 index from September 30, 2015 through the end of 2025. Scenario 1, which would get us back to a 15-year annualized return of 5.0% by the end of 2025, shows that the market would basically have to tread water for that to happen. In other words, the only return an investor could expect to receive under this scenario would be the dividends paid out by the S&P 500's member companies.

Scenario 2 is a bit more sanguine, showing a nearly doubling in the stock market over the next decade. Scenario 3, which is the one that would get us back to our long-term historical average of 10.9% annual returns, would necessitate that the market almost triples in value over the next ten years. That seems like it could be a tall order, given that our most recent tripling in the stock market's value took a little over six years and came from the very depths of the financial crisis in late 2008 and early 2009.

Que Sera?

So what will actually happen? Will the market's return over the next decade be somewhere between Scenario 1 and Scenario 3? Again, we have no idea. It's entirely possible that the prospective returns could be worse than any of these scenarios. On the other hand, it's also possible that it could be better than even the most optimistic scenario.

Over the course of time, the general trend of the value of the U.S. stock market has been higher and higher. That trend comes in fits and starts, sure, but overall it has held true and we see no reason for it to stop. So where will the market go in the long term? Our answer is, "Higher." How much higher, and how fast will it get there, and how many downdrafts will we have to endure before we get there? For that, we would refer you back to the first paragraph where you can read again Doris Day's timeless words of wisdom.

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