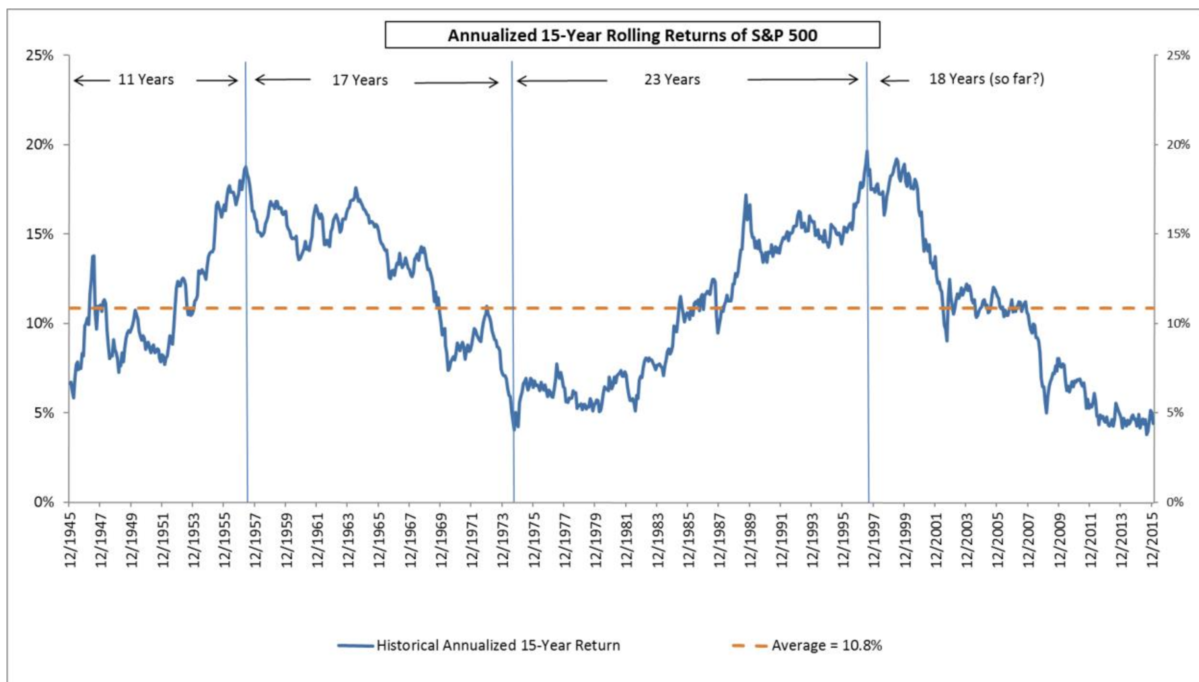
Que Sera, Sera, Continued

A few months ago we wrote an article entitled Que Sera, Sera, which looked at long-term stock market returns and wondered what the future holds for us as investors. We noticed that the stock market moves slowly through natural cycles over the decades, from peaks to troughs and back again, and we saw that it certainly appears that we are currently in one of those troughs.

To do that investigation, we looked at a chart which showed a historical plot of the 15-year rolling average annual return of the S&P 500 index. It showed that, from a starting point after World War II, that graph moved steadily higher until it reached a peak in 1957. From there it began a gradual decline to its next trough in 1974, from which it began another ascent to its eventual peak in 1997:



Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

Since then we've been on the downward slope of the graph, and it is entirely possible, though not certain, that we may have hit another trough in August 2015. To be specific, the S&P 500 index returned on average 3.8% per year from August 2000 through August 2015. This figure was slightly lower than any of the preceding months of 2015, and it's lower than any month since then, up to the time of this writing.

Month of Extreme	Years from Previous Extreme	15-Year Rolling Average Annual Return at Extreme
December 1945		6.6%
May 1957	11.4	18.8%
September 1974	17.3	4.0%
July 1997	22.8	19.7%
August 2015?	18.1 (so far)	3.8%

Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

In our original article, we envisioned a few different scenarios for how this graph may unfold over the next decade or so. In other words, if we continue to draw that solid blue line in the graph above over the ensuing months, how much higher might it climb, and how fast?

But that answer only gives us a bird's-eye view of the answer to our original question of "Where are we headed from here?" We thought it might be interesting to get a ground-level view of things and see what sorts of returns an investor might reasonably expect to earn starting from today. So let's look at each of the previous peaks and troughs on our graph above and see what actually happened to the stock market starting at each of those points.

The Five-Year Plan

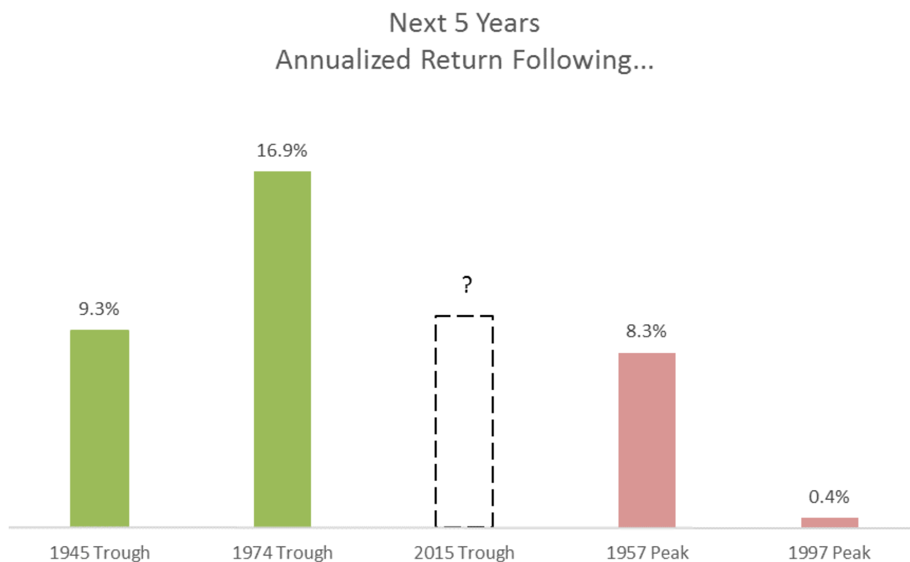
We always counsel our clients, friends, and family that they should never put at risk in the stock market any money that they are going to need to spend in the next five years. The stock market is a wildly volatile place, and there's simply no telling what will happen from year to year. Yes, over the long haul it generally goes up, so we should invest at least a portion of our overall portfolio in stocks. But only long-term capital should ever be exposed to it.

So let's look at what happens in the five-year periods following the extreme points in the graph above. Take September 1974, for instance. Starting from then and going until September 1979, the S&P 500 index returned an average of 16.9% per year. That's nearly breath-taking, isn't it?

What about the other trough point on the graph? If you start instead at December 1945, the average annual return investors earned over the ensuing five years was just 9.3%. A far cry from 16.9%, but still not too shabby.

However, the next data point sort of confuses things. From May 1957 (a peak point on the first graph above) through May 1962, the average annual return of the market was 8.3%. Was that answer as unexpected for you as it was for us? We were expecting to see boffo returns for any five-year period following a trough, together with meager returns for any five-year period following a peak.

Indeed, the five years after July 1997 saw a measly 0.4% annualized return, which is just as we would have expected. But 8.3% following the May 1957 peak and 9.3% following the December 1945 trough seem too close to each other for us to be able to draw any meaningful conclusions.

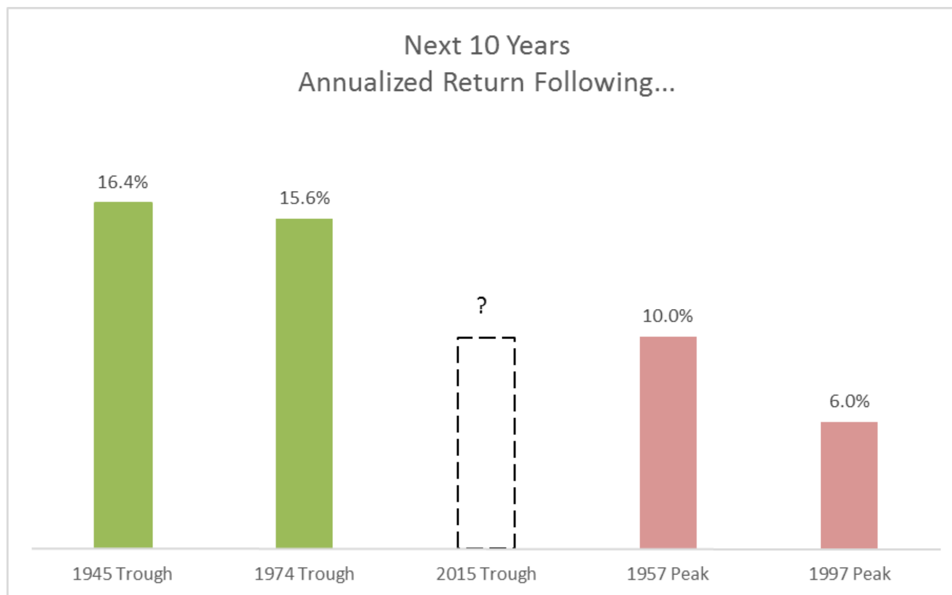


Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

Monet's Lesson for Investors

Have you ever stood really close to an Impressionist painting at an art museum? You know how the brush strokes seem completely random and disjointed at close inspection, but then as you step slowly away from the artwork it all begins to mesh together and make sense? That same thing happens here.

Let's re-create that exact same graph again, but this time the header is going to say "Next 10 Years" instead of "Next 5 Years."



Source: Yahoo! Finance, Robert Shiller, Inkwell analysis

Now that's more like it. Here are the lessons that jump out of that graph to our eyes.

First, the returns following trough points on the graph are generally higher than the returns following peaks. The 1945 and 1974 troughs saw roughly 16% average annual returns over the ensuing decade, compared to just 6% or 10% returns following the 1957 and 1997 peaks.

Second, even after the peak points of the graph, the market still exhibited rather healthy returns over the next decade. Certainly 6% per year over a decade is not going to make any of us fabulously wealthy, but it's a lot better than treading water.

And finally, in investing one has to take the long view. In the short run the market can do anything, and jumping in and out of stocks is a fool's errand. Holding for the long term will greatly increase the odds of achieving a satisfactory result.

The Outlook

It's entirely possible, though not certain, that August 2015 will become a trough point on the long-term graph of the stock market cycles. If that turns out to be the case, what will the next five or ten years bring to us investors? Well, again, we have no way of knowing that answer with any sort of precision. But based on historical context, even after the multi-year bull market following the 2008-09 financial crisis, it appears that the odds are good that we will see some healthy returns in the not-too-distant future.

We would never advise someone to put into the market any money that they cannot afford to lose or that they need to spend in the near future. But for an investor with a long-term outlook—the longer, the better—and no pressing need for his or her cash, we wouldn't hesitate to recommend a prudent level of stock market exposure.

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