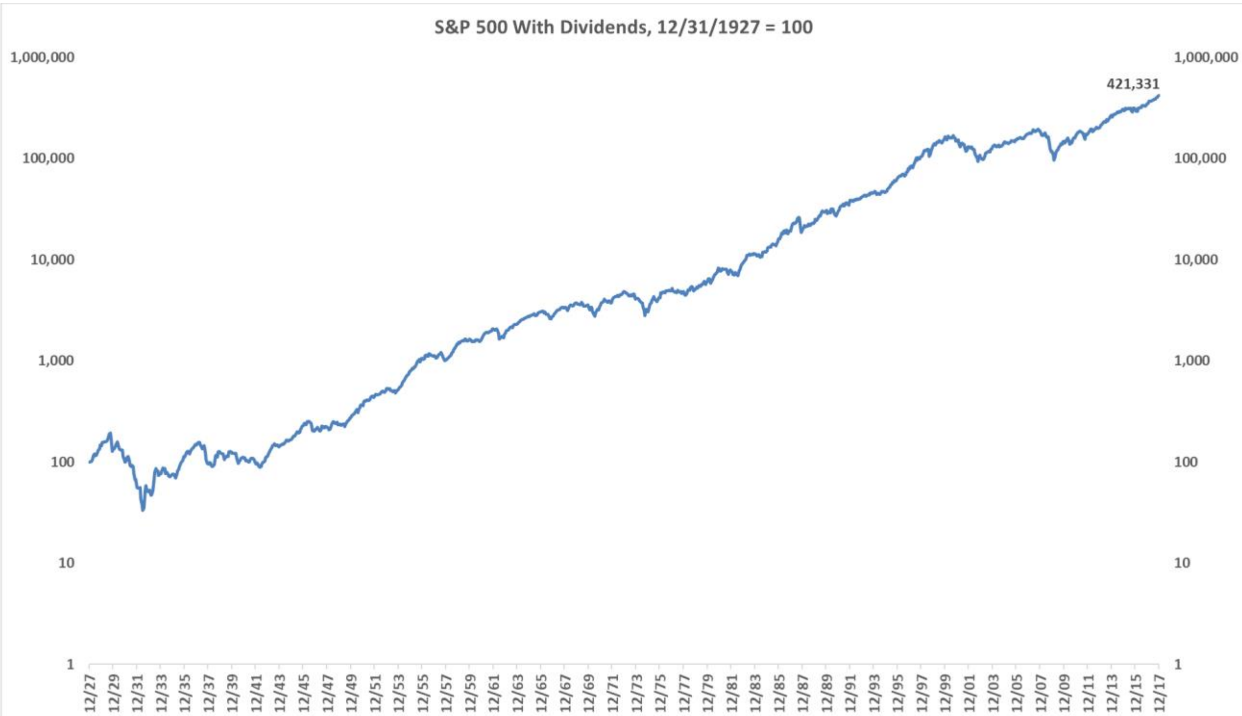
Feeding at the Trough of the Stock Market

We write a lot about what a great place the stock market is for long-term investors to be. From its starting point at the end of 1927 (as far back as we are able to go with good data), we are now more than 4,200x higher at the time of this writing. That works out to an annualized return of just under 10%, which is not too bad.



source: Robert Shiller, Marketwatch, Inkwell analysis

It's hard to make it out in the chart above, but there have definitely been peaks and valleys along the way. Even casual students of market history know about the calamities of 1929, 1987, and 2008. But there have been other painful bear markets too, like in 1974 when the U.S. market declined more than 40%.

Cycle	Peak Date-to-Trough Date	Length in Months	Return
1	1929-32	33	-47%
2	1937-42	62	-10%
3	1946-49	37	-4%
4	1961-62	6	-21%
5	1969-70	13	-25%
6	1972-74	21	-27%
7	1980-82	20	-10%
8	1987-87	4	-24%
9	2000-03	30	-20%

10	2007-09	16	-42%
11	2011-11	5	-16%
	Average:	**22**	**-22%**

note: returns annualized for peak-to-trough cycles greater than one year
source: Robert Shiller, Marketwatch, Inkwell analysis

The second column in this chart describes the eleven market cycles we have experienced over the last 90 years using the terms "peak" and "trough." What is it that defines a market peak or a market trough? Well, it's only with the benefit of hindsight that we are able to identify these market turning points.

A stock market trough is defined as a low point in the index *after a decline of more than 20%*. We have to set a certain minimum threshold, otherwise we would be experiencing "market troughs" multiple times per day and this sort of analysis would be pretty impossible.

Why did the powers that be select 20% as that threshold? Who knows? It's a nice round number, and we seem to surpass only once every so often. But they could just as easily have selected 15% or 25% or even 23.4%, but 20% is the standard so that's what we're going to work with.

Now that we've defined what a trough is, we can define a market peak: it's simply the highest point immediately before a market trough. Therefore, we can't define a market peak without first defining a market trough. For instance, most all of us can viscerally recall the market bottoming in early 2009, when the S&P 500 index reached a low point of less than 700. If we look back from that period, the highest point that the S&P 500 index reached was in late 2007 when it briefly crossed the level of 1,500.

Thankfully, both of those points are quickly becoming distant memories, as the S&P 500 sits at just under 2,700.

Cycles Measured from Peak to Peak

In past articles we have examined the question of whether one should go ahead and invest at what appears to be a market peak. Here is how an investor would have fared by doing just that in each of the eleven market cycles since 1927:

Cycle	Peak-to-Peak Dates	Length in Months	Return
1	1929-37	89	-3%
2	1937-46	111	+5%
3	1946-61	187	+15%
4	1961-69	89	+8%
5	1969-72	43	+7%
6	1972-80	95	+7%
7	1980-87	81	+19%
8	1987-2000	156	+15%

9	2000-07	86	+2%
10	2007-11	42	-1%
11	2011-????	80 (and counting)	+13%
	Average:	**96**	**+8%**

source: Robert Shiller, Marketwatch, Inkwell analysis

An investor who invested at each of the past eleven market high points, held on throughout the decline and subsequent recovery all the way until the next market high point, would have earned an average annualized return of 8%. Of course, there was significant dispersion around that 8% average. Some market cycles saw great returns, like the one from 1980 to 1987 which returned 19% per year on average. Others, though, were terrible: starting at the high in 1929 and holding on until the next high in 1932, an investor would have actually *lost* 3% per year, or an aggregate of 20% of their initial outlay.

Cycles Measured from Trough to Trough

If we perform the same analysis over each of the ten complete market cycles (we are still in the midst of the 11th, since we have not had a 20% decline since 2011), we see better returns across the board. First, we see that there have been no negative returns for a hypothetical investor who held the S&P 500 index from a trough point to the subsequent trough point. There were two periods (1970-74 and 2003-09) when an investor would have basically been flat over the course of the cycle, but there has not been one yet in which an investor would have lost money.

Second, we see that the average return of 11% per year is higher than the peak-to-peak return of 8%, and seven out of the ten cycles saw annualized returns in the double digits compared to just four out of eleven in the peak-to-peak cycles.

Cycle	Trough-to-Trough Dates	Length in Months	Return
1	1932-42	118	+10%
2	1942-49	86	+14%
3	1949-62	156	+17%
4	1962-70	96	+7%
5	1970-74	51	0%
6	1974-82	94	+12%
7	1982-87	65	+22%
8	1987-2003	182	+11%
9	2003-09	72	0%
10	2009-11	31	+21%
	Average:	**95**	**+11%**

source: Robert Shiller, Marketwatch, Inkwell analysis

The exact figure in the bottom row of the previous chart is 11.3%, which should be compared to the figure cited in the first paragraph of this article of “just under 10%” by simply buying and holding for the duration.

Conclusion: Don’t Be Tempted to Time the Market

Yes, only investing at market troughs can be an appealing idea. But how often do those opportunities come along? And how will you be able to recognize the inflection points in real time? After all, there’s no proverbial bell that rings to alert you that the stock market is right this very moment experiencing a near-term high or low point. And what will you do with your cash as you wait for the next “buying opportunity”? It would have to be in something relatively liquid for you to be able to act quickly in the market, which will probably expose you to the erosive effects of inflation. And would you have the emotional fortitude to be able to buy big when everything around you—from your neighbors to your brokers to the talking heads on CNBC—are preaching doom, gloom, and the end of business as we know it? Then there’s the question of capital gains taxes and whether you’d be able to overcome the tax man’s take with your opportunistic buys and sells.

In short, there are too many variables and too many unknowns for someone to successfully time the stock market. It has been a fool’s errand for as long as there has been a stock market. We believe the best course of action is to follow an intelligent investment plan. For those using market indexes, that means dollar cost averaging and allocation re-balancing over the years, creating a natural system of buying low and selling high. Or for those who invest in individual securities, it means insisting on bargain purchases and using a margin of safety in all calculations.

We believe that these strategies virtually assure an investor of getting rich slowly. For us, there is no shame in the “slowly” part of that statement, because the first two words are still applicable.

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