

New Year, New Market Highs

February 2018

Throughout 2017, the S&P 500 Index recorded 62 new closing highs in 251 days of trading. In the first three weeks of January 2018 alone, the index crossed 10 new record closing highs in 13 days of trading.

With stock indices continuing to set new highs, does this mean negative returns for stocks are on the horizon? When addressing this question, it is helpful to keep the following in mind:

- Every day, stocks have a positive expected return regardless of whether markets are at an all-time high or not.
- While expected returns are always positive, positive realized returns are never guaranteed and may deviate from expectations.

The reason we can expect positive returns, regardless of the current market level, is attributable to the mechanism by which markets set prices. Stock prices are the result of the interaction of many willing buyers and sellers. Current prices reflect the discounted value of future cash flows expected by those buyers and sellers. But, there is uncertainty around these future cash flows for stocks, and investors bear the risk of potential losses. If the buyer of a stock views the future cash flows as more uncertain, they will likely want to pay a lower price for the stock. They will only transact when the price reaches a level where they expect to earn a positive return. For these reasons, we expect stock market prices to be set to a level at which the required rate of return for investing in stocks is positive, whether the market is at a new high, a new low, or something in between. Otherwise, why would buyers in the marketplace willingly transact at a given price?

History can help illustrate this point and show us that a market index reaching an all-time high has not necessarily provided actionable information for investors.

Exhibit 1. S&P 500 Index Total Return Highs
Percent of cases where index is higher after monthly closing high vs. any monthly closing level
January 1926–December 2017

Look-Ahead Period (N)	Percent of Cases Where Index is Higher (after new high)	Average Gain (after new high)	Percent of Cases Where Index is Higher (after any previous level)	Average Gain (after any previous level)
1 year	80.9%	19.6%	75.0%	21.1%
3 years	84.2%	51.1%	83.5%	51.8%
5 years	84.2%	89.2%	87.5%	85.0%

For illustrative purposes only. Average gain is a simple average of all positive returns for the 1-, 3-, or 5-year periods analyzed. © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved.

Exhibit 1 measures monthly closing levels of the S&P 500 Index from the beginning of 1926 to the end of 2017. Of the 1,103 months observed, almost one-third represented new closing highs for the index. This may not be surprising for some. Since markets generally tend to go up over time, new highs should be a relatively common occurrence. Considering this, it is worth posing the question: If prices increasing over time was a troubling development, what would be the point of investing at all?

This data also shows that looking ahead on a one-, three-, and five-year basis, the percent of cases when the index was higher or lower after a new market high is about the same when compared to any other previous price level. In other words, positive and negative returns tended to make up a similar proportion of returns after the fact, regardless of whether a new high was reached or not. For example, for a three-year look-ahead period, the index was higher around 84% of the time both after hitting a new closing high as well as after any other previous level. Additionally, this data shows us that the average return experienced after those highs vs. any other level is also quite similar. For example, for the three-year look-ahead period, the average cumulative return after a new high was 51.1% vs. 51.8% for any other level. These results indicate that new index highs have historically not been useful predictors of future returns.

Another reason investors should be cautious about reevaluating their approach at an all-time high is the potential opportunity cost of switching in and out of the market. Last year, the S&P 500 Index returned more than 20%, and yet 2017 started with three new market highs during the first 20 trading sessions.¹ The opportunity cost paid by investors reacting to the new highs by selling stocks could have been substantial. There is no reliable way to predict when stock returns will be positive or negative, and while the long-term average return of the US stock market² has been around 10% since 1926, year-to-year results often deviate markedly from the historical average.³ Investors looking to capture what the equity markets offer over the long term are likely well served by sticking with their approach rather than making changes based on short-term noise.

CONCLUSION

The question of whether new market highs portend a fall in stocks can often be translated to another, more general question: “Is now a good time for me to be invested?” The evidence suggests that the current state of the market is not helpful in answering this question. Rather, an appropriate answer is highly dependent upon an investor’s unique situation and their risk and return objectives. For investors concluding stock market exposure is appropriate, a disciplined approach with a long-term view is likely a more prudent course of action than reacting to new market highs.

1. S&P 500 Index data © 2018 Dow Jones Indices LLC, a division of S&P Global. All rights reserved.

2 As measured by the S&P 500 Index.

3. For more on this topic, please see “The Uncommon Average” from October 2017.

Source: Dimensional Fund Advisors LP.

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