Observations and Outlook

December 9, 2016

The Definition of "Long Term Investor"

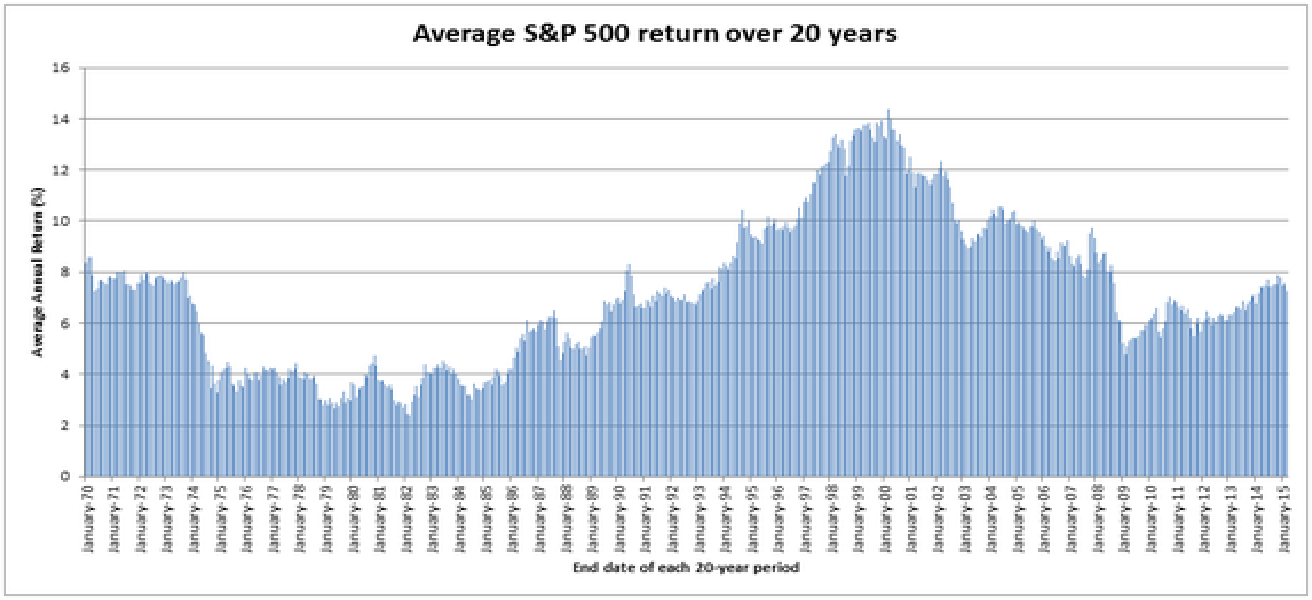
The phrase "Long Term Investor" is used quite often, and there are many definitions. The IRS defines a long-term investment as anything held more than 1 year. Most people though would agree that long-term refers to a much longer time frame, usually at least 5 years. However, when we read about equity market statistics, we are shown 30 and often 70 or even 100-year time spans. I saw a recent article with a 500-year time span. Given the average human life span, and that our peak earning and accumulation years are from our mid-40s to mid-60's, most investors actually have about a 20-year time horizon of accumulation.

A "long term investor" isn't one who buys and holds for a long span of time. A long-term investor recognizes the long-term characteristics of equity (and other) markets. For example, over the very long term (+20yrs), earnings per share follow GDP growth, the average 20yr annualized return is just over 7% (with dividends adding to this), and that over shorter periods of time, actual returns can vary greatly from the average. The long-term investor also understands that the averages over the more volatile shorter periods of time are the pieces that create the 20-year average. One can see the volatility, or range of returns, over shorter periods below.

Source: http://www.investopedia.com/articles/stocks/08/passive-active-investing.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186

The periods when we most often hear the phrase "I'm a long-term investor" being used, unfortunately, are when stock markets have experienced a significant decline. To assuage the pain of real or paper losses, investors will often claim this characterization, with the unspoken assumption that 'it will come back'. And it always has, if you waited long enough. From Charles Schwab Inc., via Investopedia.com we can see that yes, over very long periods of time, 20 years in this case, the market always has a positive return.

The chart below shows us the extremes. The low seen in 1979 to 1982 at about a 3% 20-year annualized returns, and the late 1990's, from 1998 to 2001 which saw 20 year annualized returns over 13%. While still positive, it's much more helpful for an investor to invest over the right period! But how can one tell when 'the right period' might be at hand? Or even better, when the 'wrong time' might, so one can avoid a period of poor returns. While not widely disseminated, missing the bad times has a far more powerful impact than staying invested, per this study by Meb Faber of Cambria Investment Management https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1908469

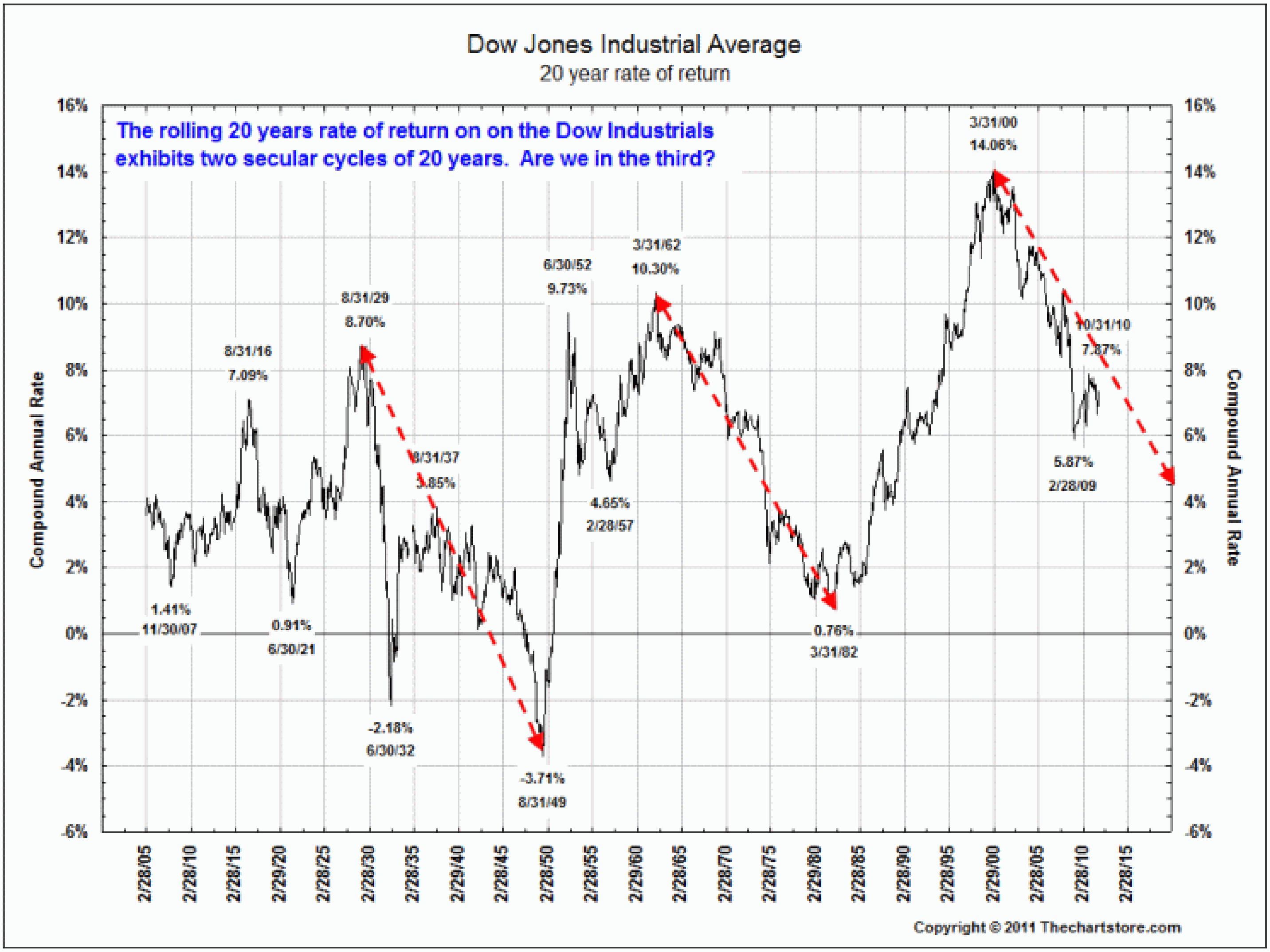


Source: https://www.quora.com/What-is-the-average-S-P-500-return-over-20-years

Buying Low Aids in Long Term Returns

So, while it is clear that, 'in the long run', if you wait long enough you will have positive returns. From the chart above we can see that there are periods when long term returns are well below and above the 7% average. How can we avoid being drawn into the low return eras? Another long-term characteristic of equity markets is that Price to Earnings (P/E) ratios expand and contract. That is for $1 in earnings, sometimes people pay $25 in price (a 25 P/E ratio) and other times less than $10.

For those well versed in market history, we know that the exemplary 20 year annualized returns seen in the late 1990's, saw their birth in the ***low Price to Earnings era of the early 1980's***. There are many studies showing how long term returns are borne from low P/E multiples. Given that currently we are only beginning to enter the 20-years-later period after the dot.com bubble, we only have the first 20-year cycle from 1995, which gave us 7.3% annualized price growth. Given that the late 1990's saw large price appreciation, this acts as a headwind to the 20yr annualized returns in the next few years. The S&P 500 started 1997 at 766 and if we end at 2200 in 2016 that will give us only 5.4% 20yr returns. The S&P500 started 1998 at 963, and to maintain the 5.4% 20yr returns, the S&P500 would need to end 2017 at 2765, a gain of more than 25%! The propensity is for the 20 year annualized returns to continue the downward slope that began in 2002 and likely repeat the bottoms like 1980, 1949 and four other periods where long term (20yr+) returns were very low. The chart below is from Barry Ritholtz.



Source: http://ritholtz.com/2011/12/dow-jones-industial-average/

The results since this chart was created in 2010 are indeed following the red dashed line down. Knowing that the market in 2000 was amongst the most expensive ever (highest P/E ratio) it should be considered that the 20 years ending in 2020 may see results that are amongst the worst in the past 100 years. To have 0% return from 2000 to 2020, the S&P 500 would only need to decline by 31%, about the average for a bear market. To have 2.5% annualized return from January 2000 to January 2020, the S&P500 would end 2019 at 2335, a change of about 6%, or only 2% annually. The moral of the story is outlook for equity returns over the next 2-3 years is low and likely volatile, not a good risk to return prospect.

What Should One Do?

While 20yr annualized returns are slow moving data points, it's clear that the long-term average is in decline. Paying a high price (high P/E multiple) leads to poor long term returns is a slow lesson investors simply don't have the time to learn from experience, and that many Baby Boomers can ill afford to learn now.

Knowing, or rather, expecting returns from stocks to be low going forward will enable an investor to seek returns from other asset classes. Few Investment Advisors currently work with models outside of the traditional stock/bond portfolio mix. An Advisor who recognizes that there are indeed 7 asset classes with which to pursue returns has an advantage. Being successful at putting that understanding to work, is, indeed, the **work** of portfolio management.

Investors who want to earn returns in the medium term should look to other asset classes for returns, ideally ones that meet the 'low' metric for their markets. True diversification is the call today, not simply bonds and stocks, but also commodities like oil and agriculture, precious metals and even cash.

If you would like more information on my Volatility Based Dynamic Asset Allocation process that seeks positive gains regardless of how equity or bond markets perform, contact me via email at awaszkowski@namcoa.com.

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Please do not interpret this as a prediction of an imminent crash. This range of possibilities should inform the long-term investor that equities at current price levels offer little near term reward. And if any reward is gained, the averages indicate an even more harsh decline from higher levels. While it is well known that to make money in the market one, 'buys low and sells high'. It's important to know if we are 'high' or 'low' and the long-term averages, P/E multiple, Price to Sales multiple, low interest rate and low unemployment rates all point towards the 'high' indicator. And when we are 'high', one must sell, or rather reduce exposure to equities. Once we get back to a 'low' price level it will then again be time to overweight equities, but not before the Big Sale. The average bear market sees a decline of 33%, and the worse ones see -55% or more. It's likely that a low market will coincide with low P/E ratios setting up another very promising 20 yr. cycle.