Investing In a Five Year Bull

April 1, 2014

Do you remember how you felt in March of 2009? Intense fear was rampant, as our financial system teetered on the brink of collapse, unemployment soared, and stocks on March 9, 2009 closed 55% below their record level reached just 17 months earlier. According to the American Association of Individual Investors (AAII), 70% of individual investors were bearish and expecting the market to decline further. Not to be outdone, the majority of so-called experts – financial planners, professional investment advisors, and market strategists – expected the market to get worse before it got better. Discouraged investors continued to pull cash from stock mutual funds and sell exchange traded funds in three of the four following years.

As it turns out, March 9, 2009 was a great time to buy stocks. The current bull market in stocks, born in the depths of the worst economic and financial downturn since the Great Depression, turned five years old in March. Not counting dividends, the S & P 500 Index appreciated 178% over the five year period. Appreciation in the technology heavy NASDAQ Index and the Russell 2000 Index of smaller stocks was 242% and 251%, respectively.

For the first quarter of 2014, the S&P 500 Index eked out a 1.8% total return, and today, U.S. stock indices sit at or near record levels. Unlike March of 2009, investors are feeling good about the future. Again according to the AAII, 70% of individual investors are now bullish, expecting stocks to rise further. Sentiment among the experts is – you guessed it – mostly positive – although many would use the terminology “cautiously optimistic”. And unlike the years following the market lows, more cash flowed into stock funds last year than ever before.

Yet after the five year run up in prices, by most any measure, U.S. stocks today trade at elevated valuations. According to Fact Set, the forward price to earnings ratio (PE) of the S&P 500 Index stands at 15.4, near the long term average as compared to 10.3 in March of 2009. While the current PE ratios are near long term averages, noted Yale economist Robert Shiller arrives at a PE of 25 for stocks today using average earnings of the last ten years. Whatever the method, stocks certainly are no longer inexpensive.

Warren Buffett, perhaps the greatest investor of our time, once said “Be fearful when others are greedy and greedy when others are fearful”. Certainly March of 2009 was a time of great fear and also a great time to be greedy with stock investments. What about today? With stock valuations much higher and sentiment running very positive, are we in a period of greed that should lead us away from stocks? Just how should we invest in this five year bull market?

First and foremost, investors must assess their ongoing cash flow requirements and known or potential liquidity needs. Investment portfolios should be positioned so that cash or “near cash” securities such as treasury bills are held for expected liquidity needs, and cash flow requirements are met with income from securities and cash reserves. We generally believe that investors

should have cash or income in their portfolios to cover the expected and potential outflows for the next two to three years. To do otherwise increases the probability of being forced to sell assets, such as stocks, at depressed levels.

More risk-averse investors may also wish to allocate additional portions of the portfolio toward assets that are likely to hold their value – typically fixed income investments. In this low interest rate environment, we recommend that the duration of the fixed income portfolio be kept relatively short, as a rise in interest rates would have a significantly negative impact on longer term fixed income investments.

The remaining assets in a portfolio are then available for long term investing. For some portfolios, such as the retirement plan of relatively young people with thirty year or more time horizons, the entire portfolio should generally be invested in assets such as common stocks. For others, only the portion available after allocating for the cash needs of the next three years or so should be invested in common stocks or funds that own common stocks. But with stocks at elevated valuations and sentiment running strongly positive, should investors hold their stock allocation, and should they buy stocks with their available cash?

In our opinion, the answer is yes. According to data recently published in *The Wall Street Journal*, on average, it takes 3.3 years for the stock market to recover the losses sustained in a bear market, defined as a 20% or more decline in stock prices. While valuations are elevated, in past years they have at times remained elevated for years during which the markets produced good returns. Prudent investors, after allocating for their known cash flow and liquidity needs, should maintain their long term investment portfolios in common stocks, because it is simply impossible to know when the next decline will take place. We do not know when the market will peak; we only know that sooner or later we will experience a bear market. However, it is quite possible that the next bear market will occur well into the future, and the subsequent decline will not bring us back down to the price levels of today. On the other hand, if today happens to be the beginning of a bear market, enjoy the growing cash dividends from your diversified stock portfolio, knowing that you have addressed your spending needs and stock prices will once again rebound and eventually surpass today's levels.

At Knox & Downing Advisors, we seek to invest in quality companies whose stocks are trading at reasonable valuations relative to the overall market. We build a diversified, core portfolio for our clients. In today's market, we also believe client portfolios should have significant exposure to foreign markets, where stock valuations are considerably lower than in the U.S. In particular, average valuations of the emerging markets are upwards to 50% lower than U.S. stocks. With this dichotomy in valuation, we believe significant allocation to foreign stocks is prudent in most client portfolios. Most importantly, we will set aside cash for your short term needs and do our best to keep your long term portfolio invested in a diversified portfolio of quality companies that we believe will generally provide a growing stream of dividend income and likely appreciate over a period of several years.