

## WINTER 2020 – STAY THE COURSE

The American Heritage Dictionary of Idioms defines “stay the course” as “to hold or persevere to the end”. Following a year of quite extraordinary returns in stock markets across the globe, many investors are asking what the markets will do for an encore in 2020. The popular press, in business to attract viewers and readers so that more advertisements can be sold, bring a wide range of opinions about just what the market will do. It’s amazing to us how much focus there is on the short term, and not on the proper development of an investment plan and focus on long term investing. In his recent article published in Market Watch, Mark Hulbert asks the question “which of the many predictions for how the stock market will perform in 2020 should you pay attention to?”. His response – “None”!

We’ll touch on this premise later in this newsletter, but first a review of the year just ended. As we began 2019, stock markets had experienced a sharp decline during the fourth quarter of 2018, and concerns abounded about trade wars, Brexit, rising interest rates and slowing economic growth across the globe. Despite the gloom, or perhaps because of it, large U.S. stocks as measured by the S&P 500 Index produced a price increase of 28.9% from the end of 2018 to the close on December 31, 2019. With dividends added in, the total return of the index in 2019 was 31.5%, the highest calendar year return since 1997.

Small and mid-sized company stocks in the U.S. produced sizeable returns as well, with the Vanguard Mid-Cap ETF (symbol VO) and Vanguard Small-Cap ETF (VB) producing total returns for the year of 30.9% and 27.2%, respectively.

The 2019 returns from foreign stocks were substantial and usually would be considered a banner year. However, relative to the U.S. market, foreign stocks continued their several year record of underperformance. The Vanguard Foreign Developed Markets ETF (VEA) and the Vanguard Foreign Emerging Markets ETF (VWO) produced total returns for the year of 22.4% and 20.5%, respectively.<sup>1</sup>

Interestingly, the advance of stock prices in 2019 was not accompanied by increasing corporate earnings. In 2018, for the S&P 500 companies, total earnings grew 24% yet the Index declined 6.2% in price. Switch to 2019, and total earnings barely budged, but the price of the Index rose 28.9%. This price advance without simultaneous earnings growth

has pushed valuations to high levels compared to historical norms, at least by most measures. As published in the January 13, 2020 issue of Barron's, the S&P 500 Index now has a forward price-to-earnings ratio on 18.9, which Barron's classifies as extremely expensive as compared to historical averages which are more in the 14 - 15 range.

With U.S. stocks now trading at high valuations relative to historical norms, some investment firms have very modest long-term return projections for U.S. stocks. Indeed, as expressed in the November 13, 2019 issue of Barron's, Research Affiliates expects large U.S. stocks to provide only a 0.5% real return (nominal returns include real returns plus inflation) in the decade ahead, and a slightly higher 1.9% annualized real return for domestic small-cap stocks over the next years. Boston investment firm GMO LLC has negative 7-year real return expectations for U.S. stocks.

However, foreign stocks are trading at valuations more reasonable relative to long term averages. Both Research Affiliates and GMO LLC expect positive real returns from foreign stocks over the next decade, with particularly rosy return expectations for emerging market equities ranging from 5% – 9.5% real annual returns.

Historically, bonds have provided a more stable value investment and a reasonable level of income, generally without the benefit of long-term growth of principal. Today, however, the ten year and thirty-year U.S. treasuries yield 1.8% and 2.3%, respectively. Spreads between the yields on treasuries and riskier debt are modest, much lower than historical norms. Indeed, Research Affiliates and GMO LLC both expect negative returns from bonds in the years ahead.

Following a year of huge returns, and with stocks and bonds trading at lofty valuations, should we expect a down year for stocks? The simple answer is that we don't know. And neither does anybody else, although many a Wall Street market strategist will be happy to tell you what will happen. We do know that years with returns from stocks over 20% are more often followed by positive return years than negative return years. We also know that given elevated valuations, future returns are likely to be modest, and investors should certainly expect and be prepared for a downturn at some point in the future.

But downturns don't last forever. According to Wayne Thorpe of the American Association of Individual Investors, 80% of stock market down turns recover within one year – that is less than one year from top to trough and back to top again. Further, he states that 95% of the “big” drops return to the previous market top with 3 to 4 years.

All of this leads back to our original premise – stay the course. Investors should have a long-term plan that while reviewed and updated periodically, is reflective of the investors' risk tolerance, time horizon, income and liquidity needs, tax situation, and individual special situations. Of paramount importance is knowing the need for income and principle withdrawals from the investment portfolio. Investors should always have a reserve for known cash needs, as well as for the inevitable “rainy day”. We generally believe investors should have liquidity in a portfolio and projected income that will cover cash needs for at least three years, and longer for more risk-averse investors. With enough liquidity and income from dividends and interest, investors should be able to avoid selling stocks after they have fallen in price and are trading at lower valuations.

Given the lofty valuations of stocks and most asset classes, we encourage our clients to help us ensure they have enough portfolio liquidity and income to cover their cash needs for several years. We will also encourage clients to diversify their portfolio, including exposure to foreign stocks, particularly emerging markets. So, update your plan, raise cash if needed with stocks at high levels, and then stay the course – regardless of the daily, weekly, monthly, or even year-to-year swings in stock prices.

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