SHOULD I SELL OUT OF THE STOCK MARKET?
John Jennings, President

Over the past several months, many people have asked whether they should take risk off the table by selling some of their stocks. Given the heightened perception of uncertainty in geopolitics and the financial markets, this question is understandable. In response, this article outlines investor concerns, examines various historical facts pertaining to investing in stocks and concludes with advice from The St. Louis Trust Company.

THE CONCERNS

Most investor concerns fall into one or more of the following categories:

1. **Dow 20,000.** Achievement of all-time highs on the S&P 500 and Dow Jones Industrial Average begs the question of whether the markets are overvalued and how much longer the upward trajectory can continue.

2. **Eight Years of Bull Market.** On March 9, 2017 we will celebrate the eighth anniversary of the bull market that emerged from the financial crisis. Just as trees do not grow to the sky, at some point the bull market will end and we will experience a bear market again. After eight years, it feels as if the economic expansion and bull market may have run their course.

3. **Historically High Valuations:** For the past few years stock market valuations have been running above long-term historical averages. Basic investment logic suggests that it makes sense to “buy low” and “sell high.” The high valuations, along with the Dow hitting 20,000 and the long-running bull market, cause investors to want to pull the rip-cord.

4. **Rising Interest Rates:** Even though interest rates have been predicted to rise each of the past six years, it does seem as if we may have finally reached the point at which it might happen. Rising interest rates will slow the economy and, historically, have increased the likelihood of a recession.

5. **Trumpian Uncertainty:** Regardless of whether or not you are a Trump supporter, financial optimism over Trump’s proposed tax cuts, regulatory reductions and infrastructure spending are tempered by concerns about how President Trump’s potential protectionist policies and spending proposals will affect long-term growth and the level of government debt. Uncertainty about how he will handle himself on the diplomatic front interjects potential geopolitical risk into the mix.

SOME FACTS

While the above concerns are valid, should an investor act on them? What factors drive successful investing over time?

1. **Market timing is almost always unproductive.** Study after study has confirmed that there is no reliable method to profitably forecast the movements of the market. Trying to call market tops and bottoms is especially perilous. If there was an effective way to time the markets, everyone would do it. And, if everyone does it, then the opportunity ceases to exist.

2. **Historically, unless you call it perfectly, you are better off investing in advance of a bear market (assuming you are investing in a diversified and disciplined manner).** This statement may seem counterintuitive but consider the following two charts which tell the same story over two different time periods. Each chart assumes an investor starts with $20 million of cash and invests in a diversified portfolio (about 70/30 stocks/bonds) which is rebalanced quarterly. The $20 million of cash is invested in a lump sum on January 1 of each of the years indicated in the charts below.
The chart above shows that investing on January 1, 1998 (the green line) – about 2 ¼ years prior to the top of the market during the 2001 dot-com bubble – resulted in the best long-term returns. The second best result came from investing on January 1, 1999 (dark blue line), only 1 ¼ years before the market top! Under all scenarios, the $20 million more than doubled.

The next chart goes through the same exercise over a shorter time period.
This second chart has similar, but slightly different, results. The best performing portfolio was invested on January 1, 2009 just prior to the market bottom (green line). The second best result, however, came from investing on January 1, 2006 (dark blue line), which is about 1 ½ years prior to the market top. Waiting until after the market bottom and investing at the beginning of 2010 and 2011 produced two of the four worst results.

Considering both charts together, there are a few conclusions to be drawn based on history:

a. If you are a diversified, disciplined investor, you will weather the storm regardless of when you invest.

b. Investing a year or two ahead of the market peak has worked out well for disciplined, diversified investors.

c. Waiting until the “all clear” signal is not a good strategy. In the second chart investing in January 2008 was better than waiting until January of 2011!

3. **The domestic stock market delivers positive returns two-thirds of calendar years.** This statement is true regardless of whether or not the stock market was up the prior year. It is true regardless of who was president or which party controlled Congress. Despite the fact that each passing year brings us one year closer to the next bear market, the probability of the S&P 500 rising in any given year is remarkably consistent and something you bet against at your own peril.

![The Probability of the S&P 500 Rising in any Calendar Year](image)

4. **Getting out of the market requires getting it right twice.** Selling out of the market (whether partially or completely) is actually a two-step decision because at some point you will want to get back in the market. So, even if you sold out of the market at the right time, you still need to figure out how to get back in at the right time. Being right both selling out and buying back is extremely rare and often is attributable to luck.

Additionally, as illustrated in the chart below, if you miss some of the best days in the market, you can never make it up.
5. **Most economic factors do not have material relevance in predicting stock market performance.** Below is a fascinating financial chart, courtesy of Vanguard. The vertical Y axis tracks predictability from 1.0 (perfectly predictable) to 0.0 (no predictability). The horizontal X axis lays out various economic factors that the financial literati love to cite in their predictions. The chart illustrates the historical relevance of various economic factors in relation to domestic stock market returns over the next one-year (yellow bars) or ten-year (blue bars) periods.
Some powerful conclusions can be drawn from the chart:

a. None of these seemingly important economic factors is materially relevant in predicting the next year’s stock market return. No yellow bar is above about a .10 R-squared, which means that no factor has been materially predictive. Accordingly, it is not productive to make changes to a portfolio over the short-term based on any of the listed factors.

b. Most factors also have no relevance to the longer-term, ten-year returns. Interesting, Vanguard included a dummy variable (average rainfall) which proved to have as much predictive power as more than half of the other economic variables.

c. Even the two factors with some relevance in predicting ten-year returns, two types of price-to-earnings ratios, are not sufficiently relevant to justify making portfolio shifts. Rather, valuation of the market (as represented by price-to-earnings ratios) is best utilized to set expectations for returns, not for market timing.

d. A counterintuitive fact shown in the chart (and numerous other studies) is that a country’s GDP and the performance of its stock market have a zero to slightly negative correlation. Thus, the health of an economy cannot be used as a proxy for investing in that country’s stock market.

Because the factors represented on the chart have no or little relevance for predicting the market’s performance, an investor should ignore them when making portfolio decisions – including the decision to sell out of the market.

6. The economic expansion is old, but not ancient. The current economic expansion has continued for nearly eight years. Although each day brings us one day closer to the next recession, there is no definite expiration date on economic expansions. It is nearly impossible to predict when we will have reached an economic peak. In fact, we can identify the beginning and end of recessions only with the benefit of hindsight. While the current economic expansion is getting old, it could continue for much longer. The below chart shows the longest running expansions globally:

**Longest Economic Expansions – In Years**

<table>
<thead>
<tr>
<th>Country</th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>25.75</td>
</tr>
<tr>
<td>Australia</td>
<td>25.25</td>
</tr>
<tr>
<td>Canada</td>
<td>20.50</td>
</tr>
<tr>
<td>France</td>
<td>17.00</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>16.75</td>
</tr>
<tr>
<td>Sweden</td>
<td>15.00</td>
</tr>
<tr>
<td>U.S. (1961-1969)</td>
<td>8.75</td>
</tr>
<tr>
<td>U.S. (2009-present)</td>
<td>7.50</td>
</tr>
</tbody>
</table>

Sources: Business Insider, Capital Group, National Bureau of Economic Research as of 9/30/16.

7. Taxes matter too. Selling out of the market after an eight-year bull run likely will generate a hefty capital gains tax bill. If you happen to both sell out and buy back in at the right times, your investment
performance will be partially offset by the taxes generated by selling. If you sell out too early and/or buy back in too late, your poor investment results will be exacerbated by the taxes you incurred.

8. **Is this time different?** The prior sections contain some compelling facts based on history. As investors, we want to know what is going to happen in the future. What if this time is different? In fact, each time is different. History does not repeat itself exactly. The financial system could have collapsed in 2008 and it may collapse in the future. We cannot know with certainty. We do know that “this time is different” has been a very expensive strategy to follow when it comes to investing.

**OUR ADVICE**

The point of this article is NOT to predict what the markets will or will not do. All we can do is look at the historical evidence and assume that the future will have some correlation with the past...though even this assumption is not certain. Nevertheless, we do not advise investors to sell out of stocks based on their concerns. We have found that the investors who have fared the best in various market environments are those who have adhered to their investment plans, even during perceived market highs and lows. As such, we offer the following suggestions which have served investors well over time:

1. **Keep one to three years of planned portfolio withdrawals in cash or short-term fixed income.** This allows you to maintain liquidity for spending needs so there is no need to sell out of risk assets when they are down.

2. **Invest only long-term assets in stocks and other riskier assets.** “Long-term” generally means having a time horizon greater than five years. Assets with shorter time horizons should be invested more conservatively.

3. **Maintain some dry powder.** Realize that the liquidity from your cash and bond holdings is also your dry powder to buy stocks at lower valuations during bear markets. Thus, having an appropriate level of cash and fixed income is important.

4. **Resist the temptation to time the market.** Do you have information that is not readily available to others or a special insight into the economy and financial markets? Without special information, your market predictions are just guesses. What you can do better than many market participants is behave better – be calm and disciplined. Stick with your plan and rebalance appropriately.

5. **Re-confirm your asset allocation.** If your life has changed in ways that affect your time horizon or your cash flow needs, it makes sense to re-evaluate your asset allocation. However, we do not recommend changes to asset allocation based on your views of the market or economy. The correct asset allocation should be appropriate when the market is performing well or poorly.

6. **When it comes to investing, put politics aside.** Markets bring together hundreds of millions of participants with trillions of dollars and vastly different goals, time horizons and political viewpoints. Making investment decisions based on who is inhabiting the White House or controlling party in Congress has not been productive.

7. **Do not make portfolio changes on gut feelings or intuition.** Portfolio changes should be made only with robust analysis and facts. Does your sixth sense have proven predictive ability? My prediction: it does not! Stay the course.