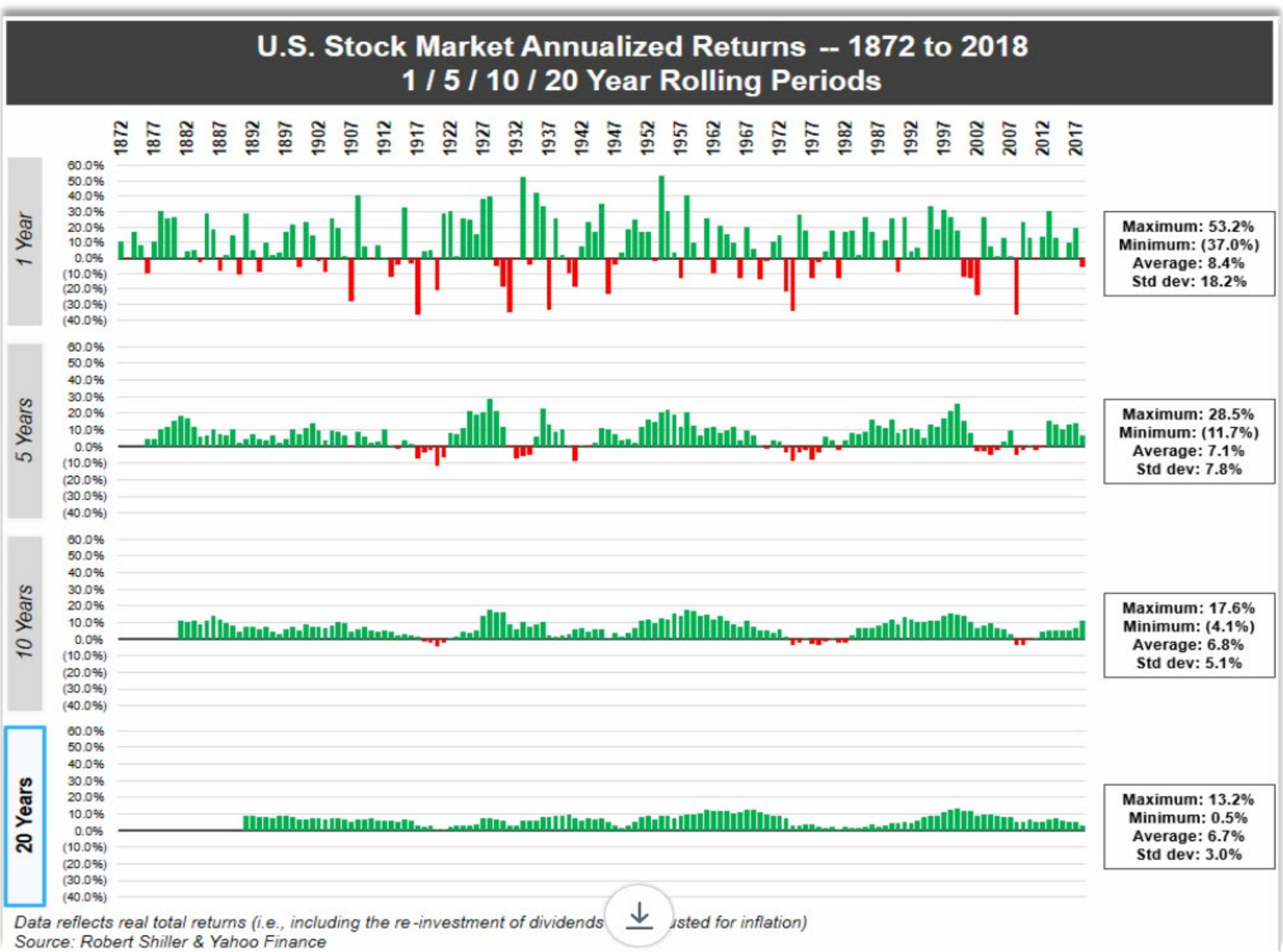
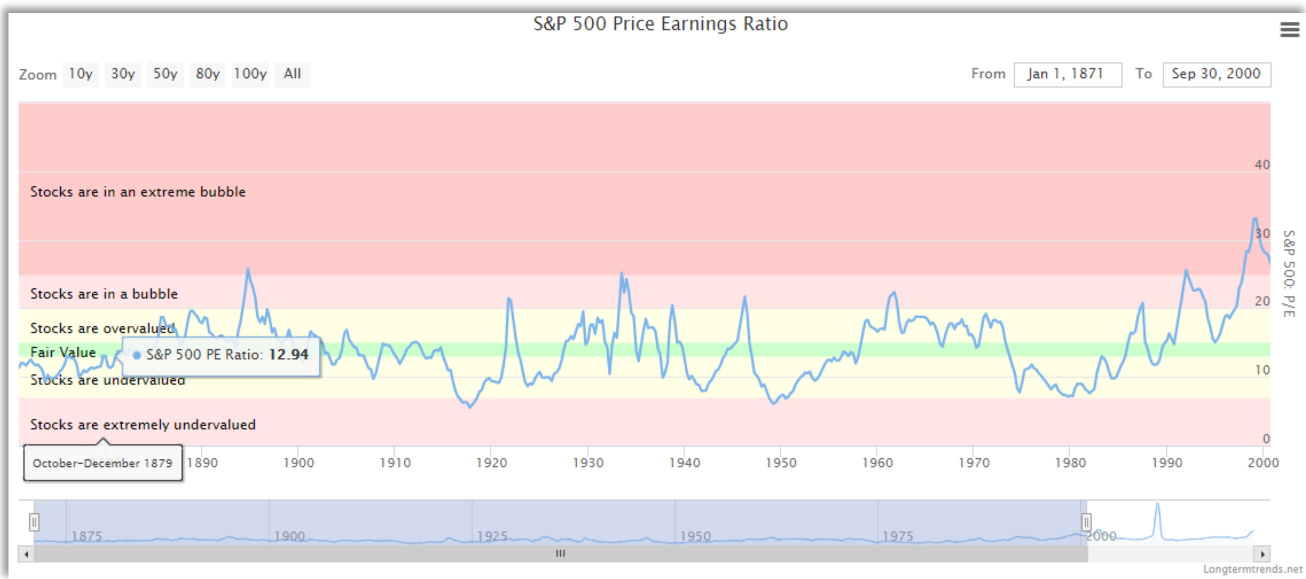
Market Commentary: Timing the Top

April 2021

In one of our first Explorations we had shared the following chart which illustrates that, at least historically, the longer an investor was in the market, the lower risk of loss one had. Averaging into the market for long-term investment objectives is especially good as it diversifies entry while at the same time creating consistent saving habits.

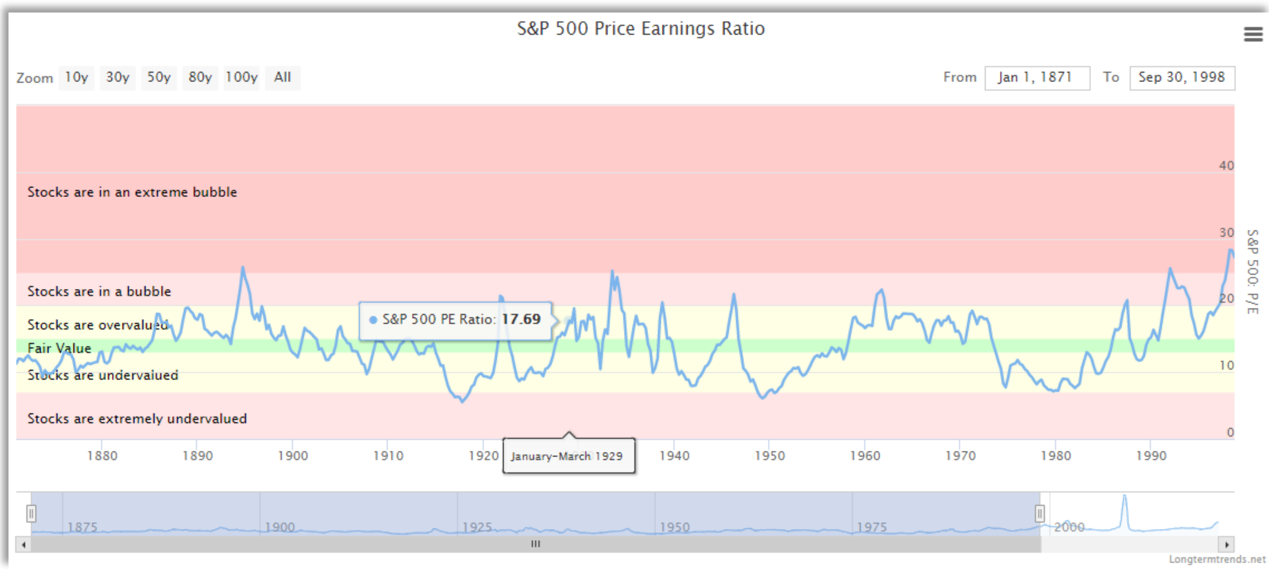


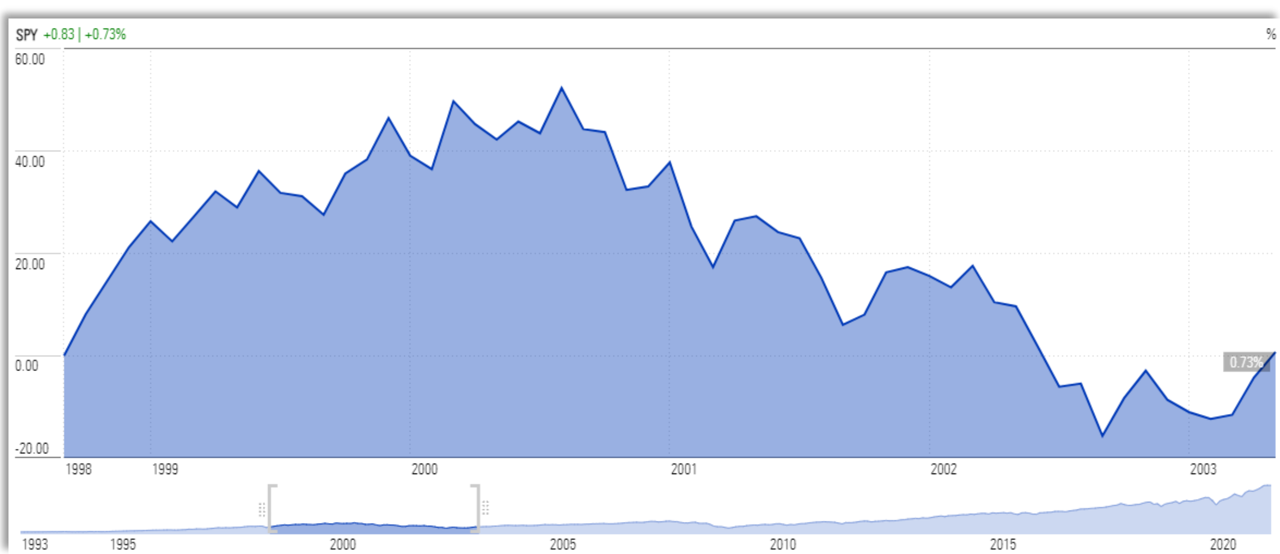
Over the analyzed time frame, a 20-year investment period never generated a loss. There have been occasional drawdowns over a 10-year investing period with the most recent occurrence due to the dot-com bust. The chart below illustrates the ~6 years it took to break even for an investment in the S&P 500 at the top of the market - September 2000. The first chart on the following page illustrates the apparent bubble we were in at that point as represented by the Price / Earnings ratio (P/E)[1] as compared historically.



[1] Price / Earnings measures the current share price of a stock over the current earnings. A company that earns $1 a year per share that is currently trading at $20 a share would have a P/E of 20 (20 / 1). A P/E for the S&P 500 is simply price over all earnings of underlying constituents on a per share basis.

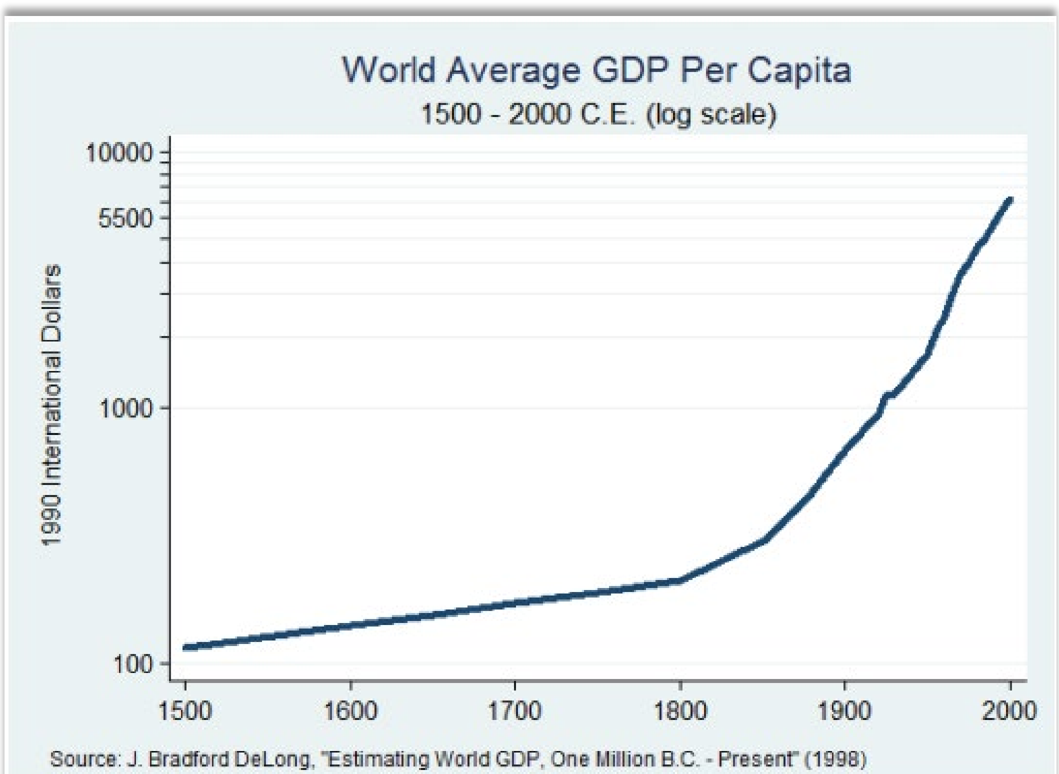
However, by late 1998 there was already quite a bit of exuberance for the incredible innovation and productivity leading to the assumed massive GDP and market growth that was expected to come. As can be seen in the first chart below, the P/E ratio in late 1998 was higher than it had been in at least 100 years; higher than that of the period entering the '29 crash. Simply based on relative valuation of P/E, a well-used measurement of value, it seemed prudent in late 1998 to be cautious - if one was a market timer to perhaps move to cash. However, if one exited then, they would have missed out on a 50% jump in value over the next two years, which would have made them feel bad and perhaps that they were wrong resulting in entering the market near the top. Despite a heightened P/E not seen in over 100 years, an exit in September 1998 would have had a small window near market bottoms to get back in profitably as can be seen in the bottom chart on the right. Once exiting a position, it is very hard to decide when to get back in. When to cut one's losses.





Innovation and productivity are themes that we frequently bring up in our Explorations pieces. Humans have been innovating for millennia and it has allowed us to dominate this world for better or worse. Below is a graphic illustrating the long history of wealth growth exhibited via GDP. This upward trend makes it dangerous to remain out of the market for too long a period assuming one does not believe the trend will end - we do not. Markets are more volatile than GDP but ultimately have enough correlation that it must be pulled up by the trend in our opinion.

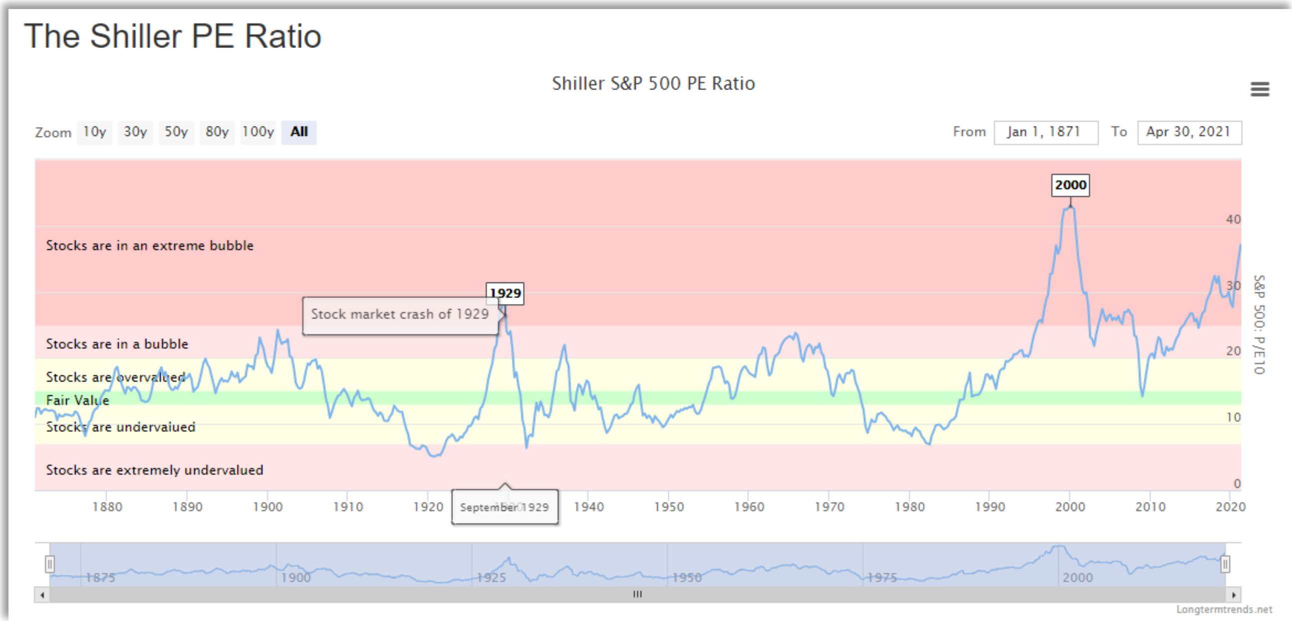
With all that being said, there are many signs of market exuberance and relatively high valuations as of late. There are many examples, principally in NFTs[2], where my most recent favorite is: ZED RUN | Digital Horse Racing, which combines elements of traditional online gaming with exorbitant pricing - Perhaps better examples are the ~$70 million spent on Beeple's art[3] and $500K on what is known as "Disaster Girl".

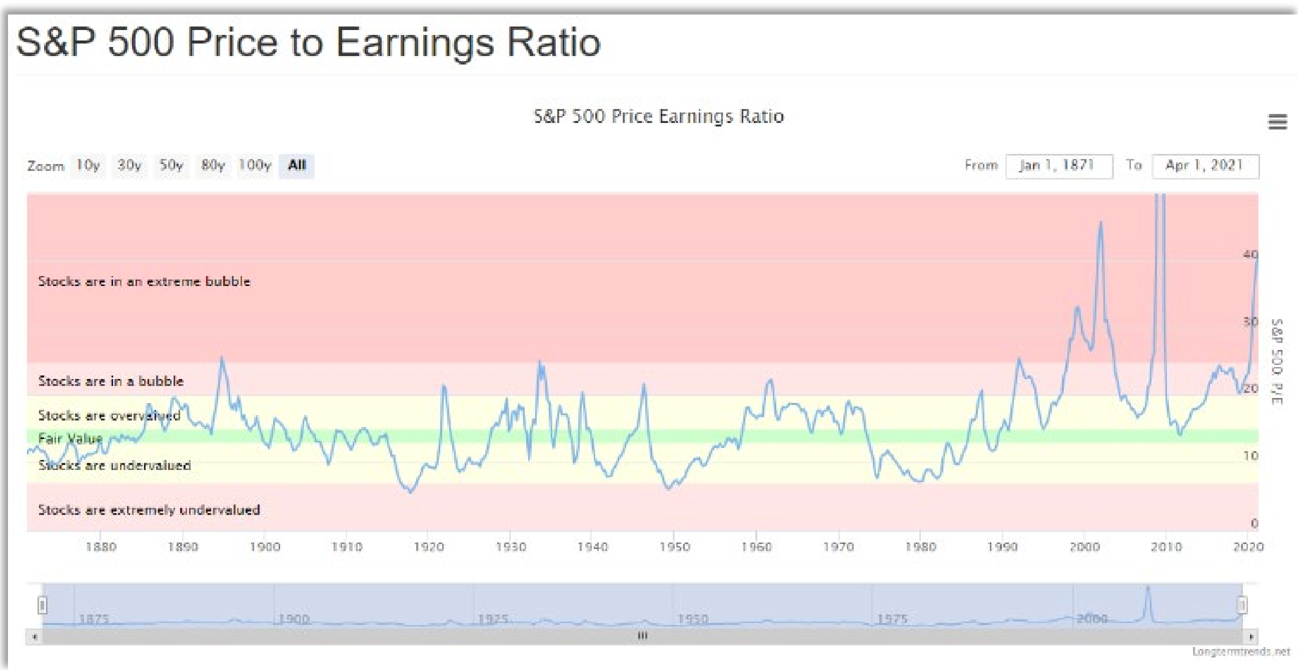


[2] Non-Fungible Tokens: Non-fungible token - Wikipedia – look up Beeple, Girl on Fire

[3] Sway has a podcast with Beeple as a guest where they help define the NFT interest as well as Beeple laughing at what he believes is a ridiculous value he received.

When looking at valuations for the U.S. stock market, we are also near all-time relative highs as is exhibited in both the Shiller CAPE[4] and traditional P/E ratios seen in the charts below.

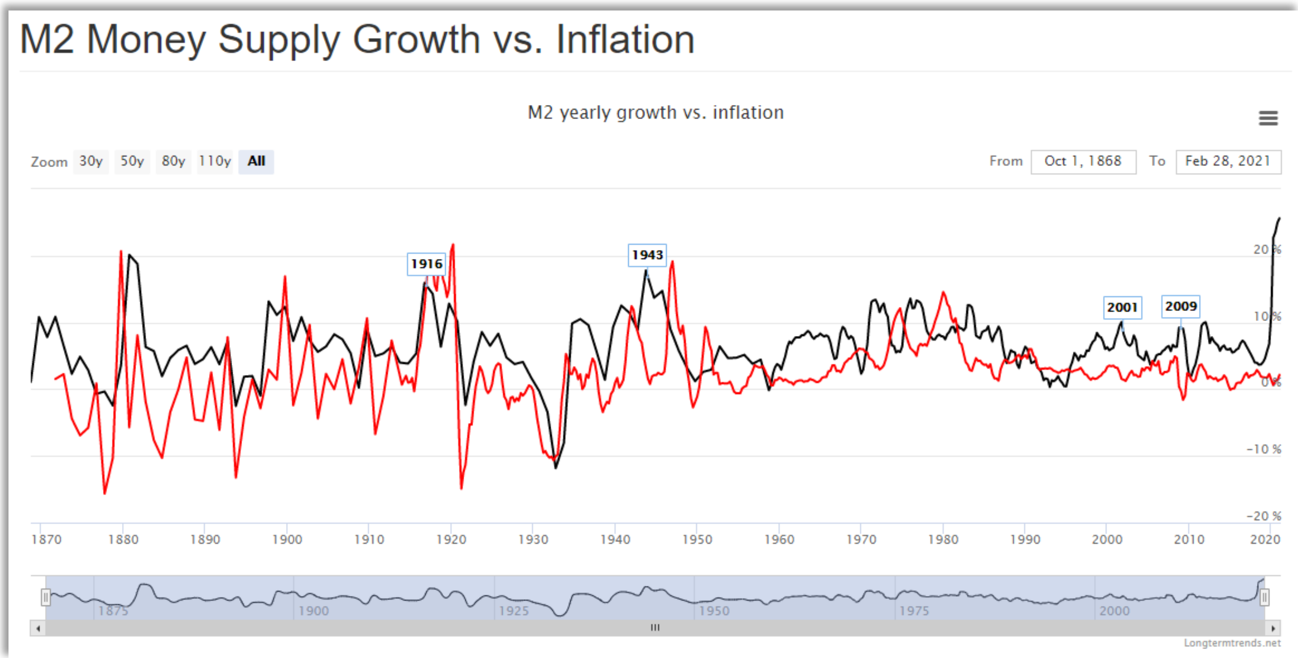




[4] [Cyclically adjusted price-to-earnings ratio - Wikipedia](https://en.wikipedia.org/wiki/Cyclically_adjusted_price-to-earnings_ratio) – a definition of Shiller

FOUNTAINHEAD INSIGHTS

We agree with those pundits attributing the quick financial recovery from the deflationary Covid market drop, as well as recent gains to historic easing by the government. This is perhaps best illustrated by the following chart which shows annual growth of money supply (in black) and inflation (in red). Inflation need not necessarily follow, but it has been a concern.



So now that we have shown some scary charts illustrating founded fears in regard to current valuations and potential inflation, we state once again that (1) no one can time the top and (2) the overwhelmingly long-term trend is for GDP growth with market growth correlated over the time period. For those with longer term investment periods, take one more look at that first chart. For those with shorter time frames, reach out to your advisor.

We believe one of our jobs is to guide one through the life cycle of investing. The other is to dot i's cross t's, diversify and attempt to find reasonable risk/reward opportunities in the marketplace – manage portfolios. We continue to work at this with context to the market trends laid out above.