# *Nexus Notes*

December 2017

Friends,

Where do we go from here? As of 12/1/2017, the major indices are up as follows:

| | |
|---|---|
| Dow Jones Industrial Average | 25.49% |
| NASDAQ Composite | 27.20% |
| S&P 500 | 20.25% |

*Revenge of the returns?* By many measures, stock valuations seem to be high. A well-known measure of market valuation is the Shiller CAPE (Cyclically Adjusted Price to Earnings) Ratio. This is a measurement conceived by Robert Shiller, professor of economics at Yale University and a Nobel Laureate, which adjusts past company earnings by inflation to present a snapshot of stock market affordability at any given time. The current ratio (as of 11/30/2017) is 32.796 (10 year). The median has been 16.158. The last time the ratio was this high was September of 1929 when it was 32.399 and September of 2000 when it was 41.716.

*Sell, Sell, Sell?* As an indicator of stock market valuation, this particular index is used by many investors as a predictor of future market returns. It doesn't necessarily indicate an impending market decline so much as it indicates that expected average returns over the next several years may be lower than what's been experienced over the past few years. Here are a couple of interesting charts sourced from Robert Shiller and published by Ben Carlson in the BloombergView, October 25, 2017.

**S&P 500: 1945-2017 Average Annual Returns**

| CAPE Ratio | 3 Years | 5 Years | 10 Years |
|---|---|---|---|
| 5 to 15 | 16.4% | 16.1% | 15.7% |
| 15 to 25 | 10.3% | 10.8% | 9.1% |
| 25 & Higher | 3.9% | 2.1% | 4.9% |

Data through Sept. 2017

One can certainly see the pattern that is illustrated where the higher CAPE Ratio, the lower average returns over next 3, 5 and 10-year time periods. However, if one gets down in the weeds a little, one can see a wide variance that make up those numbers.

**S&P 500: 1945-2017 Best & Worst Annual Returns**

| CAPE Ratio | 3 Years | | 5 Years | | 10 Years | |
|---|---|---|---|---|---|---|
| | Best | Worst | Best | Worst | Best | Worst |
| 5 to 15 | 33.4% | -3.0% | 29.7% | 1.5% | 21.4% | 7.0% |
| 15 to 25 | 32.8% | -10.6% | 28.6% | -4.1% | 19.5% | 0.5% |
| 25 & Higher | 29.7% | -16.1% | 18.7% | -6.6% | 9.3% | -3.4% |

Data through Sept. 2017

Even though the average market return for rolling 10 years was 4.9% when the Ratio was 25 and higher as illustrated in the first chart, the best 10-year period was still 9.3% while the worst was -3.4%.

*Diversify, Diversify, Diversify.* These numbers represent a 100% U.S. stock portfolio. What about allocations over the same time periods which include non-U.S. stocks and fixed income instruments? While I couldn't find information on portfolios with non-U.S. stocks, I did find some information on a 60% U.S. stock / 40% fixed

income. From an article in FundXchange dated August 19th, 2014, I found data using 10 year rolling periods from 1925 to 2013. The best 10-year return was 17.18% and the worst was 0.39%. Given the starting date, I'm thinking that 0.39% was a 10-year period ending sometime during the Great Depression, but I can't be certain of that.

Why did I go through some of this investment return history? Simply, I want to keep expectations for portfolio returns from getting too high going forward. There is certainly a chance that over the next 10 years, returns will be lower than what we've experienced since March of 2009, which represents the low point of the Great Recession. However, this is for a portfolio of 100% U.S. stocks. Who among my current clients are in this type of portfolio? No one.

As 2017 comes to an end, I wish all of you a wonderful holiday season. 2018 will begin with much uncertainty in the world, but we must keep our eyes focused on the long term and not allow short term challenges to lead us off course.

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