Financial Alternatives
integrated wealth management

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Review of 2017

As you can see from the returns listed below it was a great year for globally diversified investors. Market returns around the globe were excellent and volatility was lower than normal which made for a very comfortable and rewarding year.

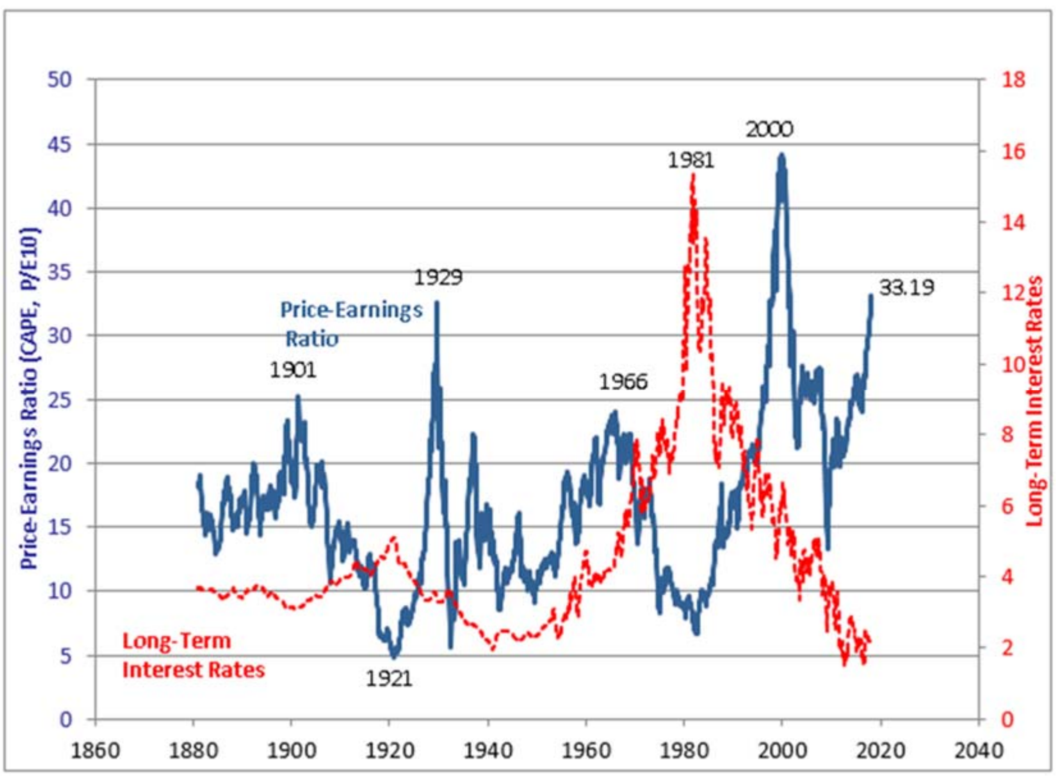
In spite of having just completed an excellent year, many investors seem nervous and have a lot of questions on their minds. Questions like: Is the stock market overvalued? Should we expect lower returns in the coming years? Should I sell my stocks before the next big correction? Or should I invest more money into the stock market? We will address these questions in this year-end newsletter.

Is The Stock Market Overvalued?

A look at the Shiller PE 10 Graph can give us a quick look at how the market's current valuation level compares to past levels. If you remember from past newsletters, the Shiller CAPE PE 10 is the current price level of the S&P 500 Index ("P") divided by the average earnings ("E") of the prior 10 years.

Executive Summary

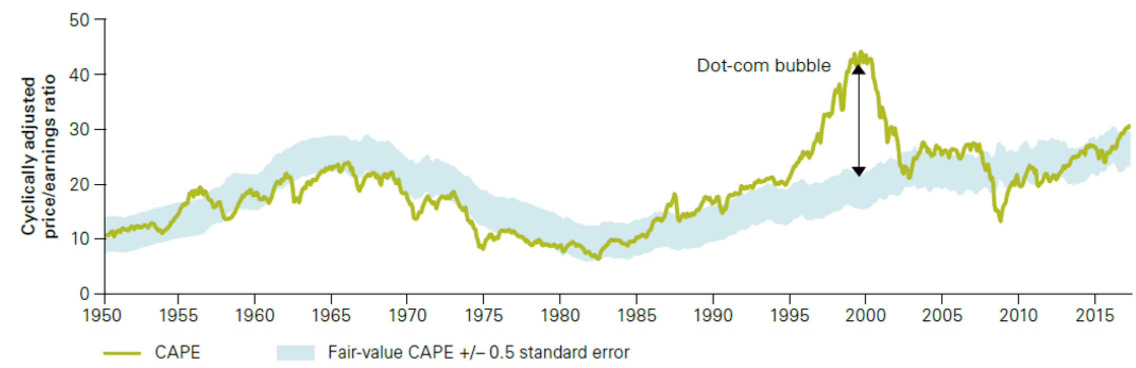
- 2017 was an exceptional year for globally diversified investors.
- The US Shiller CAPE 10 year PE ratio is reaching historic levels indicating that the US stock market may be overvalued.
- Vanguard's US fair-value CAPE measurement that adjusts for inflation and interest rates indicates a less overvalued US market.
- International Developed and Emerging Market Shiller CAPE 10 year PE ratios are less elevated which may indicate higher future long term returns for these markets versus US markets.
- Valuation measurements such as the Shiller CAPE 10 PE ratio tell us nothing about when to expect the next market correction or bear market.
- Rational investors should expect lower returns in the foreseeable future.
- After significant gains in 2017, investors should consider rebalancing their portfolios especially if they are concerned about elevated stock market valuations.



Source: Robert Shiller

As you can see from the graph on the left, at 33.19 the CAPE PE 10 is reaching historic highs which suggests that the US market is on the more overvalued side. That stated, some of this may be justified by the historically low interest rate environment we currently find ourselves in.

In Vanguard's Economic and Investment Outlook for 2015, they introduced a fair-value CAPE measurement that accounts for current interest rates and inflation levels. This fair-value concept provides a more useful time-varying benchmark against which the traditional CAPE ratios can be compared. See the Vanguard fair-value graph on the next page which suggests that the US market may be overvalued but not as



Source: Vanguard

That stated, it is important to understand that averages can be deceiving. The table below shows the range of best and worst annual returns using the same valuation starting points and time frames.

There have been some very good returns during periods of a high CAPE valuation, and also some poor returns during periods of a low CAPE valuation. Again, this information will not tell what is likely to happen in the short term.

In summary, it is sensible to expect lower future returns when starting from a point of higher market valuations; so we feel safe in writing that you should expect lower future returns. On the other hand, it does not require high returns to stay ahead of an inflation rate that is only 2%.

overvalued as the standard CAPE PE 10 graph would seem to indicate.

The other point to remember is that Developed International and Emerging Market CAPE PE 10 ratios are not nearly as high as the US CAPE PE 10 ratio. This is another reason why we feel that international diversification is important to have in the current environment.

One important observation to keep in mind is that these CAPE Valuation Ratios - as well as other valuation methodologies - tell us nothing about short term performance or when a market correction is most likely to occur. Stock market valuation models will not accurately predict future market crashes.

Should we expect lower returns in the coming years?

The short answer to this question is yes - you should expect lower returns in the coming years. The graph below shows the 3, 5, and 10 year historical returns when the CAPE PE 10 is at various levels. On average, your future returns would have been higher if you began investing when the CAPE PE 10 ratio is lower.

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

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

Source: Ben Carlson, CFA

Should I sell my stocks before the next big correction?

Yes - if you think you can successfully time the market and get out of the market before it drops, and back into the market at the bottom before it begins to rise again. But good luck!

Over the last several years, we have researched and written extensively about bear markets and market timing. To this day, we have not found anyone who has successfully timed the market over the long term.

If you are worried about the market being overvalued, instead of entertaining thoughts of market timing, consider rebalancing your portfolio. For example, if your allocation to equities was 50% a few years ago and is now 60% due to market increases, reduce your equity allocation back to 50%. We call this rebalancing, and we do it on an ongoing basis for our clients.

If you are extremely nervous and truly at risk of selling your stocks during the next correction, consider making your portfolio slightly more conservative - so that you will actually look forward to buying stocks during the next inevitable correction. For example, if your equity allocation was at 50% before the market increased and is now at 60%, consider taking it down to 40% if it will help you sleep better at night and weather the next bear market.

Should I invest more money into the stock market?

Given the stock market performance of the past year or two, you may feel an urge to invest more money into these investments. If you already have a proper allocation to stocks for your age and circumstances, we discourage you from increasing your allocation to stocks now.

If you have an appropriate allocation to stocks, but long-term would prefer a larger allocation, we suggest that you remain patient and consider increasing your percentage allocation to stocks during the next market correction. Once again, a prudent strategy for doing this is to rebalance your portfolio during a stock market correction to your preferred stock allocation.

All of this is of course easier said than done. When stocks begin falling during a market correction or bear market, it's difficult for people to buy stocks that continue to fall in value. But if you had the discipline to do this, historically you would have been rewarded for having the courage to do so.

Diversification & Discipline

Successful investing so often comes down to diversification and discipline. If you have proper diversification, you should be confident your investments can weather a storm regardless of how grim the economic or stock market conditions look. Knowing this gives you the discipline to hold onto your investments, and even add to them through the bad times that inevitably come and go.

Summary

2017 was an excellent year for investors but it has left many wondering how long the good times can last. Some valuation measures indicate the US market may be overvalued but other measures show a less overvalued US market.

International Developed and Emerging Markets appear to be more fairly valued using such measurements. We encourage clients to continue to adopt a long term perspective, remain globally diversified and resist the temptation to time the markets.

Historically, those who have remained diversified and disciplined have been rewarded with positive long term investment returns, and we think future investors who do the same will achieve similar long term results.

Please call us if you'd like to discuss your investments or any other aspect of your financial life in greater detail. We want to wish you all a Happy New Year.

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