JVL Associates, LLC NEWSLETTER

March 2017

Basketball, Birthdays and Bulls

With another March Madness behind us, my congratulations to Coach Roy Williams and the North Carolina Tar Heels on winning the NCAA men's basketball national championship. Millions of people fill out their March Madness brackets starting with 68 teams and watch their picks move through (or out of) the brackets as the games are played. ESPN's" Tournament Challenge" had over 18.8 million brackets turned in this year yet only 18 correctly picked all 16 teams making their way into the sweet sixteen – 1 in a million! [1] One could think that after a 4 month - 30 game season, multiple weekly polls, constant scrutiny by TV experts and analysts people would be better at predicting the winners.

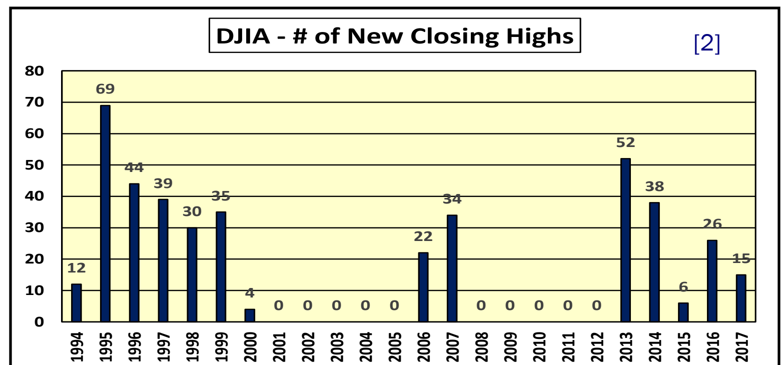
Given the hype and excitement surrounding March Madness one would believe that the winners are imbedded in our memories forever, but could you name the winner of the 2008 national championship game? Maybe you aren't into college basketball and consider yourself more of a baseball fan, could you name the winner of the 2008 Major League Baseball World Series? The answers, for you trivia buffs, are the Kansas Jayhawks defeated the Memphis Tigers 75-68 for the 2008 NCAA men's basketball national championship and the Philadelphia Phillies defeated the Tampa Bay Rays 4 games to 1 to win the 2008 Major League Baseball World Series.

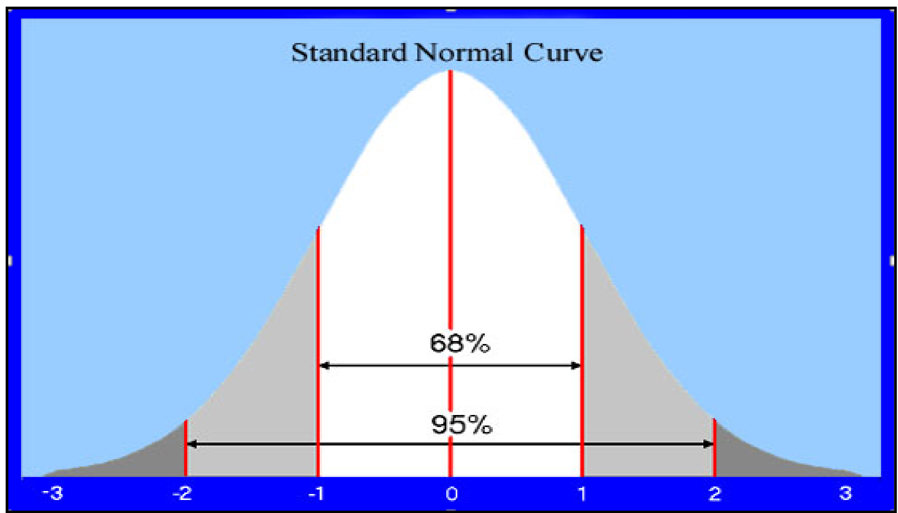
So, what does basketball and baseball have to do with investments and financial strategies? Most investors remember 2008 as the year the stock market crashed. The market actually peaked on October 9, 2007 and continued to fall until March 9, 2009 when the market hit its low point. Since that date we have been in a bull market that just celebrated its eighth birthday and has gained 249% during that time. Yet the crash is imbedded in the minds of investors. As the post election markets hit new highs in 2017 the questions come - "what do we do now?"

Let's break the answer down into two distinct points. First, are you investing to a financial strategy?

JVL Associates, LLC helps our clients develop a financial strategy that we invest to. While everyone starts out "wanting to make the most money," we help them realize that that is not a strategy! Their financial strategy involves an understanding of investment time horizons, annual cash flow needs, both short term and long term financial goals, market risks and rewards, investment options, asset class diversification and correlations. All of these enter into how and where the investment portfolio is invested. There are many moving parts to the strategy and when blended together the stock market is but one piece of a much larger plan.

If one were to sell at a market high – which high would they sell at? Since 2013 there have been 137 new highs in the Dow Jones Industrial Average (DJIA) – 52 in 2013, 38 in 2014, 6 in 2015, 26 in 2016 and another 15 in the first quarter of 2017! During the strong bull market of the 1990's the DJIA hit 229 new highs. In 2006 and 2007 the DJIA saw another 56 new highs. Who is capable of picking the "right" market high?





When we invest to a financial strategy it means that market fluctuations are factored into the investment plan. The plan will account for average market returns as well as fluctuations, both positive and negative, based on standard deviations. As a refresher, standard deviation results in a statistical bell curve whereby market returns will be plus or minus 1 standard deviation 68% of the time and plus or minus 2 standard deviations 95% of the time.

Using the actual historical returns of the S&P 500 as the stock market, there is a 68% probability (1 standard deviation) that the stock market will return between plus 32% and minus 8%. There is also a 95% probability (2 standard deviations) that the stock market will return between plus 52% and minus 28%. Given the width of that range that may seem like standing on the back of a cruise ship and trying to hit a golf ball into the ocean! But as we look a little closer we see that the market isn't that unfriendly after all.

As this chart shows, since 1926, the S&P 500 has an obvious bell curve. Using the 95% probability range (returns between plus 52% and minus 28%) the stock market was up in 65 of the 87 years in that range. That means that 75% of the time the stock market was up while fluctuating within plus or minus 2 standard deviations. Unfortunately, in 2008 the stock market was below that range and is still fresh in investors' minds. Yet, that has only happened three times and two were during the great depression.

Large Cap Domestic Stocks (S&P 500)

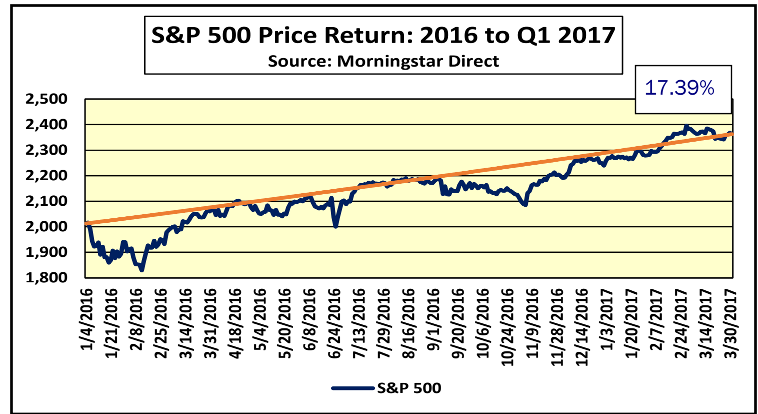
Annual Performance - In 10% increments

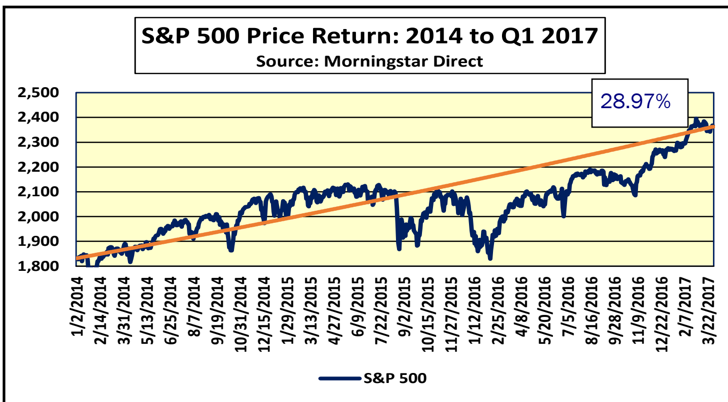
1926 - 2016

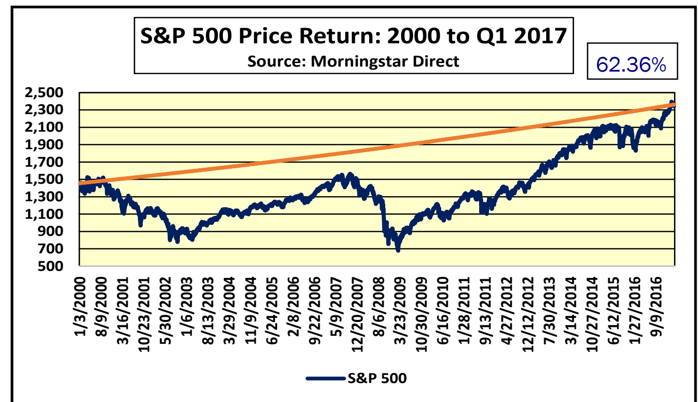
20 years											
19 years							2016				
18 years							2014				
17 years							2012				
16 years							2010				
15 years						2015	2006				
14 years						2011	2004	2009	2013		
13 years					2000	2007	1988	2003	1997		
12 years					1990	2005	1986	1999	1995		
11 years					1981	1994	1979	1998	1991		
10 years					1977	1993	1972	1996	1989		
9 years					1969	1992	1971	1983	1985		
8 years					1962	1987	1968	1982	1980		
7 years					1953	1984	1965	1976	1975		
6 years					1946	1978	1964	1967	1955		
5 years				2001	1940	1970	1959	1963	1950		
4 years				1973	1939	1960	1952	1961	1945		
3 years			2002	1966	1934	1956	1949	1951	1938	1958	
2 years		2008	1974	1957	1932	1948	1944	1943	1936	1935	1954
1 year	1931	1937	1930	1941	1929	1947	1926	1942	1927	1928	1933
Range of Annual returns	*-40% to -50%*	*-30% to -40%*	*-20% to -30%*	*-10% to -20%*	*0% to -10%*	*0% to +10%*	*+10% to +20%*	*+20% to +30%*	*+30% to +40%*	*+40% to +50%*	*+50% to +60%*
Number of Years	1	2	3	5	13	15	19	14	14	3	2

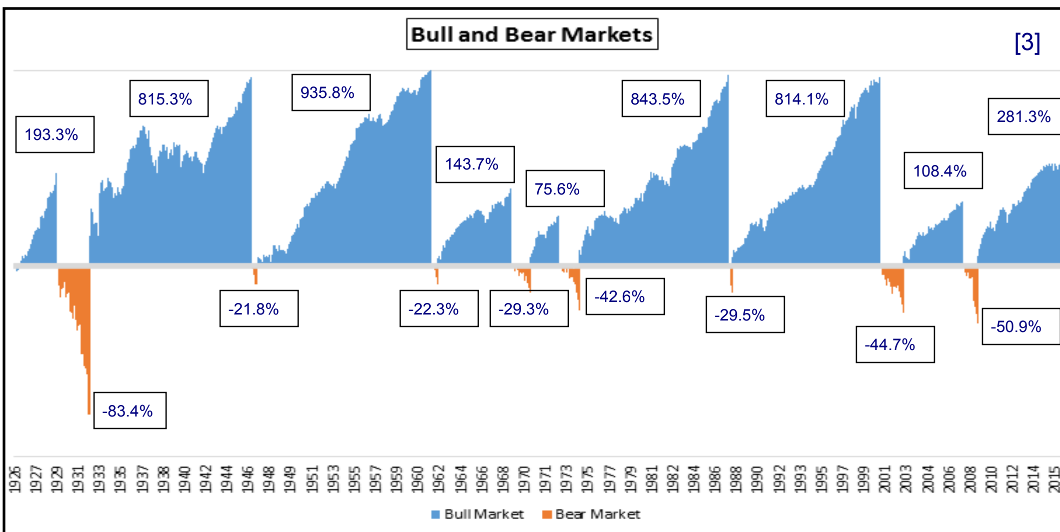
As part of the financial strategy, we also know where the next few years cash flow is coming from. It is part of a well thought out investment plan. When the stock market goes up, we can harvest gains in the most tax efficient manner to rebalance the portfolio so we are not taking on unnecessary stock market risk. However, when the stock market drops we can take cash out of the cash or fixed income portion of the investments thus protecting the portfolio from having to sell into a down stock market to fund living expenses. This gives the stock market time to recover, and historically, it always has.

Another thing we like to help clients understand is that stock markets do not grow on a straight line. There are differing periods presented to the right and below that show that even though markets grow over time, their path is not straight! Stock market ups and downs are normal and should be expected.









It is also important to remember that Bull Markets are usually much longer than Bear markets and have a much greater impact. As this chart shows. Bulls are much bigger than Bears!

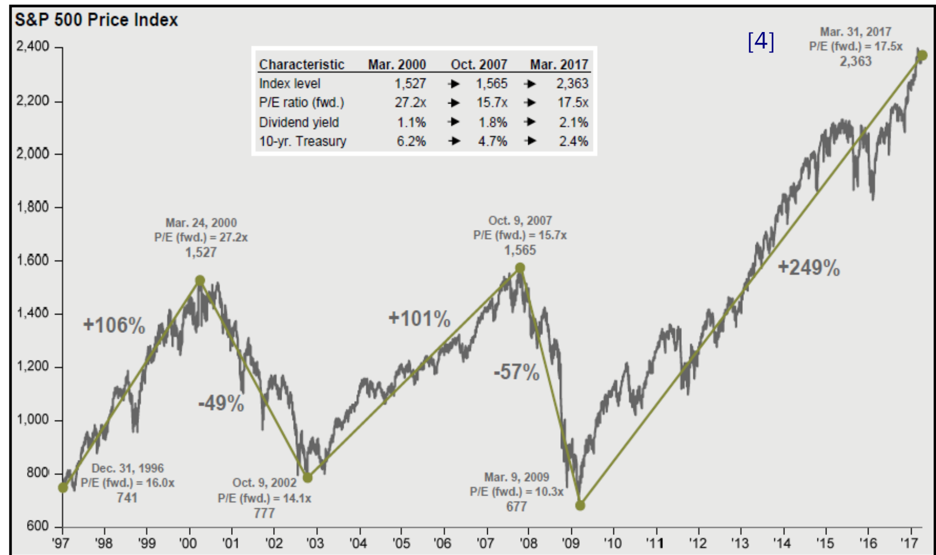
I like to use the analogy that investing in the stock market for the future is like driving from Michigan to Florida. We all start out wanting the trip to be a steady 65 MPH trip with no traffic jams, accidents, construction or detours. But in reality, time lost hitting a traffic jam in northern Indiana can be made up by driving a little faster in Kentucky. Coming on an accident in Kentucky can be made up by shorter rest stops or eating breaks in Tennessee. Running into construction in Tennessee can be made up by driving a little later into the night before stopping in Georgia. A slowdown in one state is normally made up for by adjusting something in another state. Stock markets do not grow at a consistent steady pace.

The second point to consider is where are the markets today? I have often said, and written in our newsletters, we are planners not predictors.

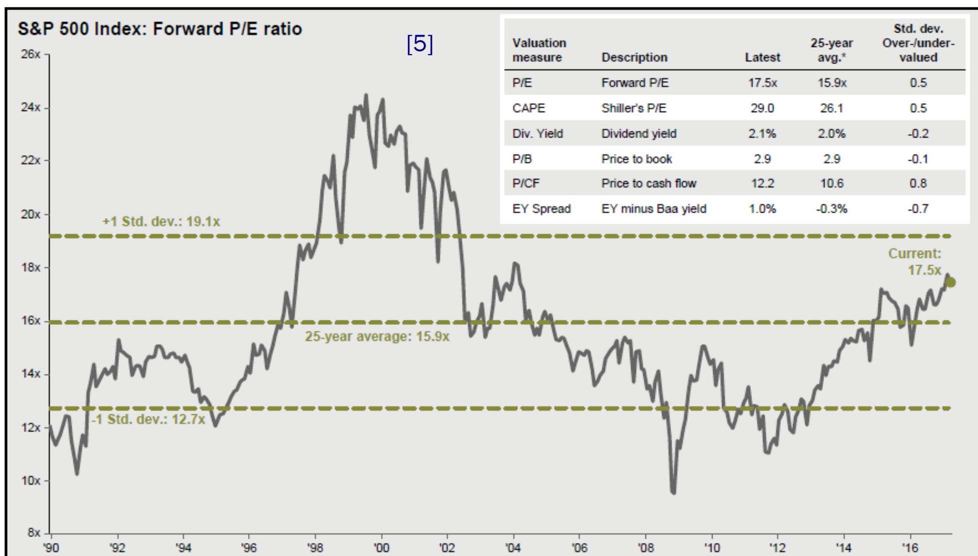
Even though I consider myself a pretty knowledgeable basketball fan I didn't get all 16 sweet sixteen teams correct (and I only had 1 final four team correct). We do not make predictions on where the markets are going short term, but we do look at many important factors to help guide our thinking on the markets over the course of a longer term financial strategy.

One of the most important signals of the stock market revolves around valuations. Valuations are based on a Company's earning capacity and the multiple investors are willing to pay for those earnings. This valuation methodology is called the P/E ratio (Price to Earnings). History confirms that stock market returns will be better than average over the long term when starting from a lower P/E ratio. It also confirms that returns will be lower than average over the long term when starting from a higher P/E ratio.

By looking at this chart we see that P/E ratios rise during bull markets and fall during bear markets. From January, 1997 to March, 2000 the P/E ratio rose from 16.0 to 27.2 while the stock market grew 106%. The P/E ratio then fell from 27.2 to 14.1 while the markets lost 49%. Beginning in Oct, 2002 the P/E ratio moved from 14.1 to 15.7 during which time the stock market rose 101%. It then fell back from 15.7 in October, 2007 to 10.3 in March, 2009 while the stock market crashed 57%. Since the March, 2009 low the P/E ratio has grown from 10.3 to 17.5 while the market has increased 249%.



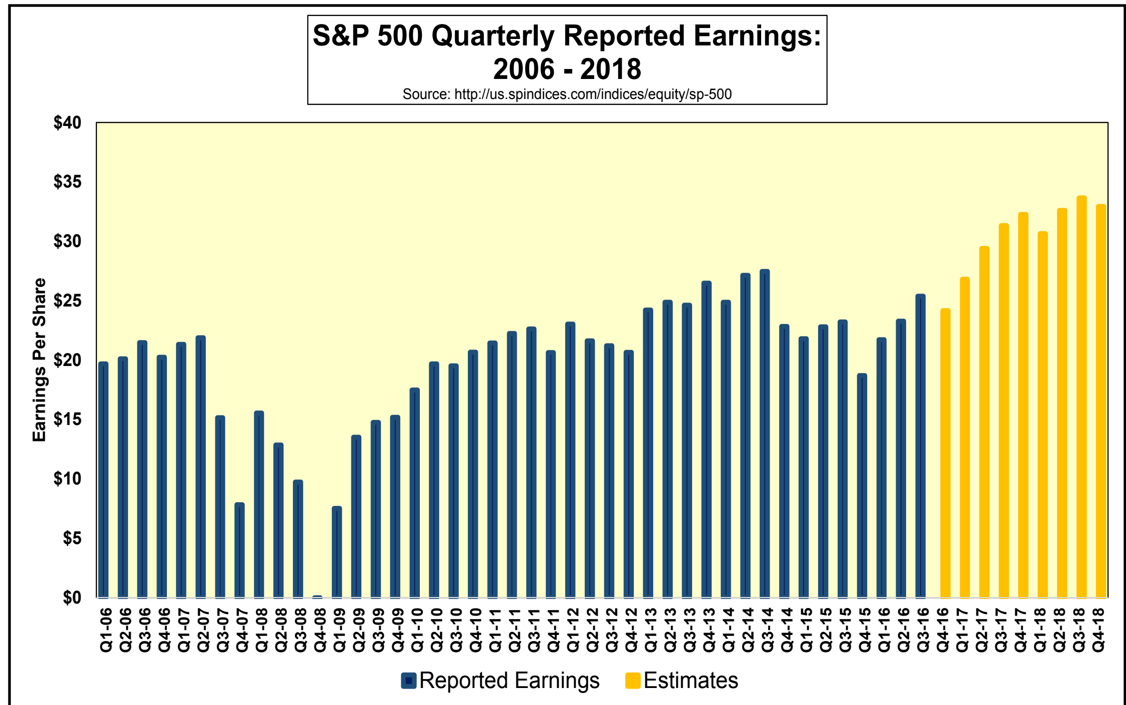
Characteristic	Mar. 2000		Oct. 2007		Mar. 2017
Index level	1,527	→	1,565	→	2,363
P/E ratio (fwd.)	27.2x	→	15.7x	→	17.5x
Dividend yield	1.1%	→	1.8%	→	2.1%
10-yr. Treasury	6.2%	→	4.7%	→	2.4%



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	17.5x	15.9x	0.5
CAPE	Shiller's P/E	29.0	26.1	0.5
Div. Yield	Dividend yield	2.1%	2.0%	-0.2
P/B	Price to book	2.9	2.9	-0.1
P/CF	Price to cash flow	12.2	10.6	0.8
EY Spread	EY minus Baa yield	1.0%	-0.3%	-0.7

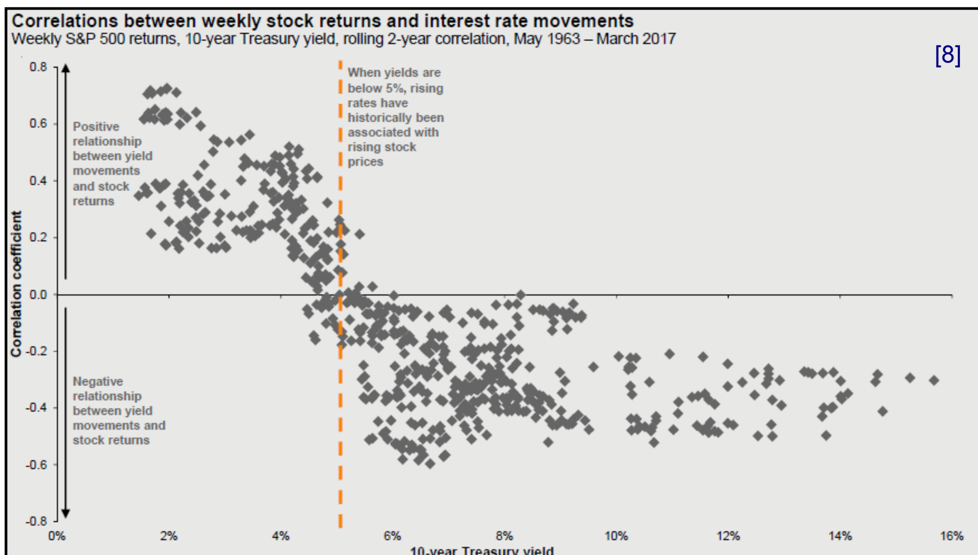
What the P/E ratio never tells us is when the markets will correct! Robert J. Shiller, Sterling Professor of Economics at Yale, is considered the "godfather" of P/E ratios. He is one of the most widely cited economists on stock market valuations. In his March 31, 2017 article in the New York Times he is quoted as saying "None of this tells us where the market is going tomorrow, but suggests that some caution is advisable, and that returns over the next decade or so are likely to be constrained." He goes on to say "The current level of CAPE (his measure of P/E) suggests a dim outlook for the American stock market over the next 10 years or so, but it does not tell us for sure nor does it say when to expect a decline." [6] Professor Shiller's sentiments are exactly what we have been telling our clients over the past year. The above chart shows that while the Forward looking P/E ratio is above its 25 year average it is not outside of a plus 1 standard deviation – i.e. above average does not equate to excessive!

The other side of the P/E ratio is Earnings. Quarterly earnings for companies in the S&P 500 peaked in the 3rd quarter, 2014. From that quarter through the 4th quarter of 2015 Reported Earnings dropped over 30%. Consequently, the stock market lost 1% from June 30, 2014 (beginning of 3rd Q 2014) through February 29, 2016 (Reporting Season 4th Q 2015) as earnings were being reported – a period of 20 months with no positive return.



But earnings began to recover in 2016. The November election brought an optimism for corporate earnings as cuts to regulations and taxes appear favorable. The latest forecasts have corporate earnings growing at a healthy pace in 2017 and again in 2018. While corporations have to prove they can deliver, an increase in corporate earnings is a favorable tail wind to the stock market.

There are many other items we like to stay on top of as well. Such as - what investment alternatives are available other than the stock market? A ten year U.S. Treasury Bond yields 2.40% as of March 31, 2017. Inflation is running at a 2.22% pace resulting in an after inflation return to an investor of 0.18%. [7] Consider that you have to pay Federal income tax on the 2.4% yield and one actually loses money on an after tax, after inflation basis for the next 10 years!



We also watch the interest rate environment. Most analysts believe the Federal Reserve will increase the Fed Funds Rate over the next 2 years at a methodical pace. Raising short term interest rates usually results in a rise in longer term rates (which are not “set” but are market driven). As the chart indicates when the 10 year Treasury Bond yields less than 5% a rise in interest rates generally results in positive returns for the stock market. Thus, this rising interest rate environment could also be a tail wind for stocks.

I could continue with other thoughts and facts that we watch, but I will end by citing an article that was written by a financial advisor in Florida. As the stock market hit its high he received a call from a client saying that he was missing out on the easy money with a portion of his portfolio and wanted to move more money into U.S. stocks. Shortly thereafter, another client called thinking the market is about to crash and wants to reduce his exposure to stocks. [9] Planner or predictor?

Are there things that can go wrong and reverse the market trend? Yes! Are there geopolitical problems with ISIS, Syria and North Korea? What about our future relations with Russia and China? Is our national debt too high? Will China stop buying our bonds? How will the Fed sell off its 4 trillion dollar balance sheet? What if Washington can't pass bills? What if inflation can't be curbed? What if … fill in the blank! We can sit in the house with our raincoats and umbrellas waiting for the rain to come but in the meantime we miss out on a lot of sunshiny days. And today, the sun is shining!

At JVL Associates, LLC our mission is to create financial strategies that help clients withstand the ups and downs of the markets. Our role is to advise and prepare clients no matter what the conditions. We cannot control what happens in the markets but we can control the strategies and the planning to prepare our clients for the uncertainties that come their way. If you know of someone who could benefit from our experience please let us know.

All of our newsletters can be found on our website at www.jvlassociates.com Feel free to pass the link along.

By: Jerry VanderLugt CPA, CFP®, CVA

References:

[1] Information obtained from: *Brackets With the Whole Sweet 16? Just 1 In 1 Million at ESPN* - By Dan Haar at http://www.courtant.com.

[2] Information obtained from: *Dow Jones Industrial Average Report Card - Q1 2017 in Review.* Source: S&P Dow Jones Indices. March 2017.

[3] Information obtained from Morningstar Direct.

[4] J.P. Morgan Asset Management - *Guide to the Markets U.S. March, 2017*, Pg. 4.

[5] J.P. Morgan Asset Management - *Guide to the Markets U.S. March, 2017*, Pg. 5.

[6] The New York Times, *Caution Signals Are Blinking for the Trump Bull Market* - By Robert J. Shiller, March, 2017.

[7] J.P. Morgan Asset Management - *Guide to the Markets U.S. March, 2017,* Pg. 32.

[8] Information obtained from: J.P. Morgan Asset Management - *Guide to the Markets U.S. March, 2017*, Pg. 17.

[9] Information obtained from: Financial Advisor magazine, *Conflicts Are Interesting* - By Dan Moisand, March, 2017.