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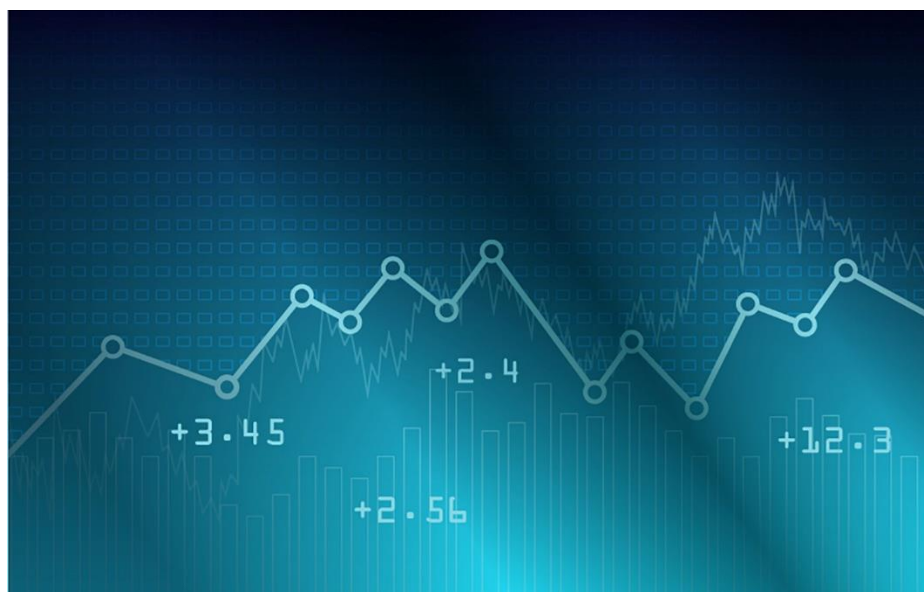
FEDERAL STREET

SUMMARY

Just two months into 2017, U.S. stock markets have already generated near the annual return they averaged over the past two decades.

Naturally many investors are asking, "Should I take gains off the table?" It's a fair question, as human nature makes us want to hold onto gains and avoid losses.

However, these averages are misleading, and given an improved fundamental backdrop, further gains could ultimately be possible. Any corrections, which are in the normal course of market behavior, should be transitory.



Fooled by Averages

Stocks are off to a fast start in 2016. Gains in each of the first two months have propelled the S&P 500 to an early 6% year-to-date return. The gains are even more impressive going back to November's election—the S&P 500 is up nearly 12% since then and regularly hitting new record highs. That's quite a nice rally in less than four months' time.

Given such a strong run, and considering that we have not experienced a correction (a price decline in excess of 10%) in more than a year, many investors may be getting a bit wary. Some may even be contemplating taking a portion of recent gains off the table. After all, the average annualized return for U.S. large cap stocks over the past twenty years is only 7.5%. The S&P 500 has almost achieved that average return already this year and it's only February—mission nearly accomplished!

But hold your horses. In our opinion, a strategy of relying on these types of mathematical averages is a little fuzzy, as markets seldom act average. In fact, calendar year stock returns are usually anything but average.

Most of the time, market returns are far from average. If one considers a reasonable expected return for U.S. stocks in any given

calendar year to be between 0% and 10% (quite a wide range), they might be surprised by how few calendar years actually saw returns that fall within those parameters. Since 1926, the S&P 500 has logged a calendar-year return within those bounds only 14 times. Astoundingly, our analysis showed that about 85% of the time stocks either posted double digit yearly percentage gains or they were in the red (more specifically, roughly 60% of calendar years have been up 10+%, and 25% of calendar years have been below zero). In other words, stocks market returns are seldom mediocre—normal is not always the norm—as far as any year's performance may relate to the long-term averages.

Now, we are not saying we expect equities to necessarily double their returns from current levels nor are we calling for the gains made thus far to evaporate. However, we do believe short-term market movements will likely catch many investors off guard, one way or another. The key is to expect the unexpected.

So what now? A pullback after a string of solid gains would not be out of the ordinary (history suggests a 10% pullback happens on average once a year). Lest you forget, the S&P 500 has experienced multiple 10%+ corrections during this bull market cycle. On the other hand, given an improved economic backdrop with corporate earnings coming out of their recent recession and business-friendly policies on the table, it would not be surprising to see stocks extend their gains.

That said, worrying about short-term price fluctuations often ends up being a fruitless exercise. Corrections come and go, and for long-term investors these random price movements eventually fall into the realm of background noise. Most investors would, in retrospect, happily ride through any temporary drawdowns in exchange for capturing full bull market gains. We spend less time thinking about when a correction will come, but rather when it inevitably does occur, whether or not there will be some catalyst that turns a normal drawdown into something worse (about 1/3 of corrections turn into bear markets, or a decline greater than 20%).

Hope for the best, prepare for the worst. Currently, absent asystemic shock, it does not appear that many common triggers for a stock market collapse are currently present. As monetary policy remains generally accommodative and valuations have not yet reached overly-excessive levels previously seen, we see a higher likelihood of additional gains as long as corporate earnings continue to recover.

Now, that does not mean we are sitting idly by—we constantly reassess macro risks and actively manage portfolios as necessary. Rebalancing is certainly in order if portfolio allocations have gotten out of whack, as is keeping in place proper diversification. But while we recognize that in all likelihood stocks will not end 2017 with the "average" return, given the improved fundamental backdrop, a reduction to stock allocations is not yet in order.

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