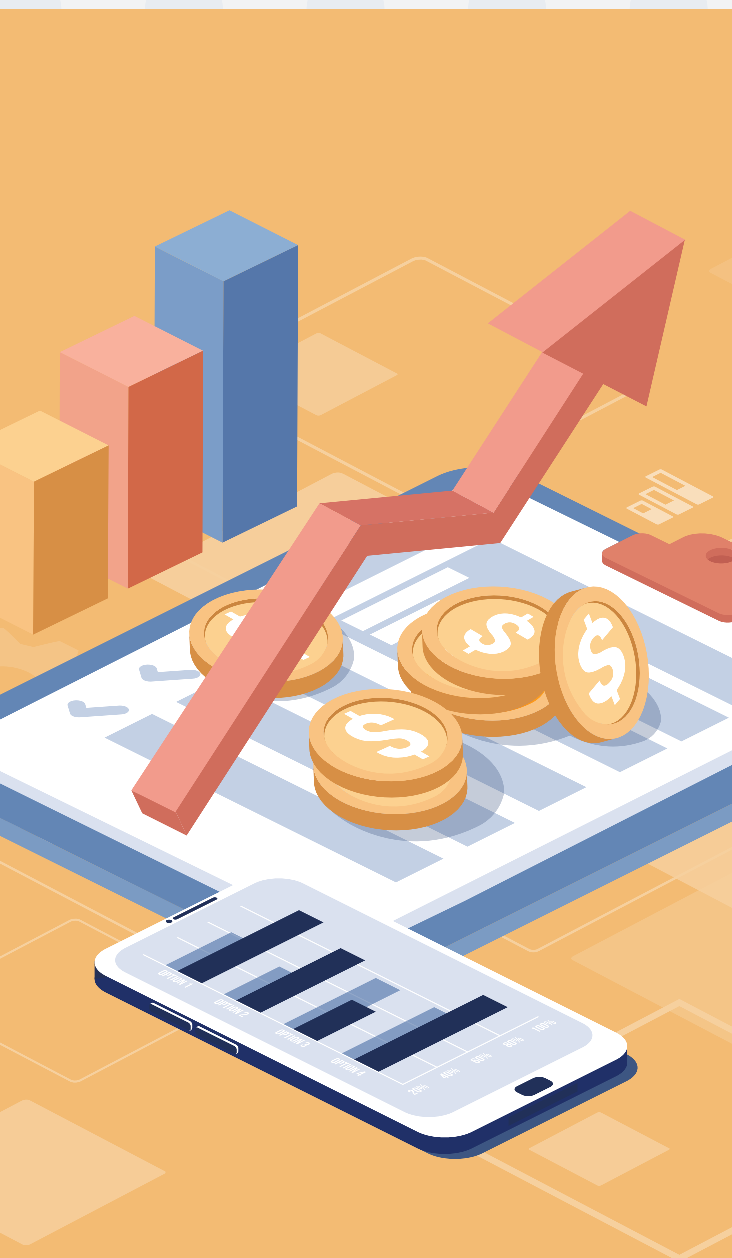
THE IMPORTANCE OF

Market Valuations

Although financial professionals often rely on long-term historical averages when making capital market assumptions, not all starting points are the same. As such, investors need to take current stock market valuations into account as they make financial plans and allocate assets.



Getting into the market when stocks are highly valued can work against an investor. Even over time horizons as long as 20 years or more, investing in high-valuation environments can lead to below-average returns. Conversely, if stock valuations are low when the investor begins, he or she may be able to ride a secular bull market* to above-average returns.

Even young investors with long time horizons must be careful not to assume too much risk in an overvalued market, even if the long-term return eventually averages out to what was initially anticipated. And unfortunately, retirees taking withdrawals can suffer even more from an unfavorable sequence of returns.

WHERE ARE WE NOW?

The concept is relatively straightforward: Higher valuations tend to lead to extended periods of sub-standard performance. For example, if you bought an index fund tracking the Standard & Poor's 500 (S&P 500) when valuations were at an all-time high in mid-2007, how long would it have taken you to recoup the 38.49 percent decline in the S&P 500 in 2008?

Let's look at it another way:

Suppose you invested in the S&P 500 on January 1, 2008—you would have enjoyed a 70.72 percent cumulative return through December 31, 2018. And you would not have "broken-even" until March 2012.

Had you waited just over a year and presciently bought at a lower valuation on January 1, 2009, you would have enjoyed a cumulative return on your investment of 177.54 percent.[1]

The lesson here is to avoid risk in high-valuation environments, and consider increasing your risk when valuations are low—in other words, the optimal investment strategy shifts depending on where you are in the secular market cycle.

RETIREES NEED TO PAY ATTENTION TOO

The implications of market valuations extend beyond just when to invest. Market valuations also have a significant impact on determining a safe withdrawal rate when someone retires. Those who retire in favorable valuation markets generally have safe, sustainable spending levels that start higher than those who retire when stocks are overvalued.

Market valuation can also be relevant for tax decisions. Investors often try to hold their shares for tax reasons—some hold an appreciated position long enough for it to qualify for preferential long-term capital gains rates, then they sell. Others are simply unwilling to sell a position and take a gain (and some risk) off the table because of the tax impact.

The bottom line is that a long-term average is a useful piece of information, but it doesn't tell the whole story. And once you begin to account for how markets are valued, the implications quickly spread beyond just a discussion of portfolio composition.

Talk to a financial professional about market valuations and how to ensure your portfolio is consistent with your risk profile and personal goals.

* Market-watchers refer to a broad, long-term trend as secular. A secular bull market is a several-year period when the prevailing tendency is for rising valuations. A bear market, of course, is one where stocks fall.

[1] Source: finance.yahoo.com