Just Asking

Jonathan Clements | November 2, 2018

"I DON'T KNOW." Those may be the three toughest words for an investor to utter—and yet perhaps also the most important.

Despite the robust rebound of recent days, the S&P 500 is still down 6.5% from its September all-time high. Indeed, U.S. stocks just suffered their worst monthly loss since 2011. What should we make of the craziness? Here are five crucial unanswered questions:

1. Where are stocks headed?

As the saying goes, if you ask a stupid question, you'll get a stupid answer. Trying to guess the stock market's short-term direction is a mug's game, because you'll be wrong half the time.

What to do? Stop fretting over short-term performance and instead focus on risk—from two vantage points. First, there's the amount of risk it's reasonable to take based on your investment time horizon and the riskiness of your broader financial life, including whether you have a regular paycheck and how secure it is.

Second, there's the amount of risk you can stomach. No matter how long your time horizon, you shouldn't invest heavily in stocks if you freak out over minor market dips.

2. Has the great rotation begun?

Nobody knows the answer to this one, either. But it's an intriguing question. Cast your mind back to the late 1990s. Growth stocks, and especially technology shares, went on a tear. Meanwhile, value stocks—those shares that are cheap relative to corporate earnings or the value of a company's assets—were left in the dust.

But all that changed in early 2000, when the tech stock bubble burst. Over the three calendar years through year-end 2002, the Russell 3000 growth index shed a cumulative 55.1%, while the Russell 3000 value index lost just 12.4%.

Could we see a similar rotation this time around? In other words, will the laggards of recent years—not only value stocks, but also emerging stock markets and developed foreign markets—suddenly get their moment to shine, while growth stocks fall from favor? Here's a sliver of evidence: Last month, U.S. growth stocks dropped 9.2%, while value stocks fell 5.5%, developed foreign markets 8% and emerging markets 8.7%.

Will this sort of performance gap persist? In the absence of a crystal ball, your best bet is broad diversification. My advice: If you have a lopsided portfolio that's heavily focused on U.S. growth stocks, it would probably be wise to add some U.S. value stocks and foreign shares.

3. Are value and foreign stocks cheap?

To answer this one, I turned to money manager William Bernstein, author of *The Four Pillars of Investing*. "Both U.S. growth and value are definitely not cheap," Bernstein says. But he thinks U.S. value stocks are cheap relative to growth stocks and hence priced for better performance.

"This has been the longest dry spell for U.S. value stocks ever," Bernstein notes. "As with the stock market overall, the lion's share of excess returns from value stocks come packaged in relatively brief periods." Translation: When the moment arrives for value stocks to sparkle, the gains will come quickly—and those who don't already own them could easily miss out.

Meanwhile, Bernstein deems developed foreign markets to be "fairly valued" and emerging markets to be "somewhat cheap." In other words, it's hard to argue that any part of the global stock market is inexpensive, except perhaps emerging markets.

Surprised? It's true that, over the past five years, we've seen big performance differences among stock market sectors. But even the "losers" have posted gains over that stretch—which means screaming bargains are hard to find.

4. What do normal stock market valuations look like?

This is a question that's tripped up many investors, both amateurs and professionals. U.S. stocks have been richly valued for much of the past three decades. Take the cyclically adjusted price-earnings ratio, otherwise known as CAPE or the Shiller P/E, which compares current share prices to average inflation-adjusted earnings for the past 10 years. Since 1990, the Shiller P/E has averaged 25.7, versus an average 15 for the 30 years prior to that. But anybody who took those rich valuations as a sell signal would have missed out on handsome gains.

There's a host of possible reasons U.S. stocks have grown more expensive. Confronted by the stock market's impressive long-run returns, maybe investors have overcome their historic "myopic loss aversion"—as academics have dubbed it—and are now less leery of stocks. In an ever-wealthier world where folks enjoy increasingly long lives, maybe we have too much capital chasing too few investment opportunities, coupled with a greater willingness to hold a long-term investment like stocks.

Maybe share prices have been bid up as the costs of investing—including trading spreads, commissions, fund fees and taxes—have come down. Maybe we're more comfortable owning stocks because we have greater faith in the economy's stability and our own financial future. After all, as bad as the 2008-09 Great Recession was, it was nothing compared to the Great Depression of the 1930s.

Whatever the reason or reasons, it seems we're now placing a higher value on stocks. But what's the new normal for valuations? Nobody knows. That doesn't mean valuations aren't important. Today's skimpy dividend yields and lofty price-earnings ratios suggest long-run returns will likely be below their historic averages. But those rich valuations tell you nothing about where stocks are headed this year or next.

5. Will active managers shine if the downturn continues?

Very few actively managed funds beat their benchmark index. Depending on which U.S. stock fund category you look at, the percentage of funds that beat the market over the past 15 years has ranged from 1% to 17%, calculates S&P Dow Jones Indices.

Defenders of active funds contend that matters will look better in a down market. That's certainly possible. While index funds remain fully invested at all times, active funds often keep a portion of their portfolio in cash, either to meet redemptions or as a hedge against declining stock prices.

Problem is, as of September, stock funds had just 3% of their assets in cash, according to Investment Company Institute data. That'll provide a very modest cushion against falling share prices—but maybe not enough to give active funds a performance edge. Why not? First, active funds charge higher expenses than index funds and that'll drag down their performance, no matter which way stocks go. Second, active funds often lean toward shares of smaller companies—and those stocks tend to get hit harder in declining markets.

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