Baron Perspective

March 31, 2019

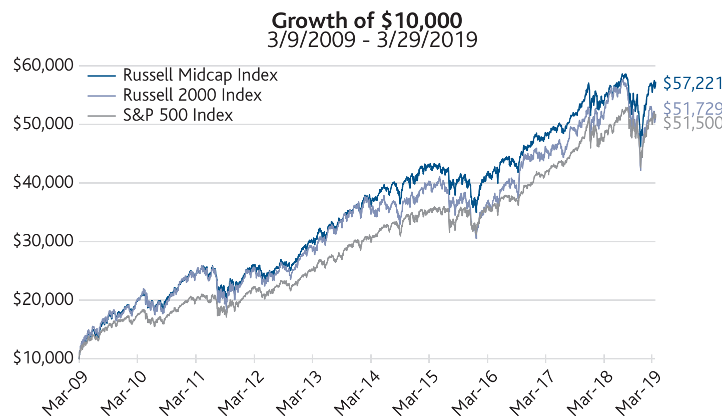
There is No Good Time to Time the Market

It is spring, which means the return of baseball and its world of statistics. Batting averages, RBIs, OBPs, BBs, SLGs, SOs, ERAs, and streaks, amongst other stats, get a lot of attention by teams and fans alike. *The New Yorker* recently published a piece about Chris Davis, the Baltimore Orioles' first baseman, who as of April 10, 2019 had gone on a hitless streak for 50 at-bats (including at-bats carried over from last season). His batting average as of April 10 was .000. Last year his average was a woeful .168. And by the way, Davis is the highest paid player on his team.

The record win streak for regular season games is at 26, held by the 1916 New York Giants. In second place are the 2017 Cleveland Indians, with 22. Do you think that anyone would have predicted that Davis, the two-time MLB home run king, would have that kind of a batting average now? Do you think that anyone could have predicted at the 12th win in a row that the Indians would win 10 more consecutive games? Would you have bet your retirement account on it? Perhaps not; yet investors make similar calls all the time.

A few weeks ago, the U.S. equities bull market turned 10 years, marking one of the best decades for equity investors in at least a century. As the chart below shows, the broad equity market indexes have increased five- to six-fold, heftily rewarding those who stayed invested.

The Bull Market Has Been Rewarding



Source: FactSet, Baron Capital.

Note: It is not possible to invest in an index.

If you (or your clients) have been invested through all or most of this time, you may be questioning how much longer this can last. The recent flows trends suggest that investors don't see significant growth prospects and/or see elevated risks in equities, thus seeking safety or better relative yield in cash and bonds. Fed Chair Powell's hawkish statement late last year seemed to have scared bond and equity investors, as money headed for money market funds in droves. After subsequent indications from the Fed that rates are not likely to go up soon, some of the fears dissipated and money headed for bonds, while the interest in U.S. and sector equities seemed to be insignificant. According to data from Morningstar, since October 2018, nearly $200 billion has flown into money market funds, $55 billion into taxable and municipal bonds, while equities had outflows of close to $10 billion.

Morningstar Broad Asset Classes Monthly Net Flows

	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Period Cumulative
US Equity	$4.6	$9.5	$13.0	-$3.9	$3.8	$6.2	$33.3
Sector Equity	–$11.3	–$5.8	–$17.9	–$8.3	$4.2	–$3.6	–$42.8
US Equity + Sector Equity	*–$6.7*	*$3.7*	*–$4.9*	*–$12.2*	*$8.0*	*$2.7*	*–$9.5*
International Equity	$6.9	$7.4	–$15.1	$13.9	–$0.2	$1.1	$14.0
Allocation	–$8.9	–$8.8	–$15.5	–$3.9	–$1.9	–$3.5	–$42.5
Taxable Bond	–$13.9	–$6.2	–$47.8	$30.7	$37.7	$35.3	$35.7
Municipal Bond	–$5.0	–$3.5	$0.2	$7.5	$11.2	$8.8	$19.3
Taxable + Municipal Bonds	*–$18.9*	*–$9.8*	*–$47.6*	*$38.2*	*$48.9*	*$44.1*	*$55.0*
Alternative	$0.4	–$3.1	–$6.3	$0.2	–$0.6	–$0.4	–$9.9
Commodities	$0.9	–$0.9	$0.8	$2.1	–$1.8	–$0.1	$1.0
US Money Markets	$19.9	$85.3	$57.3	$3.7	$40.8	–$13.3	$193.7

Source: Morningstar Direct as of 4/9/19.

Note: Flows include mutual funds and ETFs.

These shifts have come at a time when money markets pay close to nothing, and U.S. Treasury and AAA corporate bond yields are still relatively low. Since the U.S. economy is not in a recession (or even close to one) and there aren't any significant, obvious stock market dislocations, in our view this flight to safer assets makes no sense, particularly for long-term investors. The trade tensions, global growth concerns, and uncertainty about the Fed's monetary policy have surely contributed to equity investors' concerns. Some may have taken advantage of the market decline in Q4 to lock in losses for tax purposes, but we believe there is more than fundamentally-driven trading and tax-loss harvesting behind the shift toward money markets and fixed income. It seems investors are getting ahead of themselves, trying to time a recession or a drop in the stock market.

In 2018 investors appeared to pay elevated attention to milestones, including that we may be in the longest bull market on record[1], the second longest economic expansion on record (on pace to soon be the longest), and the longest period of low rates, coupled with unemployment reaching multi-decade lows. Hitting such remarkable high points has naturally led many equity investors to think that we are late in the cycle and things are more likely to get worse sooner than later. However, record levels should not be misconstrued for peaks, and round numbers should not be the basis of investment decisions. In our view, trying to time the market on such logic is akin to playing games of chance rather than investing, which could be an extremely risky and costly strategy. We believe that this kind of cognitive bias-driven decision making is partly behind the recent trend in flows.

Bull Markets Are Unpredictable

Bull markets are not mechanical, coin-operated machines that stop when the pre-set time runs out. Their length and strength can be broadly

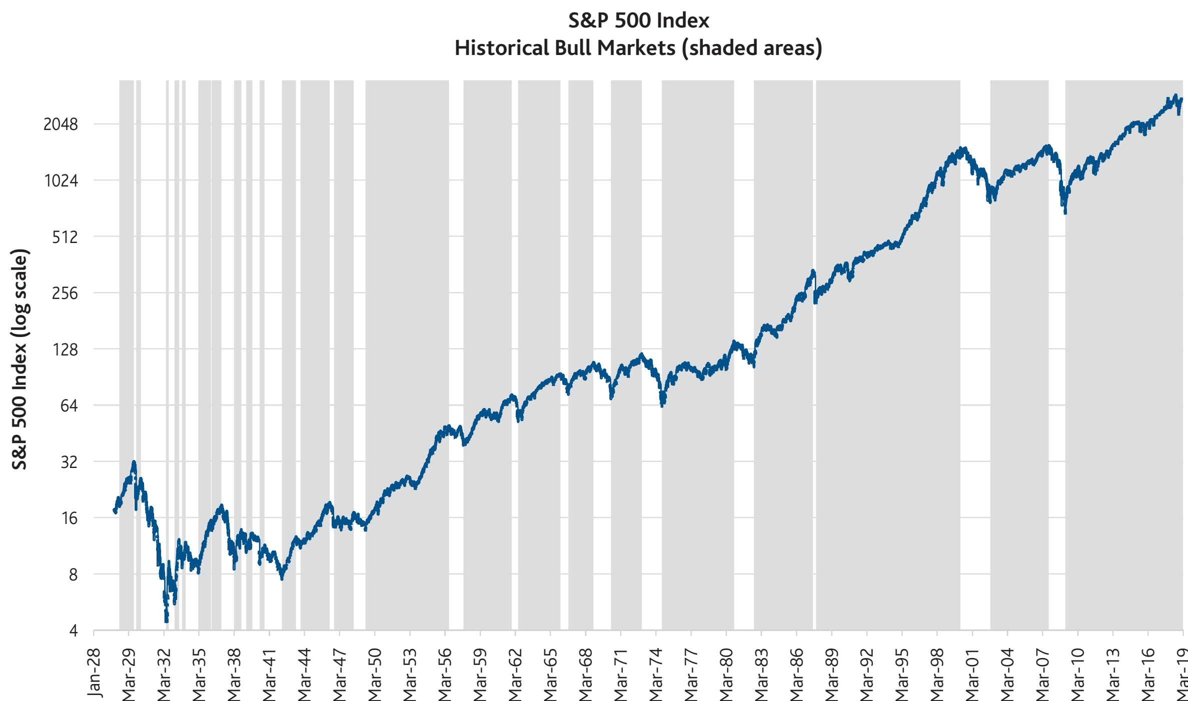
[1] Measured using daily closing prices, we are currently in the second longest bull market. Other ways of measuring may show different results.

characterized by statistics; but each bull market is different from the prior and is thus unpredictable. The chart below shows all 23 S&P 500 Index bull markets since 1928, each measured as an increase of 20% or more after a trough from a decline of 20% or higher.

The average bull market in this chart has lasted about three years; the median – less than two. Relative to these figures, a decade sounds unthinkable. However, when it comes to bull markets, we do not think it is helpful for investors to seek guidance in average and median statistics, as they don't always give an objective representation. In fact, the more recent bull runs have tended to last longer. Since 1928, the S&P 500 Index has been in a bull market 76% of the time and since 1970 – 84% of the time. The chart also shows that every time the market has declined, it recovered and eventually surpassed its prior highs. We do not find any other obvious pattern that can help predict what the market will do or to suggest that just because a bull market has lasted longer than any prior, it should end. There could always be a longer bull market, and by a large margin relative to any prior.

While equity bull markets have become longer, they do not seem to have become more immune to corrections. Periodic market corrections are important, as they help relieve pressures and revert imbalances. A long bull market with no (or few) corrections could be a concern as significant disproportions are more likely to have accumulated (i.e., excessive valuations, runaway industries, etc.). As the chart on the following page shows, the current bull market has traveled a bumpy road. There have been over a dozen 5%+ corrections, six of which were double-digit.

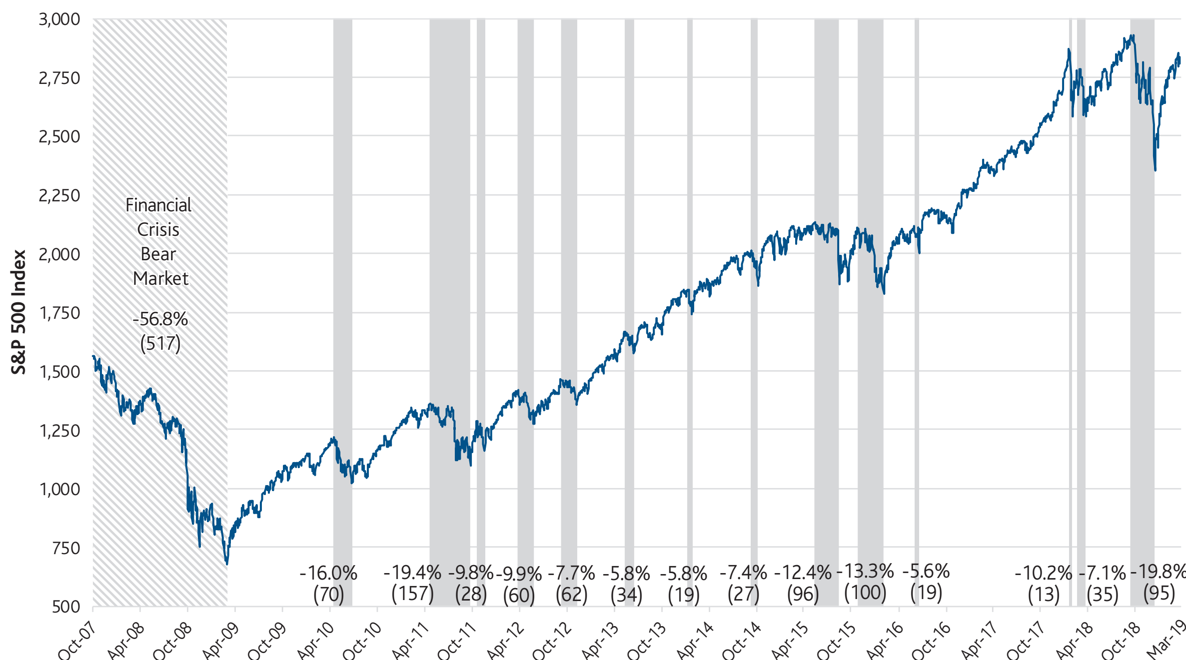
The Length of Bull Markets Has Varied Significantly



Sources: FactSet, Baron Capital, Yardeni Research.Inc.

The Current Bull Market Has Had Over a Dozen Corrections

S&P 500 Index: 5% or Higher Corrections (highlighted)



Sources: FactSet, Baron Capital, Yardeni Research.Inc.

Note: The figures in parentheses represent the number of calendar days of the respective market decline.

On two occasions, including the decline in Q4 2018, the S&P 500 Index was inches away from an official bear market. While the 20% decline rule has been widely used to measure whether the market is technically in bear mode, there is no science behind this rule; it is just a rough measure. A 19.8% decline resets the market just about as much as a 20.1% decline does. From this perspective, perhaps the S&P 500 Index has not been on a decade-long rise, but rather on a three month one. In fact, many other broad market indexes declined by more than 20% and have entered new bull periods since, as the table below shows.

Many U.S. Equity Market Indexes are in a New Bull Market

Returns of Broad Market Indexes

Index	Peak	Trough	Peak-to-Trough Return	Trough-to-3/31/2019 Return
Russell 2000 Index	8/31/2018	12/24/2018	–27.22%	21.53%
Russell 2000 Growth Index	8/31/2018	12/24/2018	–29.02%	25.73%
Russell 2500 Index	8/29/2018	12/24/2018	–25.06%	22.79%
Russell 2500 Growth Index	9/4/2018	12/24/2018	–27.10%	27.75%
Russell Midcap Index	8/29/2018	12/24/2018	–21.65%	23.12%
Russell Midcap Growth Index	9/14/2018	12/24/2018	–22.66%	27.93%
Russell 3000 Index	9/20/2018	12/24/2018	–20.56%	21.01%
Russell 3000 Growth Index	10/1/2018	12/24/2018	–22.50%	24.46%
Russell 1000 Index	9/20/2018	12/24/2018	–20.09%	20.97%
Russell 1000 Growth Index	10/1/2018	12/24/2018	–22.20%	24.36%
Nasdaq Composite Index	8/29/2018	12/24/2018	–23.64%	24.81%
S&P 500 Index	9/20/2018	12/24/2018	–19.78%	20.56%

Source: FactSet, Baron Capital.

Note: Returns do not include dividends.

The market decline in Q4 2018 seems to have reduced valuation pressures and, even after the rebound in Q1 2019, P/Es are at or around historical averages. Perhaps investors have adjusted their expectations and perhaps companies have adjusted their guidance, but there does seem to be higher comfort around company earnings.

U.S. Equity Valuations Are at or Around Historical Averages

Price-to-Earnings Ratio as of 3/31/19 vs. 20-Year Average

	Value	Blend	Growth
Large	14.5 / 14.2	17.2 / 16.6	21.1 / 20.4
Mid	15.1 / 14.6	17.3 / 16.7	21.4 / 21.5
Small	13.6 / 14.7	16.0 / 17.1	19.2 / 20.5

Price-to-Earnings Ratio as % of 20-Yr Average Price-to-Earnings

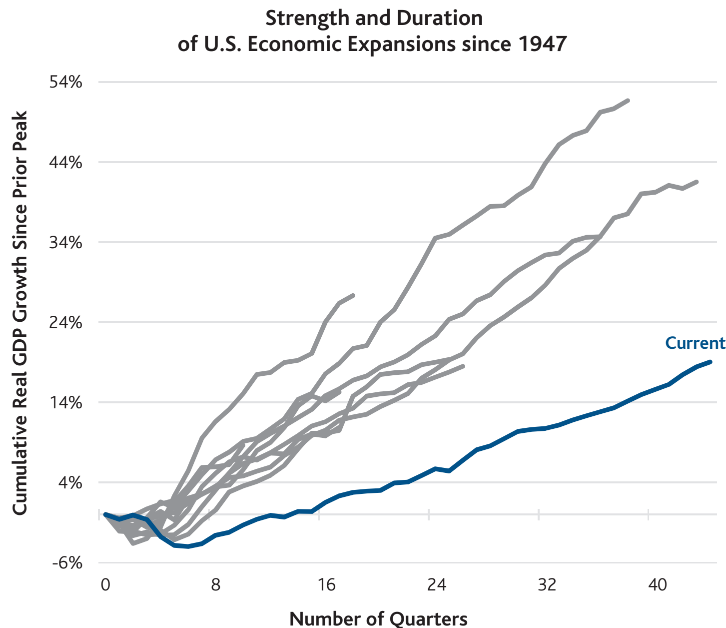
	Value	Blend	Growth
Large	102%	103%	103%
Mid	103%	103%	100%
Small	92%	93%	94%

Source: The Bank of New York Mellon Corporation using I/B/E/S 1 Year Forecast EPS.

The price-to-earnings ratios for each style box are based on Russell indexes, as follows: for Large Value: Russell 1000 Value Index, for Large Blend: Russell 1000 Index, for Large Growth: Russell 1000 Growth Index, for Mid Value: Russell Midcap Value Index, for Mid Blend: Russell Midcap Index, for Mid Growth: Russell Midcap Growth Index, for Small Value: Russell 2000 Value Index, for Small Blend: Russell 2000 Index, for Small Growth: Russell 2000 Growth Index.

The economy also seems to continue to be on stable footing and, although it has been expanding for nearly a decade, it does not show signs of overextending or rapid slowdown. This is partly because for much of this period it has been in a recovery mode. It has also expanded at a much slower pace than prior cycles, as the chart below shows. In addition, the Fed has been signaling that it is going to pause on rate increases, which may help the expansion cycle last longer.

Current Economic Expansion: Long but at a Moderate Pace



Sources: Bureau of Economic Analysis, The National Bureau of Economic Research, Baron Capital, J.P. Morgan Asset Management.

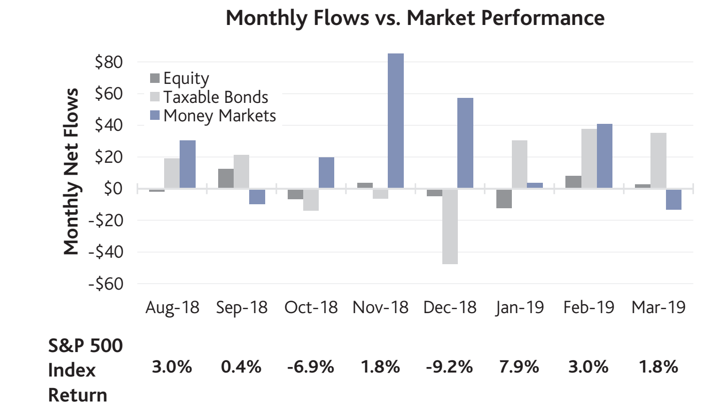
Note: Each line represents the cumulative change in U.S. real GDP since a prior GDP peak.

Timing the Market: a Costly Investment Strategy

It is difficult to precisely pinpoint the reasons behind the increasing longevity of bull markets. With respect to the current one, it is worth noting that the first four years were spent in recovery from the steep drop during the financial crisis, and the actual expansion has lasted about six years. More broadly, there have also been structural shifts in the U.S. economy that have likely contributed to the increased bull market lengths over the past few decades. Relative to the first half of the 20th century, today's economy is driven significantly more by services than manufacturing, there are more regulations and market safety mechanisms in place, and the Federal Reserve is playing a much more important role via its monetary policy and rescue mechanisms. Overall, today's economy is in a more mature stage and, in our view, it is not unreasonable to continue seeing more stability going forward. Of course, this does not mean that there won't be any more recessions or bear markets.

We cannot predict with any certainty when economic cycles and bull markets start or end, and we don't think anyone else can either. Nonetheless, we continue to see investors try to time the markets and get hurt or miss out on opportunities. Most recently, we saw that as equities rebounded significantly from the December 2018 bottom, investors did not participate in the rally. Instead, they continued to put money in lower-yielding money markets and bonds.

Equity Investors Did Not Participate in the Most Recent Rally



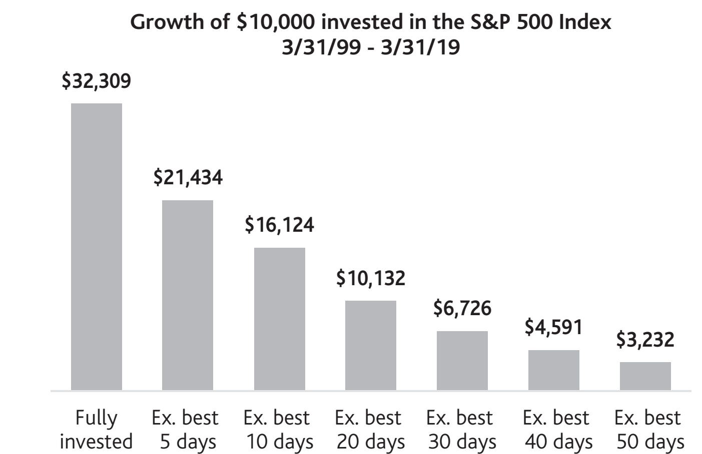
Source: Morningstar Direct, FactSet.

Notes: Equity flows are represented by the combined flows of Morningstar's US Equity and Sector Equity Broad Asset Classes. Market performance is represented by the monthly changes in the S&P 500 Index and does not include dividends.

To be effective at market timing, an investor needs to have precision timing; and that timing needs to be consistent. Missing a few opportunistic days can have a significant negative impact on the long-term value of an investment portfolio. In our view, you might have better luck in Vegas.

Because big down days are usually closely followed by big up days, those who panic and sell on the down day are highly likely to miss out on the returns from the ensuing up day. As the chart below shows, missing the best five days in the market over the past 20 years would have resulted in a 34% lower value of a $10,000 investment and missing the best 10 days would have resulted in a 50% lower value. Missing more up days would have produced even worse results.

A Few Missed Days May Be Costly



Source: FactSet, Baron Capital.

Note: It is not possible to invest in an index.

For a more recent example, an investor who left her portfolio unchanged since the end of August 2018 would have lost only 1.2% by the end of Q1 2019. On the other hand, an investor who panicked and liquidated his investment portfolio on the worst possible day, December 24, 2018 – the day when the S&P 500 Index hit its lowest 2018 value – and then reinvested at the end of January, after the market had rallied, would have lost 14.2% of his portfolio value[2].

As long-term fundamental investors, we don't make investment decisions based on the length of a streak or whether a bull or bear market line has been crossed. Statistics can be helpful in both baseball and investing, but they have their limitations. Our best advice to other long-term investors is to look at the bigger picture and not get caught up in market semantics. We believe that focusing on long-term growth opportunities, strong management teams, and competitive advantages can add significantly more value.

Linda S. Martinson
President and COO

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[2] Calculations using the daily total returns of the S&P 500 Index for the period 8/31/18 – 3/31/19.

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