The Optimistic Investor

FOCUS ON WHAT REALLY MATTERS

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TEAM KOOMAN CORNER

Welcome Back

It’s been a good start to 2024. Corporate earnings from Q4 2023 came in better than analysts predicted, inflation remained under control, and the equity market rally that started last fall has continued into this year. As a result, the major US equity indexes are at or near all-time highs, as are many of the broad international indexes.

In circumstances like these, people sometimes suggest that it’s “not a good time to invest” because markets are “high.” Having alternated between bull and bear markets each of the last four years, we understand it might feel that way. But making investment decisions based on current market levels or economic data is ***always*** a mistake. Markets cannot be “timed,” and trying to do so is a dangerous undertaking that can derail your financial plans.

The goal for this edition is to show that: (1) our return expectations shouldn't change just because equity markets are at all-time highs; and (2) trying to time markets can drastically reduce returns and jeopardize your financial future. We hope you enjoy the essay.

"High" Compared to What?

When someone says that it's not a good time to invest (or that their investment strategy should change) because "the market is high," the critical question is: high compared to what? With equity indexes near record levels, aggregate prices are clearly higher than they've been in the past. But are they higher than we expect them to be in the future? Certainly not.

We ***always*** expect that broad equity market levels will be higher in the long run. As we've discussed before, this happens as good companies innovate and improve, which eventually leads to increases in profits that make those companies more valuable. As that process plays out, collective share prices rise and inevitably reach new highs. We should therefore expect that equity indexes will often be near record levels, and that's a good thing because it reinforces that the process is working.

Some people might respond that markets may well go up in the long run, but the existence of an all-time high suggests that we're due for a correction or bear market in the short run. After the last few years, it certainly might feel that way. But history shows that markets don't decline just because they've reached a new record.

Dimensional Fund Advisors (DFA) published research demonstrating this last year. They looked at month-end values for the S&P 500 from 1926-2022 and assessed the impact that reaching a record high had on future returns. The research confirmed that all-time market highs are indeed a common occurrence, with roughly 30% of months ending at a new record. More importantly, the data also showed that ***future returns were largely unaffected by the index reaching a new all-time high***.

Figure 1 on the following page summarizes the results of DFA's research. It shows that during the 97 years from 1926-2022:

- Average 1-year returns were higher when investments were made with the index at a record level; and
- Average 3- and 5-year returns were essentially the same whether an investment was made with the S&P 500 at a record high or at some other point in time.[1]

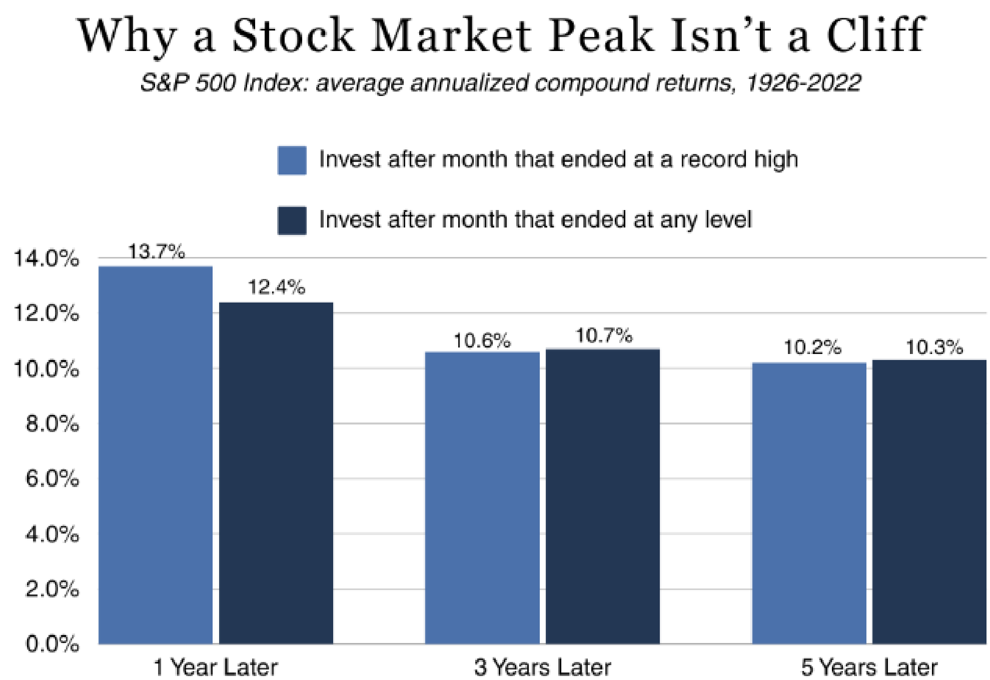
This may surprise you, but it makes sense if you think about why the values of good companies rise in the first place.[2] In the long run, increases in share prices are driven by increases in profits, which flow from innovation and good companies pushing to get better. Those drivers of future profits are not based on current equity market levels or valuations.

[1] You can view the original version of Figure 1, along with DFA's conclusions and disclosures, at: https://www.dimensional.com/us-en/insights/why-a-stock-peak-isnt-a-cliff.

[2] Remember, we invest in *companies* (not in stocks). If you need a refresher on the distinction, it was the focus of our June 2023 edition: https://www.kooman.com/pdf/optimistic_investor/OptimisticInvestor-Ed2_FINAL_6-29-2023.pdf.

Companies are constantly trying to innovate and improve, and they don't reduce their efforts or stop trying because market indexes reach new records. That's why the 3- and 5-year return comparisons in Figure 1 are virtually the same, and it's why our expectations for future returns shouldn't change just because markets are at all-time highs.

Figure 1



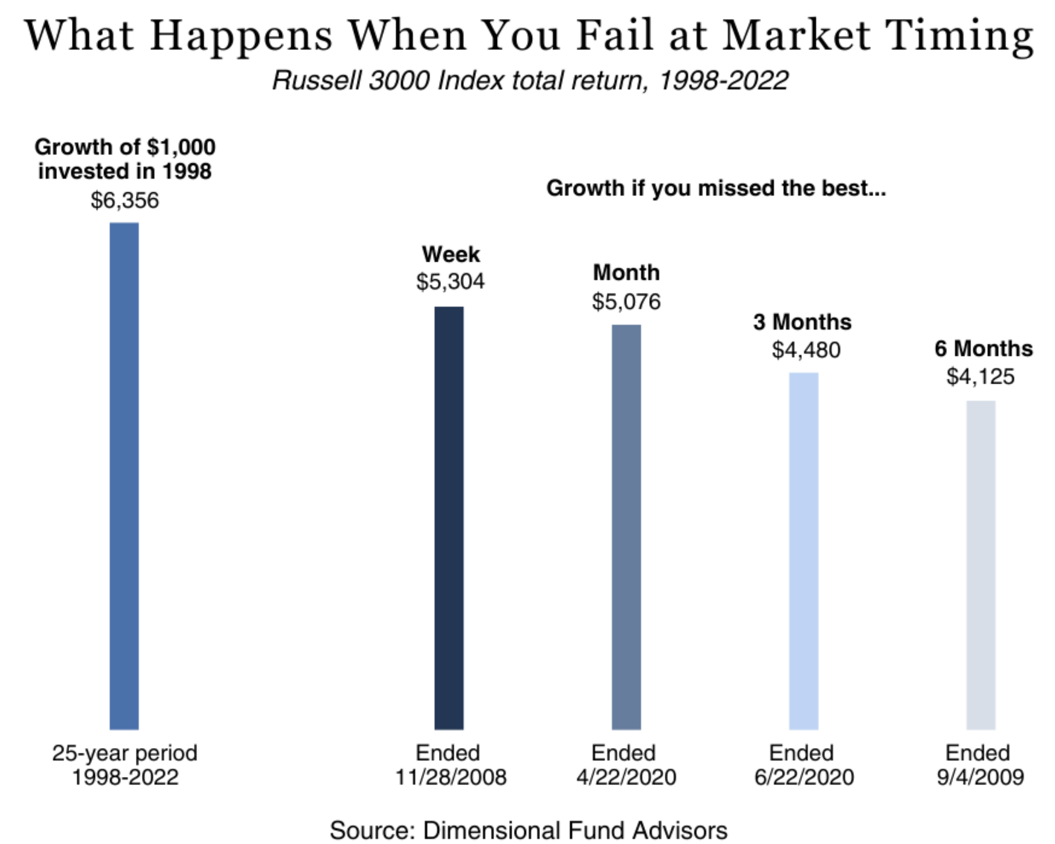
Source: Dimensional Fund Advisors

This, of course, is not the message you'll hear from the financial media. If you tune into a financial "news" channel, you'll probably hear a discussion of whether the stock market is experiencing a "bubble" or whether now is a good time to "take some profits." The suggestion, as always, is that down markets ***may*** be just around the corner and action should be taken before they arrive.

We touched on the problem with this "market timing" approach in our last edition. No one ***knows*** what will happen next in the world, nor do they ***know*** how markets will ultimately react to whatever does happen. That means market timing efforts are just ***guesses*** about short-term events – and they ultimately fail because it feels like corrections and bear markets ***might*** occur more often than they actually do. As we discussed last quarter, there is always a laundry list of issues that could lead to equity market turmoil, but most of them never amount to anything.

So, if market timing is just guessing, what happens when you guess wrong? Once again, DFA published research on this very question last year, and the results show that the consequences can be severe. In this case, DFA examined the last 25 years of the Russell 3000 index, which is generally considered to reflect the entire "investible" US equity market. As a baseline, DFA calculated the growth experienced by investing $1,000 at the beginning of 1998. Then they looked at how that growth would have been impacted by missing out on the best week, month, 3-month and 6-month stretch of returns during those 25 years. The results are summarized in Figure 2.[3]

Figure 2



These figures really drive home the risks of market timing. If you invested for the 25 years from 1998-2022 and missed only the best week of returns, your cumulative growth was 19.6% lower than if you'd remained invested for the entire period. ***Just one missed week reduced the 25-year return by nearly 1/5th!*** And the impact was even worse if you missed out on a longer stretch of great returns.

It's important to note here that, as is often the case, the best returns during this 25-year period occurred when things looked bleak. Each of the "best" stretches shown in Figure 2 took place during either the 2008-2009 financial crisis or the 2020 pandemic. In other words, they happened when markets were facing tremendous uncertainty and it ***felt*** like things could get worse.

This is exactly what famed investor Peter Lynch meant when he said that "[f]ar more money has been lost by investors preparing for corrections or trying to

[3] You can access the original Figure 2, along with DFA's conclusions and disclosures, at: https://www.dimensional.com/us-en/insights/what-happens-when-you-fail-at-market-timing.

anticipate corrections than has been lost in the corrections themselves."[4]

Corrections and bear markets have ***never*** caused a loss for a broadly diversified equity portfolio; the declines have ***always*** been temporary (unless the investor sold during the decline). That's why trying to time the market just doesn't make sense – by trying to avoid the potential for a ***temporary*** decline, the investor inevitably ends up with ***permanently*** lower returns. That's a tradeoff most investors simply can't afford to accept.

As we've said in the past, the key to successful investing is establishing a plan and continuously acting on that plan over time. We need the long-term premium return that equities have historically generated to keep our plans on track. And ***the only way to make sure we earn the equity premium is to invest and stay invested throughout the inevitable ups and downs of the market cycle***. Letting current events and market levels drive investment decisions is a recipe for failure, and that's true whether we're talking about bear markets or record highs. So, enjoy this market rally while it lasts, and take comfort in knowing that when it eventually fades (whenever that may be), you have a plan for whatever comes next.

> ***"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves."***
>
> ***~ Peter Lynch***

Innovation & Good News

1) There's more good news in the fight against cancer. A new drug, combined with chemotherapy, has quadrupled survival rates for mesothelioma patients. And a new type of immunotherapy being used to treat aggressive brain tumors has shown promising results.

2) Researchers say that a new blood test can detect Alzheimer's disease up to 15 years before symptoms otherwise begin. Earlier detection will allow treatments to begin sooner, increasing their efficacy.

3) Multiple gene therapy studies have allowed children born with hereditary deafness to hear.

4) Genetically modified pigs may be able to provide organs for human transplants. The hope is that this could resolve the shortage of available organs that claims thousands of lives each year.

5) We've mentioned the huge potential of fusion energy in past editions, and scientists are now using AI to help control fusion reactions for longer.

6) In a great example of the compounding or layering of innovation, companies are using the technology that gave rise to the U.S. fracking boom to implement geothermal energy projects.

[4] Lynch, Peter. "Fear of Crashing," Worth Magazine, September 1995, *available at* https://worth.com/from-the-archives-fear-of-crashing/.

Financial Planning News & Updates

Retirement contributions – Don't forget to adjust your retirement savings for the new maximum contribution levels.

Traditional and Roth IRAs have a 2024 contribution limit of $7,000, plus an extra $1,000 for those age 50 and older.

401(k), 403(b) and Thrift Savings Plan accounts now have a limit of $23,000, plus an extra $7,500 for those 50 and up.

529 to Roth transfers – This is the first year that excess balances in 529 plan accounts can be used to fund Roth IRA contributions. There are several restrictions and limitations to be aware of, and state tax laws may not follow the new federal rules, so make sure you ask us about this if it's of interest.

Team Kooman Corner

A new Optimistic Investor joined the K&A family on February 1st!

Welcome Sutton Louise Starkey!

KOOMAN & ASSOCIATES

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Nothing in the foregoing discussion should be interpreted as a recommendation to buy, sell or hold any specific security. Please remember that past performance and events may not be indicative of future results.

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A copy of the K&A's current written disclosure brochure (Form ADV Part 2A) discussing our advisory services and fees is available for review upon request or at www.kooman.com.

Please remember to contact us in writing:

- If there are any changes in your personal/financial situation or investment objectives, so we can review, evaluate and/or revise our previous recommendations as needed; or
- If you would like to impose, add or modify any reasonable restrictions on our investment advisory services.

Unless and until you notify us, in writing, to the contrary, we will continue to provide services as we do currently.

Please also remember to advise us if you have not been receiving account statements (at least quarterly) from your account custodian.

