The Stan Clark Financial Team's

PERSPECTIVES

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Economics and asset allocation

With the stock market, the trend is your friend

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In past issues, Mike and I have talked about investing in stocks for the long run, not the short run.

The stock market can be volatile. But nothing else has come close to matching its ability to give good returns over the last 100 years. Is it worth the volatility, though? Looking at the stock market over short periods of time, even a year at a time, shows a lot of ups and downs. But over longer periods of time, say, a decade, you see that the wild up-and-down years cancel each other out. The result: very consistent positive returns.

This has indeed been the case over the past 100 and even 200 years. But why is the long-term result so positive? That is a very important point. Understanding the reasons behind the positive past returns should give us more confidence that future returns will also likely be strongly positive.

It turns out there is a very good reason for these long-term positive returns. It really comes down to one of the main fundamentals of our economic system: corporate profits, or earnings. The stock market – let's cite the S&P 500 – is made of many companies. Not every company has positive earnings, but when you add them all up, the companies making up the S&P 500 have had positive earnings every *single year* for its entire existence. So, although the stock market goes up and down, the overall earnings for the underlying companies making up the stock market have never been negative.

These earnings have either been re-invested into the companies to make them more valuable, or paid out to shareholders as dividends. The re-invested earnings have gone into things like more factories, outlets, machinery or technology. The result? Higher earnings and more dividends in the future. The higher earnings and dividends increase the value of the companies and the prices investors are willing to pay for them.

So, earnings have been positive, and some of these earnings are re-invested. That's why the stock market also grows over time – because it's worth more. But this doesn't explain why the stock market is so volatile over the *short term*. For that, you have to look at human nature; at our emotions and our natural tendency to over-react to many things. We see this tendency all the time. Think about what happens after a bad year for stocks. No one wants to talk about stocks. They take every opportunity to shun stocks – only to see the stocks recover soon after.

On the other hand, following a great year, everyone is all gung-ho about stocks, only to see below-average returns the next year. Emotions can drive the stock market to all sorts of prices, making the market very expensive or very cheap compared to the true underlying value of the companies in it. But, as long as *we know the underlying value is there, and that it grows over time, we can be more comfortable with the volatility*.

This is part of the reason we don't try to *time the market*. Ideally, we always want to invest at market bottoms. But even if we happen to invest at the top, since the market is going to be higher in the long term anyway, it doesn't really matter as much as you would think. The longer you can invest for, the more chances you have of better years compensating for the bad years. And all this while the value of the stock market trends upward.

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To learn more about CIBC Wood Gundy, The Stan Clark Financial Team and the many ways we can help manage your wealth, please contact us by phone or by email as listed below.

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