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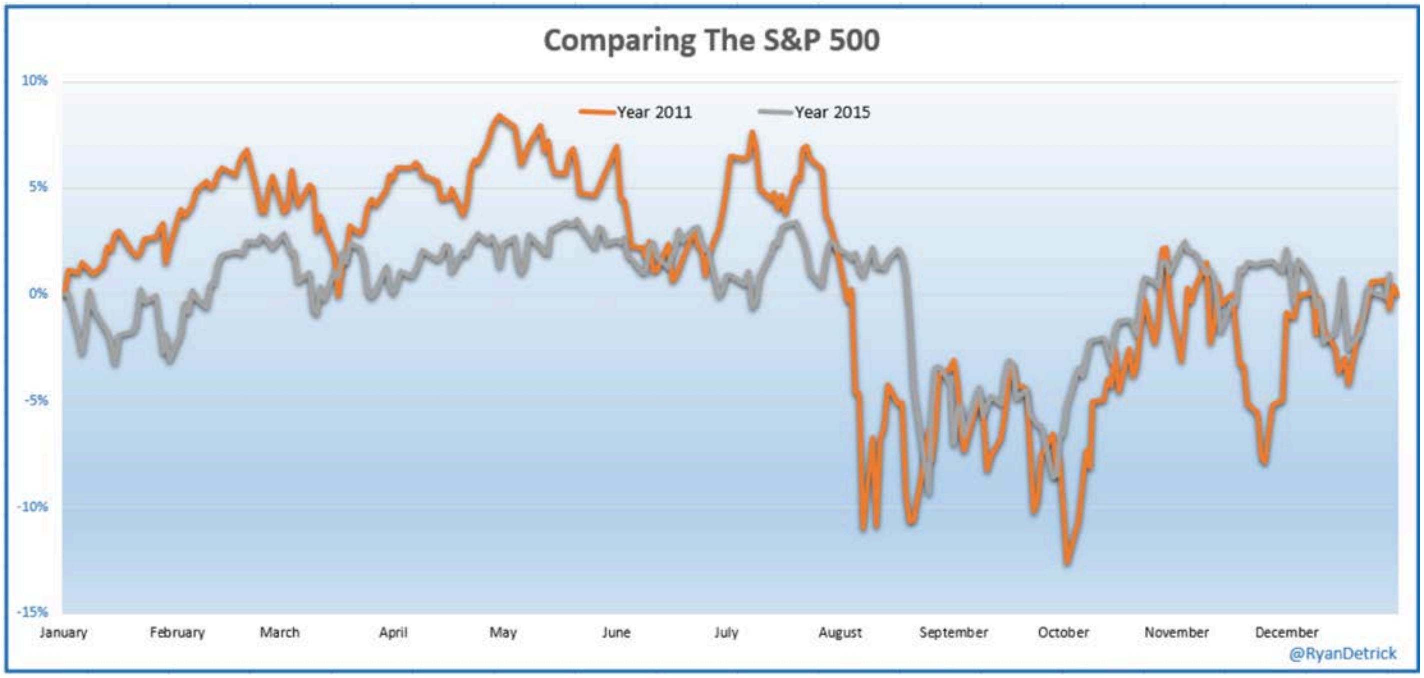
A Sideways Market for U.S. Stocks: Déjà vu All Over Again?

Examining Sideways Market Conditions and Investment Strategies

[Micah Wakefield](), CAIA® | Jan 5, 2016 | [Swan Blog]()

Haven't we seen this before?

A well-circulated chart made its way around the investment world throughout 2015. It was a chart comparing the S&P 500 in 2011 to 2015. With the exception of a little less volatility in 2015, the years are eerily similar when compared to each other, even on a monthly return basis. See below:



Source: Ryan Detrick, Kimble Charting Solutions

In both of these years the market traded sideways from January to December, however there were some historic volatility and market swings in between. After a sideways market in 2015, the focus shifts to what lies ahead, and if the market will offer more of the same.

How Often Are Markets Flat?

Statistician Ryan Detrick recently did some analysis of flat markets, defined as less than +3% and better than -3%, and found these interesting statistics:

* The last time the S&P 500 was flat two straight years was 1947 and 1948 at 0.00% and -0.65%.
* Using historical data back to 1872, only 15% of all years end up flat.
* 66% of all years move at least 10% (up or down). 28% of all years move at least 20% and 11% move at least 30%.

If you expand the definition of a flat market a little further out to +4/-4% and begin the analysis when S&P 500 data becomes more robust in 1926, flat markets only occur 10% of the time, with nine occurrences across 90 years. Of those nine, two happened in the 1930s, two happened in the 1990s, and two happened this decade. They have never occurred back to back and three flat years have never occurred within the same decade. But this is just the S&P 500; what about other equity markets?

The MSCI EAFE Index, representing Foreign Developed equity markets, began in 1970 and over the past 46 years its annual returns were flat 11% of the time. When looking at Emerging Markets using the MSCI EM Index, which began in 1989, 11% of the time its annual returns were flat.

Market history should never be a means of predicting future performance. But there are lessons to be learned by studying market history and mechanics if it can give us potential insights on the likely distribution of returns. From the data outlined above, it is reasonable to conclude that we should expect the equity markets to be flat around 10% of the time. So, we know that markets will trade sideways on occasion, but why and what happens after?

Why Are Equity Markets Rarely Flat?

One popular explanation is behavioral finance. Behavioral finance is the concept that investor psychology causes market prices and fundamental values to diverge over periods of time. Psychological biases cause investors to underreact or overreact to new information, as fear, greed, and emotion tend to drive investment decisions. But on a more fundamental basis, economies, businesses, and populations growing or shrinking over time is what truly drives the markets. As Benjamin Graham famously said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine."

Therefore, a sideways market is usually the result of some uncertainty in the markets.

Uncertainty about economic growth, government policy, the geopolitical landscape, and more, will influence investor's behavior and how they react to information as it becomes available. In 2015, the good news and bad news were pretty equally weighted, and consequently markets ended up flat. However, after a period of flatness the scales usually tip one way or the other and overreacting market participants drive the market up or down.

"So How'd You Do in this Sideways Market?"

Now it's time for a little introspection…

For the Swan Defined Risk Strategy ("DRS"), a market that trades sideways for an extended period is a less than optimal environment. Similar DRS performance in 2015 and 2011 was not unexpected. In a flat market, the underlying investment in market ETFs usually doesn't make any gains of substance. In fact, in the case of 2015, our equal-weight sector approach trailed the cap-weighted market by around 250 bps. In addition, there is a cost over the year associated with the investments always being hedged, which is generally in the 2-3% range.

It is important to note, however, that *the DRS can still be positive in a flat market* if the returns from the income component of the strategy are close to its historical annual average return. In 2015, although positive on the year, the income component's return was below its historical average.

Conclusion

In summary, another year-long flat market in 2016 is highly unlikely. Could it still happen? Yes, it could, just as a big up or down move could happen.

But history would say to be on the lookout for a big move in one direction or another. More importantly, 69% of the time since 1926 the S&P 500 has been up or down more than 10%.

These types of returns are usually better environments for the DRS to either protect on the downside or capture some of the upside of the markets. Either way, the DRS is constructed in such a way as to maximize the probability of successful returns over a long-term cycle by focusing on the 69%; protection and growth participation. We believe that even if the markets act abnormally and stay flat for years to come that the DRS will be better positioned than other equity approaches for whatever the market may bring. Here's to a happy and prosperous 2016!

Also feel free to contact your Swan representative at **970-382-8901,** or visit our Contact page if you have further questions.

About the Author:
Micah Wakefield, CAIA®, Director of Research and Product Development, is a part of the investment management team at Swan and focuses on research and analysis, strategic planning, and product development. Prior to joining Swan, Micah was the Director of Operations and Trading at an investment advisory firm.

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