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Current events, even war, not good basis for investing

ON INVESTING
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Back in 1970, Edwin Starr released a recording of the song "War." The notable lyrics, "war/what is it good for/ absolutely nothing," have been quoted often in the 40 years since. However, contrary to Starr's lines, it turns out there may be one thing that war is indeed good for: the stock market.

The first 100 days or so into our new president's administration have brought mounting tensions with foreign rivals, and in some cases even with longtime allies. The Syrian missile strike in early April is the most notable example of foreign strains actually coming to a head, but there has also been a lot of saber rattling with North Korea, China, Russia, Mexico and even some tough talk with the prime minister of Australia.

This may be a brash new approach to foreign policy that ultimately reestablishes a global position of strength for our country. It could also backfire and lead to a need for protracted, costly and damaging military action. Time will tell. However, many are concerned about the geopolitical outlook and the subsequent impact on the economy and capital markets.

A few years ago, in 2013, as the U.S. was on the brink of a potential military conflict with Syria, we did a study to see how stock market returns fared during periods of war. Clients were calling us, nervous about what impact military action could have on their investments. After all, the stock market hates uncertainty, and it seems logical that geopolitical uncertainty would cause stock market uncertainty as well.

We studied all major wars since 1926, which is the inception of reliable data on the stock and bond markets. We included World War II, the Korean War, the Vietnam War, and the Gulf War. We excluded the Iraq War, as that coincided with a major economic boom and bust that had nothing to do with the nation's involvement in the war.

What we found is that stocks have historically outperformed their long-run averages during periods of war. Bonds have underperformed.

Compared with the full period we studied, between 1926 and 2013, stocks earned 1.4 percent more annually during periods of war. Small-cap stocks earned 2.2 percent more annually. This is surprising, as riskier market segments, such as small-cap stocks, generally underperform during periods of market volatility.

However, despite what seems intuitive, war times have not been periods of increased market volatility. In fact, while stock market returns were higher during periods of war, risk was actually significantly lower. Annual stock market volatility was roughly 7 percentage points lower for both large-cap and small-cap stocks during wars than over the entire period we studied.

During each wartime we looked at, except the Gulf War, volatility was much lower than over the full market history. Capital market returns during the Gulf War were different from during other periods of war. First, this war was very short, spanning less than a full year. Also, this period coincided with an oil price spike, perhaps partially because of the war, that helped push the U. S. economy into a brief recession. The idea of recession during wartime was fairly new, and reflected the changing U.S. economy. During previous wars, the economy was more exposed to capital goods and natural resources, which experienced greater demand to feed the war. However, by the 1990s, the economy had shifted away from heavy industry and toward the current "knowledge-based" economy. Thus, military demand had less of an impact on economic growth.

It is possible that this dynamic is more relevant today than past wars, but recent research shows that even in our new economic era, military action can be beneficial to the stock market.

Market watcher Mark Hulbert recently extended our earlier study. He wrote an article for Barron's that examined stock market returns just before and just after the United States entered into military conflicts. Hulbert looked at the invasions of Grenada and Panama, the first Gulf War, the bombing of Kosovo, the war in Afghanistan, the second Gulf War, and the bombing of Libya. These actions spanned the years 1983 through 2011.

This study found that while the stock market, as measured by the Dow Jones Industrial Average, declined slightly on average just before military conflicts, it quickly recovered those losses. In the month following the start of a military conflict, the Dow rose 4 percent on average, which is 3.2 percent higher than the average of all months studied. Hulbert's study also found that the strong relative performance continued for at least six months.

Hulbert believes the removal of market uncertainty is responsible for this strong performance. He posits that geopolitical risk does indeed weigh on the capital markets prior to a military event, but there is a relief rally once an event actually occurs and a direction forward is known, even if that direction involves violence.

Interestingly, while high-quality bonds are usually a safe harbor during periods of uncertainty, they underperformed their long-run average returns during periods of war. This is probably because inflation has been higher during these periods. Increased demand for materials during wartime likely drives up prices, leading to higher general inflation. Higher inflation rates make fixed-rate bond instruments less appealing, leading to underperformance. Starting at today's ultra-low interest rates, this phenomenon could be even more pronounced with future military actions, even in our new economy.

On the brink of potential conflicts in the Middle East and Asia, the stock market may face a knee-jerk decline in the short run if tensions continue to mount, but if history is any guide, the longer-term outlook for stocks could be rosier.

Certainly, war, and its accompanying violence, cannot be construed as positive and should not be the basis for investment decisions.

My point here is not to suggest that any investor use potential military action as a factor in a trading strategy, but rather to show that markets tend to rise over time. Changing a long-term investment strategy based on current events, even events as significant as war, are likely to be damaging to long-term wealth creation.

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