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Who's Afraid of a Sideways Market?

On the heels of the 2020 global pandemic, trillions of dollars in fiscal stimulus spending led to a rapid rise in inflation and a significant increase in interest rates which, in turn, resulted in a painful bear market for both stocks and bonds. All of this was followed in the spring of 2023 by a mini-financial crisis in the banking sector.

Taken together, the attitude among many investors has shifted, believing the forthcoming investment landscape could be challenging and future common stock returns uninspiring. Indeed, some market strategists are forecasting an extended period of below-average stock returns caused by potentially poor earnings per share (EPS) growth and declining price-to-earnings (P/E) ratios.[1]

When investors think historically about the stock market, they likely recall bull and bear markets that either went up or down over a multi-year period. But, there is a third type of market which may be less familiar called a "sidewinder"—a sideways market that barely changes over time. Although unusual, the stock market has experienced several sideways markets over the last 100 years. History is littered with examples.[2]

Dissecting a Sideways Market

One of the infamous sideways markets occurred between October 1, 1975 and August 6, 1982. Charting the price only Dow Jones Industrial Average (Dow) during this period showed no change for the index, while the Dow's cumulative return—including dividend income—was 46.02% for annualized total return of 5.68%. The entire return of the Dow during this sideways market was attributed to its dividend payers and their greater than average 5% yields.

The S&P 500 Index faired a bit better during this same period—the price return was 25.06% for a 3.32% average annual return. When dividend income is factored in, the cumulative total return of the S&P 500 improved to 76.52% for an 8.65% average annual return. During this time period, 62% of the S&P 500 Index was attributed to dividend income while only 32% was the result of price appreciation.

In both cases, over this seven-year period without the 5% plus average dividend yield of both indices, the return to investors would have been miniscule. However, it is important to note, an investment in the Dow or the S&P 500 nine months before October 1975 and four months after August, 1982 would have produced better long-term returns.

In January 2010, I examined the performance of the stock market between 1975 and 1982.[3] The market rubble following the 2008–2009 Financial Crisis left many investors bewildered and provided little hope the market would quickly heal their losses and help restore net worth. Then, as now, many investors believed that the next ten years might represent a lost decade for investment returns.

Even so, back in 2010 I was perplexed. While investment returns for the Dow and the S&P 500 between 1975 and 1982 were well below historical averages (perhaps more so for the Dow), years of studying Warren Buffett suggested to me there may be better opportunities deep inside the markets.

We began by examining the return performance of the stocks in the S&P 500 Index between 1975 and 1982. Tracking these stocks at the beginning of each year, it was discovered that, on average, 3% of constituents increased in price by at least 100% over the course of the following year. In other words, on average, only 16 out of 500 stocks doubled in any one year, demonstrating that, even for the best stock traders, it would have been a significant challenge to identify these stocks in advance each year.

When the holding period was extended to three years, the results were more encouraging. Over rolling three-year periods, on average, 18.6% of the stocks doubled—or 93 out of 500.

Going further, increasing the holding period to rolling five-years revealed eye popping results. On average, an astonishing 38% of the stocks went up 100% or more—190 stocks out of 500 doubled. For those that may consider doubling an investment over five years an insignificant achievement, it works out to be a 14.4% average annual return.

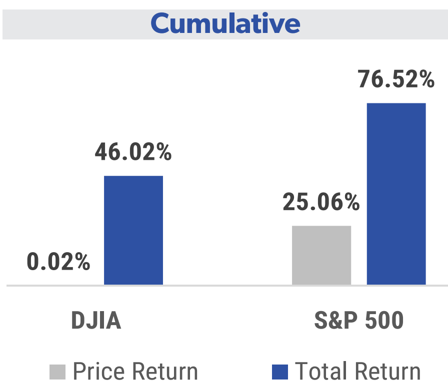
The question then became, how can 38% of the stocks in the S&P 500 go up at least 100% or more over five-year rolling periods that included a seven-year stretch of sideways price movement? The answer was revealed not by a finance professor, but by one of the most influential evolutionary biologists of our generation—Stephen Jay Gould.

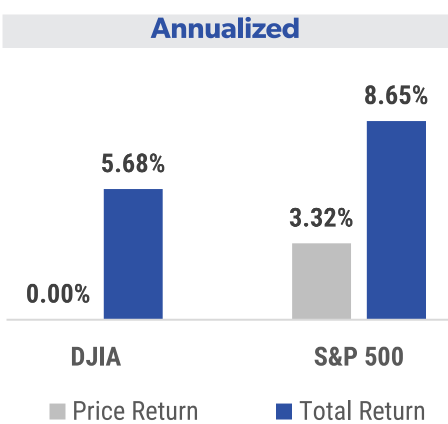
The Spread of Excellence

In his highly acclaimed book, *Full House: The Spread of Excellence from Plato to Darwin*, Gould wrote about the importance of distinguishing between the trends ***of a*** system and the trends ***in a*** system. *"The old Platonic strategy of abstracting the full house as a single figure (average)…and then tracing the pathway of this single figure through time, usually leads to error and confusion."* [4] Because there is a *"strong desire to identify trends,"* said Gould, it can lead one to *"detect a directionality that doesn't exist."*[5]

Price Return *Versus* Total Return

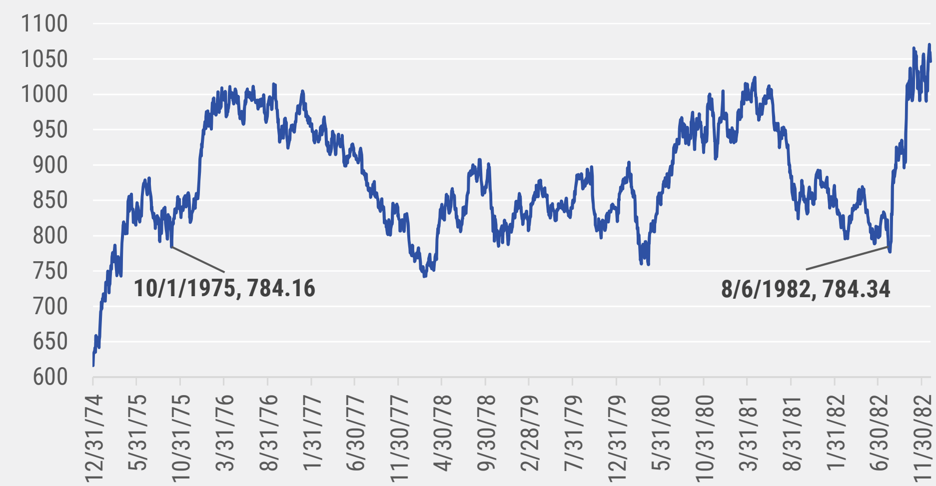
10/1/1975 – 8/6/1982
Source: Bloomberg Finance, LP





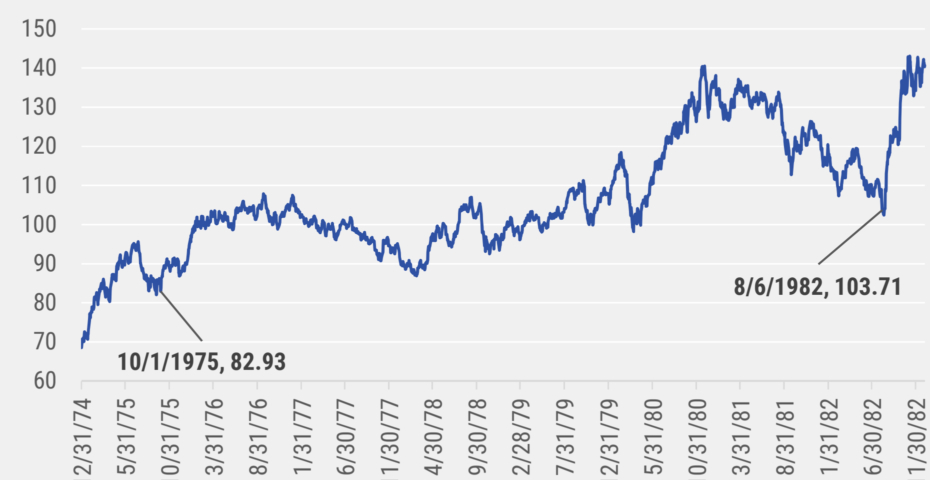
Dow Jones Industrial Average (Price Only)

12/31/1974 – 12/31/1982 | Source: Bloomberg Finance, LP



S&P 500 Index (Price Only)

12/31/1974 – 12/31/1982 | Source: Bloomberg Finance, LP



Number of S&P 500 Companies That Doubled or Greater (Top 500 Companies) 1975—1982

Table 1

Over Rolling One-Year Periods

Range	1975	1976	1977	1978	1979	1980	1981	1982	Total
# of Companies	46	5	0	2	27	34	2	8	124
% of 500	9.2%	1.0%	0.0%	0.4%	5.4%	6.8%	0.4%	1.6%	3.1%

Over Rolling Three-Year Periods

Range	1975–1977	1976–1978	1977–1979	1978–1980	1979–1981	1980–1982	Total
# of Companies	148	36	48	132	101	93	558
% of 500	29.6%	7.2%	9.6%	26.4%	20.2%	18.6%	18.6%

Over Rolling Five-Year Periods

Range	1975–1979	1976–1980	1977–1981	1978–1982	Total
# of Companies	268	186	112	193	759
% of 500	53.6%	37.2%	22.4%	38.6%	38.0%

Putting it in Gould's terms, investors who observed the stock market between November 1975 and August 1982 and focused on the "full house"—the market average—arrived at the wrong conclusion. They incorrectly assumed the direction of the entire market was sideways, when in fact the variation within the market was dramatic and led to plenty of opportunities for investors to achieve high excess returns.

Gould explains that studying the variations in systems, enhances the ability to observe patterns over time. These changing patterns are thought to be trends to improvement, or what Gould refers to as the "spread of excellence."

Applying this idea to the stock market, it became clear that what first appeared to be a trendless sideways market between 1975 and 1982 was in fact a market full of variation. That quickly prompted the next two questions: (1) where did trends of improvement occur, and (2) what outperformed?

The following tables published in the original study show the breakdown of companies in the S&P 500 Index in 1975 across the ten Global Industry Classification Standard (GICS) sectors as defined in 2010 (**Table 2**) and the percentage of companies that outperformed over each rolling five-year period (**Table 3**).

Table 2

S&P 500 Sectors & Number of Companies (1975)

Sector	Number of Companies	Number of Total Cos.
Industrials	77	15.4%
Materials	76	15.2%
Utilities	69	13.8%
Financials	65	13.0%
Consumer Discretionary	63	12.6%
Consumer Staples	54	10.8%
Energy	50	10.0%
Health Care	22	4.4%
Information Technology	15	3.0%
Telecommunication Svcs.	9	1.8%
Total	**500**	**100.0%**

Table 3

Number of S&P 500 Companies Doubling or More Over Four Five-Year Rolling Periods (1975)

Sector	# of Companies Doubling or More	# of Companies Outperforming
Energy	**135**	**67.8%**
Industrials	**131**	**42.7%**
Information Technology	**26**	**42.6%**
Financials	**109**	**42.1%**
Consumer Discretionary	**93**	**36.8%**
Health Care	30	34.5%
Materials	94	31.0%
Telecommunication Services	11	30.6%
Utilities	79	28.4%
Consumer Staples	51	23.5%
Total	**759**	**38.0% (Avg.)**

Between 1975 and 1982, the greatest number of companies within the S&P 500 Index were concentrated in the following five sectors: Industrials, Materials, Utilities, Financials, and Consumer Discretionary, while a smaller number resided among Consumer Staples, Energy, Health Care, Information Technology, and Telecommunication Services.

However, when calculating which sectors had the highest percentage of companies that increased in price by at least 100% over the time period, the lineup changed. Analyzing the five-year rolling time periods revealed that the top sectors with the highest percentage of outperformers included Energy, Industrials, Information Technology, Financials, and Consumer Discretionary. Based on these findings, one might ascertain Stephen Jay Gould's "spread of excellence" flowed through these five sectors.

Looking back, the years between 1975 and 1982 were unsettling. Regional wars in Southeast Asia and the Middle East had become commonplace. Repercussions of the failed Nixon administration continued to ripple through the political system as Americans were led by three different presidents—Ford, Carter, and Reagan. When the Arab members of the Organization of Petroleum Exporting Countries (OPEC) imposed an oil embargo against the U.S. in retaliation of support for the Israeli military, oil prices skyrocketed. The unrelenting annual double-digit rise in gasoline and diesel prices caused significant economic dislocation which, in turn, caused inflation to soar, forcing the Federal Reserve to raise interest rates. In 1981, the yield on the 10-year U.S. Treasury Note reached 15%. That same year, banks raised the prime rate to 21%.

It might be easy to analyze the list of sectors in 1975 and dismiss the high performers as nothing more than companies that benefitted from the rise in oil prices and inflation—Energy and Industrials were the obvious beneficiaries. Similarly, Consumer Discretionary companies were exceptional performers because of their ability to pass along price increases that matched or exceeded the rate of inflation.

However, looking at the 1975–1982 market as nothing more than a competition between companies to see which can raise prices the highest to beat inflation is an oversimplification. It was decided a deeper dive into the results was necessary in an attempt to uncover additional insights that might help explain how this group of select companies was able to produce above-average returns.

Empirical Research Partners was enlisted to help examine the outperforming stocks between 1975 and 1982. Empirical has a stock database going back to 1952 and analyzed individual stocks within four distinct buckets.

1) Valuation
2) Earnings Growth
3) Capital Deployment and Financing
4) Momentum

According to Empirical Research, a valuation-based strategy performed the best during the 1975–1982 period, outperforming its historical average return by 60%. Buying undervalued stocks can be an effective strategy in the pursuit of above-average results. The second best strategy was earnings growth, which outperformed its historical average by over 50%. Despite the economic challenges during the study period, those companies that could drive revenues and earnings higher were well rewarded.

Momentum strategies, which typically work best once the direction of the market has been established were the worst performing during the time period. When market variability is high, sentiment tends to slosh back and forth largely because the trajectory of the economy is unclear. At times, the data may indicate the economic recovery is gaining strength, possibly leading to a short uptick in stock prices, only to be followed by weak economic readings which cause a selloff. In this environment, momentum investors can find themselves constantly whiplashed.

Examining the results from Empirical Research, it was observed the optimal stock picking strategy to employ during the 1975–1982 market was to buy and hold undervalued growth companies—particularly secularly-advantaged companies that were able to provide double-digit growth in revenues and earnings.

Strategies for a Sideways Market

What's an investor to do if confronted with the possibility of a sideways market? For those who embrace a passive index approach to investing, the results could be well below-average. With little change in the future price of stocks, investors are left to earn income from dividend payers. With the current yield of the S&P 500 Index at 1.7% as of March 31, the S&P 500 annual return could fall below the rise in inflation.

Some argue that because a "buy and hold" strategy may not work in a sideways market, the only way to make money might be to trade stocks. The idea of buying stocks that may go up and then selling before they roll over, while intellectually appealing, is difficult to employ. For those contemplating a stock trading strategy, take a breath and truthfully admit that only a small percentage of investors have been able to profitably do so over time.

This being said, there are opportunities to pursue favorable returns in a sideways market. Based on our research, we have identified two strategies that we believe present an opportunity to earn excess returns beyond what a flat market might provide. Importantly, both strategies are compelling alternatives to trading stocks in a futile attempt to predict short-term market changes.

Strategy #1:
Invest in High Dividend-Paying Stocks

In a sideways market, dividends contribute outsized gains for investors. However with the current yield of the S&P 500 at a paltry 1.7%, the return of "average" dividend-paying stocks may not be enough to provide meaningful returns for investors in a market that, on a price basis, might barely change in the years ahead.

For this reason, we believe higher dividend-paying stocks—companies that not only provide above-average yields but that may also be in a position to raise shareholder dividends over time—are necessary during a sideways market.

Quality Dividend Portfolio

- A focused, low-turnover portfolio of high quality stocks that provide a 4.1% current yield
- Investment goal to provide asset preservation, attractive current income, and growth in current income *(View the Fact Sheet)*

High-Dividend Portfolio

- Seeks to generate a high level of current income and dividend growth covering inflation with a 5.2% current yield
- Allocation is similar to that of high-yield corporate bonds within a well-diversified portfolio that includes a higher exposure to investment grade companies *(View the Fact Sheet)*

Strategy #2:
Invest in Secularly-Advantaged Multinational Global Growth Companies

The growth of the intrinsic value of common stocks, and ultimately stock prices, are a function of the economic returns of the underlying business. Not only is it important for a company to generate cash earnings in excess of operating needs, it is also imperative the cash return of the business exceeds its cost of capital. When a company earns a cash return above the cost of capital it increases shareholder value; when it earns a cash return below the cost of capital, it destroys shareholder value.

Based on Empirical Research's findings, growth investing works best when value-creating growth stocks are undervalued and continue to generate double-digit gains in revenues and earnings. We believe investors could be well-rewarded by buying and holding secularly-advantaged growth companies that can generate above-average returns despite the economic landscape.

Global Leaders Portfolio

- A focused, low-turnover portfolio of leading global companies designed to benefit from the unprecedented growth in worldwide consumer demand
- 65% of revenues come from outside the U.S. in many rapidly growing emerging economies where young consumers are beginning their discretionary spending years
- Seeks to buy and hold companies that are compounding the above-average growth of intrinsic value over time *(View the Fact Sheet)*

Conclusion

So, who should be afraid of a sideways market? Although it is not certain we will experience a sideways market in the coming years, if we do, momentum investors will likely struggle. With no long-term trend in place, investors could flail back and forth between bullish and bearish sentiments. Second on the list might be index investors. If the price of the index is little changed over the years, then the most index investors could hope for is an annual dividend yield of less than 2%.

Who should NOT be afraid of a sideways market? Stock pickers. Whether the approach is to select stocks that pay higher dividends or companies that are growing and compounding shareholder value at an above-average rate, we believe the advantage is now in the hands of those investors with the ability to identify mispriced stocks.

Warren Buffett differentiates between the "know-*something*" investor and the "know-*nothing*" investor. If you are a "know-*nothing*" investor—without the skill set to identify which stocks may be undervalued and offer the best upside opportunity—then it might be best to implement a broadly diversified portfolio approach, something akin to index investing. *"On the other hand,"* said Buffett, *"if you are a know-**something** investor, able to understand business economics and find companies that possess important long-term competitive advantages, conventional diversification (index investing) makes no sense for you. It is apt simply to hurt your results."*[7]

Whether we are in for a sideways market for the next several years is open for discussion. However, the central point of this research is to remind investors, whatever the stock market landscape, there are significant opportunities and profits to be made by those who understand the variations within the system.

Despite stock market behavior, or performance of the underlying economy, there will continually be, in the words of Stephen Jay Gould, a "spread of excellence." In financial ecology, there are always alternating patterns and trends to improvement. As such, the investment landscape typically favors the stock picker—perhaps now more than ever.

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Robert is the author of ten investment books including *The New York Times Best Seller*, *The Warren Buffett Way*, widely considered to be the definitive book on the investment approach and strategies of Warren Buffett. The book has sold over one million copies worldwide and is translated into 17 foreign languages. In addition, Robert wrote, *Investing: The Last Liberal Art*, a multidiscipline examination of investing and decision making. His latest book, published in 2021, is *Warren Buffett: Inside the Ultimate Money Mind*. Robert earned his Bachelor's and Master's of Arts degrees from Villanova University. He is a Chartered Financial Analyst, a member of the CFA Institute, and the CFA Society of Philadelphia. Robert is also a member of the Global Interdependence Center.

Footnotes:

1. Bannister, Barry B., "Our game plan the next 9 months of 2023 and the next 9 years," Stifel Institutional Research, March 23, 2023.
2. June 30, 1933 the Dow Jones Industrial Average (Dow) stood at 98; nine years later, on May 26, 1942, it closed at 99.
   March 6, 1945 through June 13, 1949 the Dow started at 161.5 and ended at 161.6
   October 10, 1966 through February 4, 1970—the Dow began and ended at 754
   October 1, 1975 the Dow stood at 784; nearly seven years later, on August 6, 1982, the index closed at the exact price–784
3. Hagstrom CFA®, Robert G, "Who's Afraid of a Sideways Market," January, 2010, Legg Mason Capital Management. I wish to acknowledge the Legg Mason Capital Management Research Department including the work of Randy Befumo, Director of Research, Arturo Rodriquez, Security Analysts, Peter Shapiro, Research Analyst, and Graham Savage, Associate Analyst.
4. Gould, Stephen Jay, *Full House: The Spread of Excellence from Plato to Darwin*, Three Rivers Press; New York, NY, 2006. p. 217.
5. Gould, p. 41.
6. I wish to thank Empirical Research Partners, Michael Goldstein, Brian Cho, Nicole Price, and Norman Sanyour for their dedicated research help for this commentary; January 2010.
7. 1993 Berkshire Hathaway Annual Report.

Disclosures

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The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

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The **Dow Jones Industrial Average (DJIA)** is an unmanaged, price-weighted index that consists of 30 blue chip U.S. stocks selected for their history of successful growth and interest among investors. The price-weighted arithmetic average is calculated with the divisor adjusted to reflect stock splits and occasional stock switches in the index.

The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment. All index returns are shown on a total return basis and assume that all cash distributions, such as dividends, are reinvested.

*Total assets combines both Assets Under Management and Assets Under Advisement as of March 31, 2023. Assets Under Management represents the aggregate fair value of all discretionary and non-discretionary assets, including fee paying and non-fee paying portfolios. Assets Under Advisement represent advisory-only assets where the firm provides a model portfolio and does not have trading authority over the assets.

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