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Value and Prices

"Obvious prospects for physical growth in a business do not translate into obvious profits for investors."
Benjamin Graham

This is a piece about how valuations are used when measuring the stock market. Recently, there has been a lot of discussion in the financial press about whether stocks are too "expensive" or possibly overvalued. In this letter we hope to give you an overview on what valuation is, and what its consequences for your investments may be.

Valuation and P/E (Price-to-Earnings Ratio)

You have probably heard market prognosticators in the financial media discussing whether a stock is "cheap" or "expensive". What they're likely referring to is the *valuation* of the stock – how much does the stock cost when compared to the profitability of the underlying company?

By far the most widely used valuation method is called "price-to-earnings", or P/E. P/E is the ratio of a company's stock price compared to its corporate earnings. Stocks with higher P/E ratios are usually said to be "expensive", or overvalued. Stocks with relatively low P/E ratios are sometimes said to be "cheap", or undervalued.

Many investors apply this methodology to find the P/E ratio for the entire stock market, which they use to decide whether the whole market is "expensive" or "cheap". In theory, when the P/E ratio is high and the stock market could be considered expensive, the odds of a major decline are higher so some investors consider reducing their positions in stocks. Conversely, when the stock market's P/E ratio is lower, some investors will increase their stock holdings. The historical market average for the P/E ratio[**] is 15.7[1*]. As of 6/10/15, the P/E ratio for the entire stock market is 20.2, which has led many to conclude that the stock market is "expensive"[1].

In the past, attempting to predict the stock market solely using P/E was a reasonable strategy. Between 1900 and 1990, P/E valuations for the stock market were almost always in the 7 to 20 range[1]. When the market's P/E was near 20, it was likely that the stock market was overvalued and ripe for a downturn. In fact, between 1900 and 1990, there were only seven different periods when the stock market's P/E crossed above 20[1,2]. Six of those seven periods lead into economic contractions or significant stock market declines[3].

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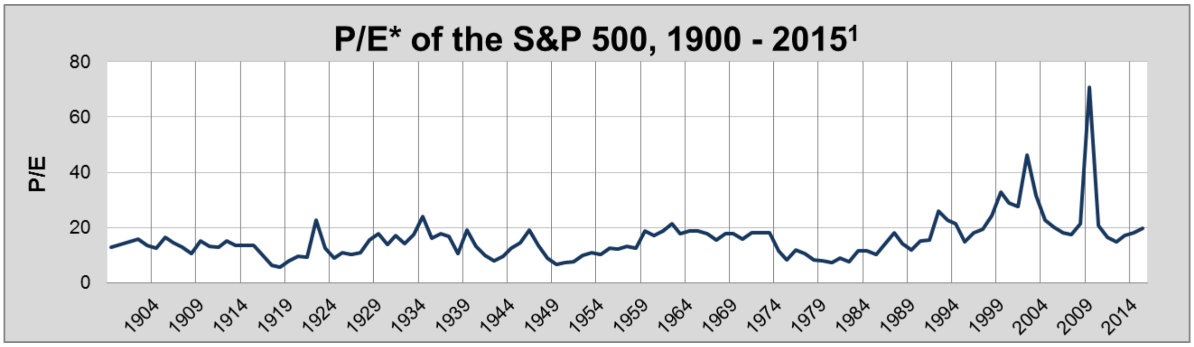

But since 1990, something strange has happened. The stock market's P/E ratio climbed above its traditional 7 – 20 range and mostly stayed there. In fact, the P/E of the stock market has been above 20 for half of the last twenty-five years[4]!

So, has the stock market been overvalued for the last 25 years, or is this just the "new normal"? There is no clear answer. 25 years is not a long time compared to the totality of stock market history, and it may be true that the stock market has been far too expensive this whole time. After all, the stock market may remain overvalued or undervalued for years or decades at a time.

But for actual human beings, 25 years will typically make up more than half of our working lives. Many investors can't afford to wait years or decades for a recovery in the stock market should it fall drastically, especially when they get close to retirement or are already retired.

Because of this, claims that the stock market is "too expensive" or "too cheap" are often useless in the decision-making process and sometimes even detrimental when applied to individual investor circumstances.

Conclusion

Nobody can say with certainty that the stock market is expensive or cheap. And even if someone could, an expensive stock market can continue to rise for many more years before it finally declines. A 2011 analysis by J.P. Morgan Asset Management found that making investment allocation decisions based solely on P/E ratios had no meaningful benefit[5].

Valuation of the stock market may be useful for investment decisions over long time periods, but in the short term it is rarely sufficient without being supplemented by other factors. Disciplined, rules-based strategies are crucial. That's why in investing, attentiveness and the ability to react quickly to new financial events is vital.

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As your financial advisor, I monitor your investments on a regular basis so you can focus on what you enjoy.

Please feel free to call with any questions regarding the issues discussed in this letter or any other financial matters on your mind.

My very best,

Derrick

*The S&P 500 is used as a proxy for the "stock market" or "market" in this article.

The **S&P 500** is an unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market. Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor's results will vary.

** All uses of P/E in this article refer to trailing P/E (trailing twelve months).

[1] Shiller, Robert. 2015. "U.S. Stock Markets 1871-Present and CAPE Ratio". Retrieved from http://www.econ.yale.edu/~shiller/data/ie_data.xls.
The P/E is calculated as the closing S&P 500 composite price divided by trailing twelve-month earnings per share. Monthly data is used.
[2] Using monthly data, the stock market's P/E crossed above 20 in these pre-1990 months: Nov. 1921 – Feb. 1922, Sep. 1929, May 1933 – Jul. 1934, Oct. 1938 – Nov. 1938, Apr. 1946 – Aug. 1946, Mar. 1961 – Apr. 1962, Jun. 1987 – Sep. 1987.
[3] Includes the Depression of 1921 – 1922, the Great Depression, the Recession of 1937 – 1938, the 1962 Flash Crash, the 1987 Stock Market Crash and Black Friday.
[4] Between Jan. 1990 and Dec. 2015, 152 of 300 months had a P/E above 20.
[5] J.P. Morgan Asset Management. 2011. "Price/earnings investing". Retrieved from https://careers.jpmorganchase.com/jpmpdf/1320525444507.pdf.
[6] *Written by Chris Whatley with R.C. Whatley & Company*
[7] Raymond James is not affiliated with and does not endorse the opinions or services of Chris Whatley or R.C. Whatley Co.

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