# THOUGHT FOR THE WEEK
## ARE STOCKS EXPENSIVE?

Global Financial Private Capital

### SYNOPSIS

- It seems as if a week cannot go by without the stock market reaching another all-time high, and this has created a spider web of investor sentiment.
- Investors have asked if the stock market is expensive, given valuations screen at the higher end of the historical range.
- Valuation analysis is far more than simply comparing one P/E ratio to another.

## ESCALATORS VS. ELEVATORS

It seems as if a week cannot go by without the stock market reaching another all-time high, and this has created a spider web of investor sentiment.

Some investors who have participated in this run want to know if now is the time to ring the register. Others who have been sitting on the sidelines, afraid to buy into a market that has not offered an attractive entry point in years, are kicking themselves for staying out of the second-longest bull market in history.

There's an old saying that stocks go up in escalators and down in elevators, and investors have had to learn this the hard way over the last two decades. The emotional scars from the dot-com bubble burst and the financial crisis will likely never heal, and the last thing any investor wants to do is take that ride again. It's a spider web indeed.

For all these reasons, several investors have reached out over the last few weeks asking if the stock market is expensive.

In order to answer such an important question, we must first discuss the concept of valuation and understand its limitations. That way we do not run the risk of jumping to misinformed conclusions.

## PRIMER ON VALUATION

Warren Buffett once said, "Price is what you pay, value is what you get." I can think of no better way to begin a conversation on valuation, so let's start here.

On its own, price offers no insight into the value of an asset. A $1,000 stock could be a bargain compared to a $10 stock, just as a $1 million home could be a steal when compared to a $100,000 home.

Since price is not an appropriate measure, we can immediately dismiss it. What we need is a metric that allows us to compare one asset to another on a level playing field.

In real estate, price-per-square-foot is commonly used since most homebuyers *value* square footage. A homebuyer can use it compare two homes in the same neighborhood that have different attributes.

For stocks, the price-to-earnings (P/E) ratio is a common valuation metric and is calculated by dividing the stock price with the earnings-per-share. The intuition is similar to real estate. How much someone is willing to pay to own $1 of earnings from a company is no different than what a homebuyer is willing to pay for a single square foot of a house.

It's also important to note that nearly any characteristic could be used to assess value. If a homebuyer cared more about the number of bedrooms than the total square footage, he could just as easily use price-per-bedroom.

> **"Valuation metrics cannot stand on their own."**

The same applies to stocks. Some stocks are used to generate income to pay bills, and these are often valued more on the cash flow they generate. Other companies have no earnings because they are young and still growing. These tend to be valued on a price-per-sales basis, where revenue is the most valued characteristic in the eyes of investors.

The problem with relying solely on valuation measures is that they tell investors very little. Vanguard published a report in 2012 that confirms the P/E ratio, along with other valuation metrics, have been unable to predict the future of stock prices going all the way back to 1926[1].

Therefore, any bear who claims that the stock market is going to crash solely due to a high P/E ratio should be ignored for the same reason a bull should be for recommending stocks because of a low P/E ratio. Valuation metrics cannot stand on their own.

Let's go back to the housing analogy. If a homebuyer were to determine that a house is selling for $500 per square foot, this would not be enough to tell her if she is getting a good or bad deal. Paying $500/sq ft in a rural neighborhood would be a rip-off in most instances, but that price in lower Manhattan is a bargain.

It also depends on the condition of the house relative to comps in the area. If new construction was selling for $500/sq ft, it would be unfair to compare a fixer-upper to this sample set.

Stocks work the same way. We must compare both the quality and expected growth of earnings to truly understand the intrinsic value of the stock market. The chart below begins this task by charting the P/E ratio of the S&P 500 over the past 25 years.

## S&P 500 INDEX: FORWARD P/E RATIO


*Source: Bloomberg, Thomson Reuters*

The red-dotted line denotes the 25-year average of the P/E ratio, which is just under 17 times expectations of future earnings. The green-dotted lines indicate a range where the P/E ratio has fallen two-thirds of the time since 1990. With today's P/E ratio north of 19, it's safe to say that the S&P 500 is trading at the upper-end of the range.

However, as explained above, this is not enough to determine if stocks are over, under, or fairly-valued. The next step is to assess the quality of earnings relative to the past, and I believe that the quality today is higher than anything we have seen in recent history.

Companies that survived the financial crisis have spent years improving their operations through cost controls, inventory management, and technology. These operational improvements should deliver smoother earnings relative to past economic cycles, which will then make them more attractive to long-term investors.

In regards to earnings growth, the future also looks attractive. Current economic data across the board continue to strengthen, and while there are still headwinds facing our economy, the tailwinds look stronger and are expected to last longer.

Furthermore, while the Federal Reserve Bank (Fed) slowly raises interest rates, my analysis leads me to believe that we are at least 18 months away from a recession watch. Since economic growth is the fuel that drives corporate earnings higher, the stock market appears to have a long runway left.

Add it all up and stocks today are trading at a higher P/E versus history because they should. I do not view stocks as expensive or cheap but rather fairly-valued.

## IMPLICATIONS FOR INVESTORS

Admittedly, this is just one person's opinion, and valuation analysis is often more of an art than a science. Plenty of pundits will disagree and point to a variety of negative data points, claiming that this recovery is nothing but a fake. They will continue to tell investors to get out of stocks but rarely offer an alternative because few exist.

On paper, cash is the obvious choice. Make a tactical move to cash, wait for the correction, and buy at the bottom of the drawdown. If it were only this easy.

The first issue is that any gains in a taxable account are going to get hit by Uncle Sam. Then, if by chance an investor got lucky and missed a stock market correction, they would need to have both the courage and timing to buy into the drawdown. Few people get lucky twice on the same trade let alone have the stomach for that ride.

This strategy also assumes that an investor has more than valuation to substantiate this move because we just learned that these metrics have zero predictive power. Otherwise, it is pure gambling.

If the investor does not get lucky and stocks continue to rise, he will want to kick himself. He paid taxes on gains, is now losing money safely thanks to inflation, and is forced to decide whether to buy back into stocks at a higher price or continue to watch the market go up in his face.

Another option is fixed income, but if a bear is selling stocks due to valuation concerns, the bond market should screen as a nightmare. The Fed's war on seniors and savers pushed valuations across fixed income to stratospheric heights, and now that interest rates are rising, parts of the bond market looks a lot like running in front of a steamroller to collect a dime.

The point here is if a bear truly believes that stocks are overvalued, then what other options exist that are large enough and liquid enough to replace an equity allocation? Personally, I cannot think of any.

But I could be wrong. Stocks could suddenly fall over any one of the headline risks out there like North Korea or tax reform. We could dip into a recession sooner than expected if the Fed screws up (they have a history of doing that). The bond market could continue to defy the laws of financial gravity. The list is endless.

The only way to manage all of these potential outcomes is through broad diversification to investments that do not move together during times of stress. This approach to asset allocation is focused more on managing risk rather than taking it in the form of using ineffective indicators to try to guess where markets are heading.

THE BOTTOM LINE is that although stocks appear to be fairly-valued with the potential for further upside over the long run, the best offense is a good defense. Schedule some time with your financial advisor to review your portfolio to ensure that it is properly diversified.

## THREE KEY TAKEAWAYS

1. **NO EFFICACY:** On its own, valuation metrics like the P/E ratio carry very little predictive power. Earnings quality, future growth, and other fundamental factors must also be considered to get a true picture of what an investor is getting for the price.
2. **FAIRLY-VALUED:** Although valuations are approaching historical highs in the S&P 500 index, the low risk of a recession, future earnings growth, and the quality of earnings today versus recent history suggest that stocks are fairly-valued.
3. **LACK OF OPTIONS:** For those who believe that stocks are overvalued, they would be hard-pressed to view the bond market and/or cash to be more attractive. Broad diversification is the key to managing the risks in financial markets today.

SINCERELY,

**Mike Sorrentino** | CFA
**Chief Investment Officer**
Global Financial Private Capital

Global Financial Private Capital

[1] https://personal.vanguard.com/pdf/s338.pdf

Index Definitions

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