

Quarterly Newsletter

High Valuations

Introduction

As the S&P 500 and other major market indices continue to reach new record highs, it remains paramount to keep a risk/reward perspective at the forefront of our investment philosophy. One way of evaluating equity prices is to take a look at a few key market valuation metrics and their historical values. It seems that almost every major valuation metric is telling investors that the market is well over valued, or “fully” valued at best.

There is no shortage of reasons as to why Wall Street has pushed stock markets to such lofty levels. The zero interest rate policy (ZIRP) and quantitative easing pursued by the Federal Reserve since 2008 has led investors to levels of speculation in the stock market never seen before (NYSE margin debt stood at a record \$476 billion in March). Since 2008, the largest central bank in the world has bought over \$3.5 trillion in assets in an attempt to spur economic growth. The idea that over- accommodative monetary policy can inflate asset prices became known as the “Greenspan/ Bernanke/ Yellen Put”. It is, “the widespread belief among Wall Street’s wise guys that it was okay to take an extra bit of risk because the Fed would always be there to provide a floor under the market if stock and bond prices started to fall too far too fast. (Pearlstein/ Washington Post)” ZIRP has also led to record levels of corporate debt issuance that is being used to send stock prices even higher through share repurchase programs and dividend distributions. Additionally, analysts have been perpetually overly optimistic, forecasting higher earnings growth rates to no avail.

All of these factors, in conjunction with many more, have led to one of the most expensive markets on record. The valuations discussed in this newsletter do not attempt to time a market correction. Rather, they are used to disclose the amount of risk being taken in today’s market. This is done by comparing the price of equities to measures of corporate financial health and economic activity. Returns and valuations tend to be mean reverting. Due to this, future long-term stock market returns may be extremely weak.

Link:

http://www.washingtonpost.com/business/wall-street-attempts-to-navigate-the-era-of-yellen-put/2014/10/17/3a267928-561c-11e4-892e-602188e70e9c_story.html

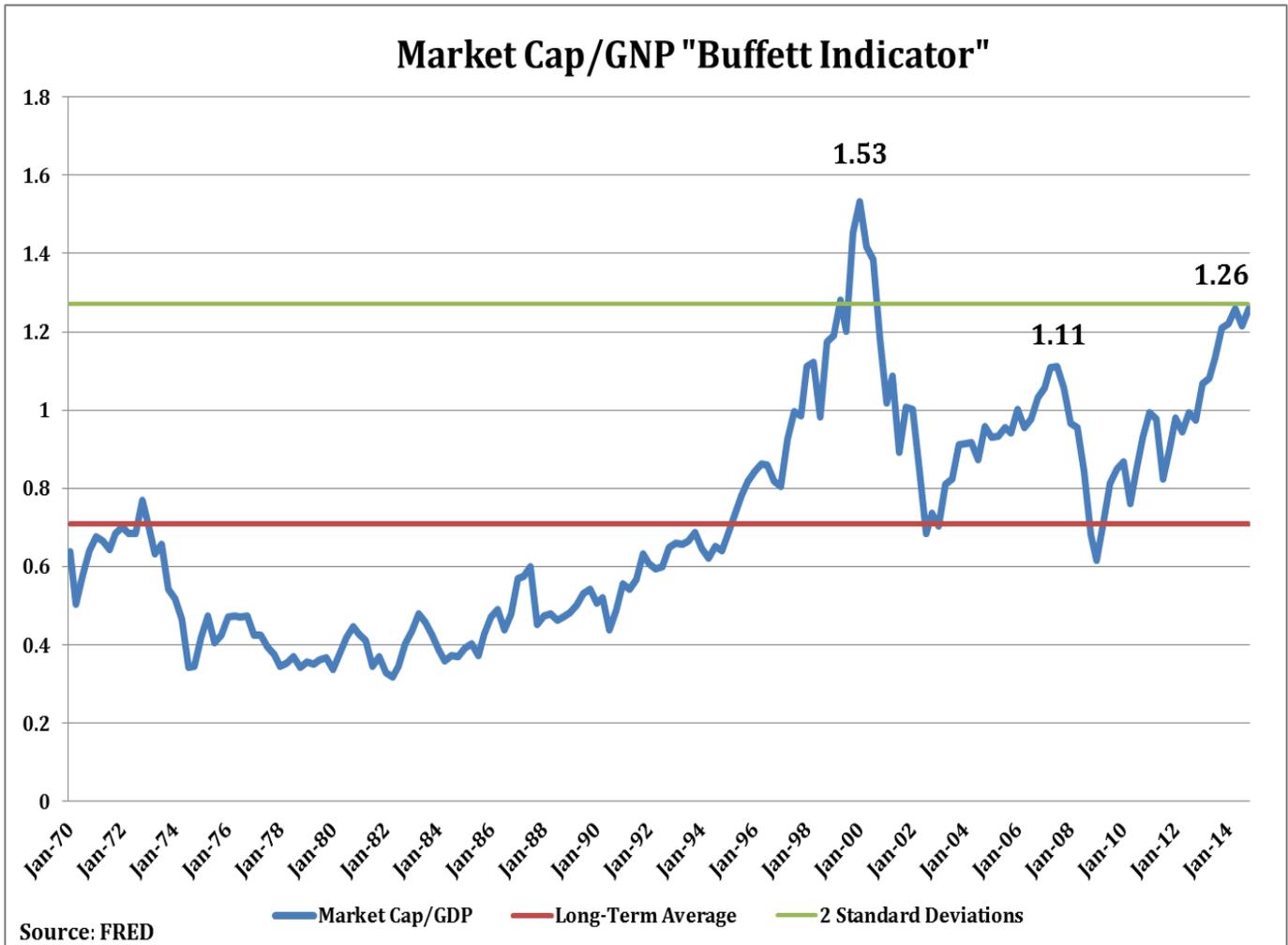
Quarterly Newsletter

Buffett Indicator

Warren Buffett considers the ratio of Total Market Cap to GNP as, “the best measure of where valuations stand at any given moment.” Market cap is the market value of a company’s outstanding shares, calculated by multiplying the stock price by the total number of shares outstanding. The market cap figure used in the Buffett Indicator is the sum of all nonfinancial corporations equities outstanding in the United States. GNP (Gross National Product) is the market value of goods and services produced by residents of a nation’s economy, even if they are living abroad.

According to Warren Buffett, the Indicator shows a fairly valued market when the value falls between .75 and .90. We can see that it is significantly over valued at 1.26 as of the Q4 2014. The increase in this ratio shows that the price of non-financial equities in the U.S. has outpaced the total value of what the economy produces. Currently it is showing the 2nd most expensive equity market since 1970. The indicator has only been higher during the tech bubble in 2000, which eventually led to a market crash. During that time, total market cap of non-financial corporations was 1.53 times the value of production. Over the long run, stock market valuations revert to their mean. Current equity prices are well above historical averages when compared to GNP, which can certainly create an environment of lower long-term returns.

Quarterly Newsletter



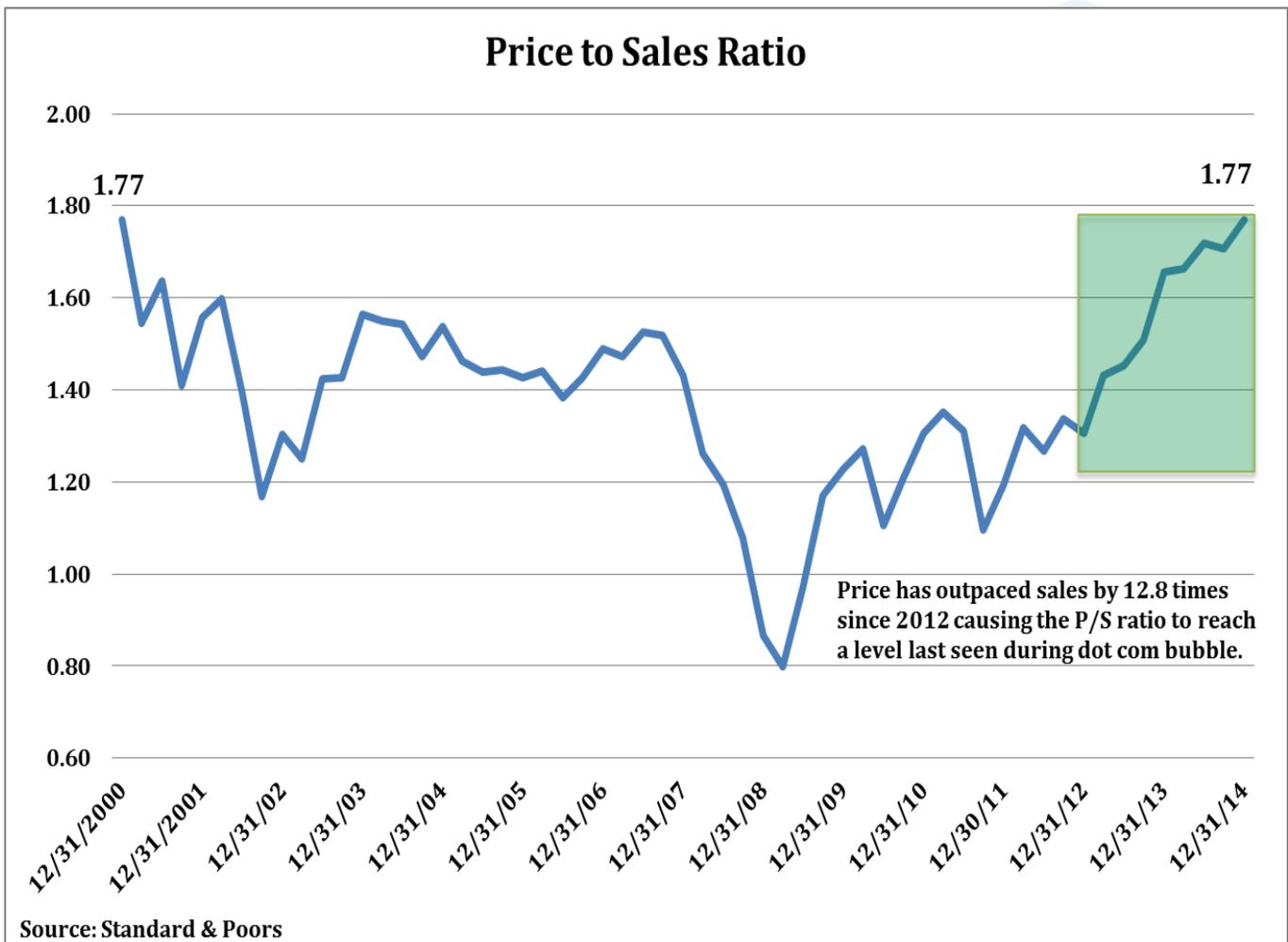
Quarterly Newsletter

Price to Sales

The price to sales ratio is a metric that measures the cost of equity in a company against every dollar of that business' sales. This ratio is known for giving a straightforward assessment of a company because sales data is typically more difficult to manipulate through accounting than a firm's net income or book value. To increase the value of a company, revenue growth is imperative because profits can only grow temporarily without sales increasing. Since the first quarter of 2009 the price of the S&P 500 has appreciated by 158% while sales have only grown by 34% (the price has outpaced sales growth by 4.5x). From the end of 2012 through the end of 2014 the price of the top 500 companies became completely detached from the important fundamental of revenue expansion. During those 24 months, sales only grew by 3.45% while the price of the S&P 500 increased an alarming 12.8 times faster, at 44.4%. As a result, the price to sales ratio increased from 1.31 in December 2012 to 1.77 at the end of 2014. The last time the ratio reached this level was at the height of the dot com bubble.

Many economists continue to believe that economic growth will accelerate, which has created more demand for owning equities. Another reason price has outpaced revenue growth so rapidly since 2012 is companies were able to increase margins leading to profits growing faster than sales. Earnings matter more than sales, but cost cutting has its limits and can't be used to increase profits indefinitely. To sustain value, companies need increasing revenues that they can use to reinvest into operations or pay to shareholders through dividends. Despite unprecedented stimulus, real retail sales throughout the entire economy have only grown by 0.6% annually during the past seven years. With price to sales at historically high levels, revenues need to start expanding at a brisk pace to justify the current price of equities in the S&P 500.

Quarterly Newsletter



Quarterly Newsletter

CAPE Shiller

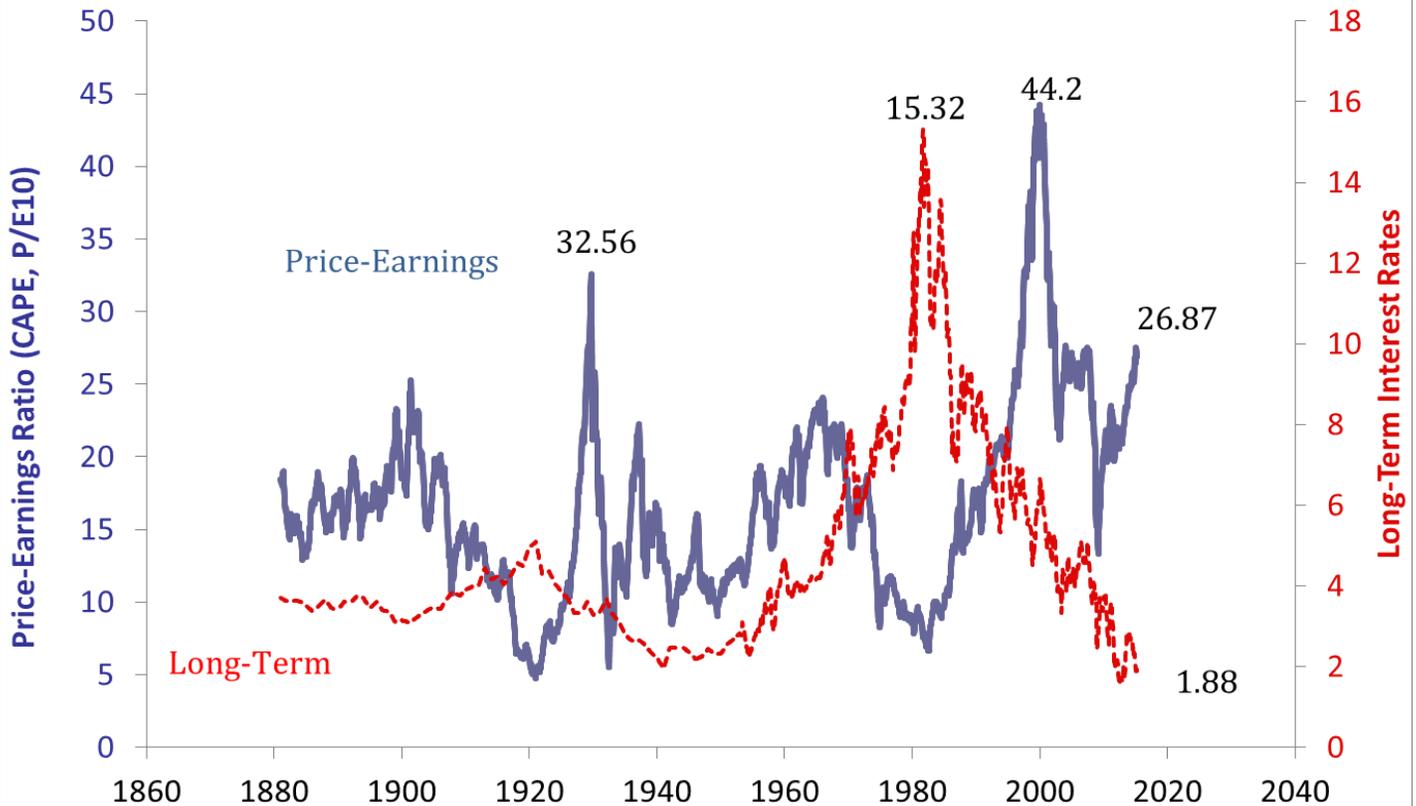
The cyclically adjusted price-to-earnings ratio (CAPE) is a valuation metric used to gauge the S&P 500. Robert Shiller, a Yale professor and Nobel Prize winner, created this measure. CAPE is calculated by taking the average of the last 10 years reported corporate earnings (reported earnings are the more realistic GAAP earnings, operating earnings is ex one-time items) adjusted for inflation and dividing that into the S&P 500 price. Using an average of 10 years earnings illustrates a more accurate picture by smoothing out swings in profit margins caused by the natural business cycle. Valuing the market on today's near peak profit margins does not reflect a company's sustainable earnings capacity.

The CAPE ratio flies in the face of most Wall Street pundits. Institutional Investors like to use a P/E ratio based upon the next 12 months projected operating earnings. There are two problems with this calculation. First, as stated above, operating earnings are not actual corporate earnings. Operating earnings can be manipulated by excluding "one-time items" such as legal expenses or merger and acquisition costs. Second, analysts are constantly overly optimistic in their earnings projections, which eventually get revised downward. Projecting earnings that are unrealistically high, results in analysts being able to justify an over-inflated S&P 500 price.

The CAPE ratio currently stands at 26.87 times. To put this into perspective, the 133-year average for the data series is 17 times and two standard deviations from the mean is 30 times. The ratio was only higher during 3 market bubbles (1929, 2000 and 2007). All three times the ratio reverted to its mean and tumbled back to the long-term average.

It is important to note that the CAPE ratio is not a market-timing tool. Valuations can stay elevated or depressed for long periods. However, this ratio does give us clues as to what returns may look like in the future. As can be seen below, when the starting value for the ratio rises, 10-year returns decline. Additionally, both the worst-case scenario and best-case scenario get much more grim. When looking at this metric and keeping risk/reward of the market in mind, it seems the future contains a great deal of risk without as much reward.

Quarterly Newsletter



Source: Yale University

Results For S&P 500 From Different Starting Shiller P/Es 1926-2012

Starting P/E		Avg. Real	Worst Real	Best Real	Standard
Low	High	10 Yr Return	10 Yr Return	10 Yr Return	Deviation
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	25.1	0.9%	-4.4%	8.3%	3.8%
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

Quarterly Newsletter

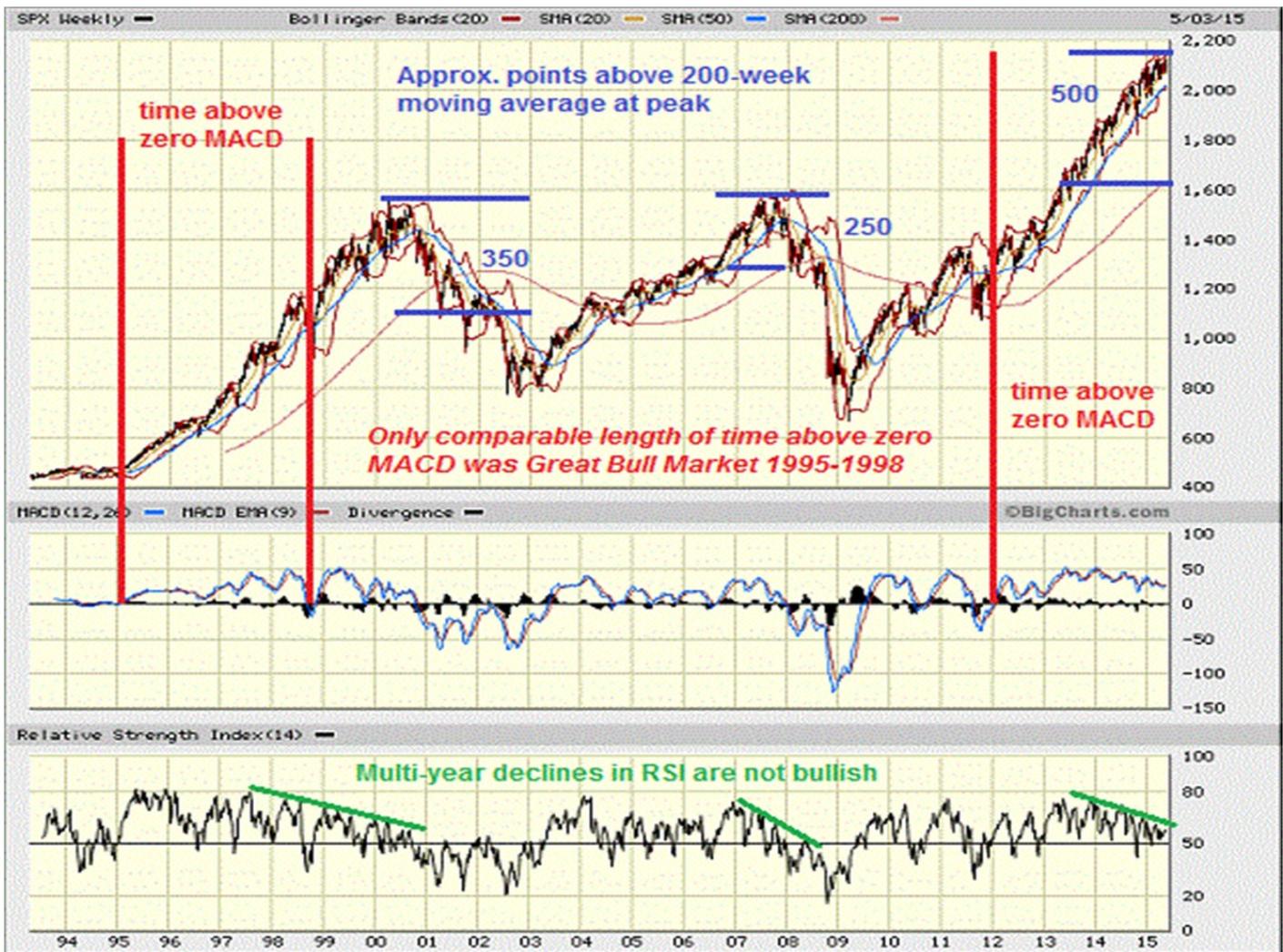
Technical Analysis

Technical analysis is used by market participants and traders to anticipate the future movement of asset prices by studying a security's past trading data. There is a belief among technical traders that prices move in trends and once a trend is established it will likely continue. Those who use technical analysis study price patterns because market participants tend to react similarly over time which leads to price movements being repeated. Moving averages are one of the tools used by technical analysts. A moving average is the mean of a certain number of data points. For example, the 200-week moving average is the last 200 weeks closing prices divided by 200. When the securities underlying price is significantly above or below its moving average it creates possible entry and exit points from a position.

Charles Hugh-Smith (<http://www.oftwominds.com/blog.html>) recently examined the current state of the 200-week moving average:

“In terms of points above the 200-week moving average at peaks, the current rally has blown past previous bullish extremes. In round numbers, the current rally is very nearly 500 points above the 200-week MA, far exceeding the point spread reached at previous tops: about 350 in 2000, and around 250 in 2007-08.”

Quarterly Newsletter



Quarterly Newsletter

Conclusion

Prices in equity markets have completely lost touch with economic and business reality. There are many potential factors that are resulting in investors justifying high valuations; belief that the economy will soon reach “escape velocity”, a search for yield in the current low interest rate environment, easy monetary policy/ “Yellen Put”, belief that over the long-run stocks prices “always” rise and firms using profits to increase share price. However, the fact remains that the price of equities is growing at a faster pace than business profits and the overall economy. As investors remain extremely bullish, continuing to push prices to new highs, fundamentals continue to lag behind. Corporations themselves don’t even share the optimism as they continue to use their cash to purchase shares and issue dividends rather than increase operations. Financial engineering may continue to result in even higher equity prices and greater levels of investor sentiment in the short-term. In the long-run, higher equity prices cannot be justified without growth in the underlying economy or expansion in business operations. If investors begin to lose faith in any of the narratives mentioned above, valuations could return to their mean quickly.

“Even Goldman has warned that this form of slow financial liquidation will not have a happy ending. As shown in one of its tables below, the S&P 500 companies have devoted \$4.2 trillion to financial engineering—M&A, stock buybacks and dividends—during the last four years (including estimates for 2015) or almost 60% of their cash dispositions during that period. That amounts to 160 percent of their gross CapEx during this four-year period and the emphasis is on “gross”. The fact is, the S&P 500 companies’ CapEx barely equals current year depreciation. So in truth, the 500 largest US based companies are spending virtually nothing on plant and equipment expansion versus more than \$4 trillion on financial engineering”

-David Stockman-

Quarterly Newsletter

Exhibit 4: We expect S&P 500 buybacks to grow by 18% in 2015
as of April 23, 2015

\$ Billions	2012	2013	2014	2015E
Capital Usage				
Capital Expenditures	\$637	\$649	\$702	\$676
Research & Development	207	228	248	245
Cash Acquisitions	228	156	185	195
Share Buybacks	396	476	514	604
Dividends	305	333	376	404
Total Capital Usage	\$1,772	\$1,843	\$2,025	\$2,124
% Year/Year Growth				
Capital Usage				
Capital Expenditures	10 %	2 %	8 %	(4)%
Research & Development	7	10	9	(1)
Cash Acquisitions	2	(31)	19	5
Share Buybacks	(2)	20	8	18
Dividends	19	9	13	7
Total Capital Usage	7 %	4 %	10 %	5 %

Source: Compustat and Goldman Sachs Global Investment Research.

Corey J. Gallahan – CFP®, MBA Canisius College

C. Clayton Sauberan – BS Economics Bentley University

Brian C. Rogers- BS Economics & Finance Bentley University