

Thought for the Week: Monday, November 8th, 2010

Are Stocks Overvalued?

As the stock market continues to rise, it's easy to start thinking it's overvalued. Human nature pushes us to consider selling stocks that have risen, and we've always been **broad proponents of taking some profit off the table**. However, this approach can lead to 'market timing', wherein you sell some or all of a position, the market appreciation continues and you are now underperforming the market.

Prices have no Memory

Most portfolio managers try to resist the temptation to sell just because the price has risen, although the temptation is still there. In the game of forecasting what a stock or index will do next; Prices have no Memory – **the next trend is not affected by previous trends**.

Yes, investors will always sell a rapidly appreciating stock to take profits and therefore move the price down for a short period. But if you believe the prevailing trend and fundamentals for that stock remain bullish, times when the market profit is an opportunity to buy cheap. Let's also apologize to technical analysts and chartists – I know it's useful to look in the rearview mirror when driving a car, but it's not going to tell you much about what's coming next!

We look for a fundamental Valuation that supports the current price together with the prospects of the valuation supporting further appreciation. We ask ourselves, "Why did that stock or index rise and are the factors that created appreciation still intact?"

When you look at the price movement of the S&P 500 since the end of August, shown in the chart below, it does look like prices are ready to drop and selling may be in order.

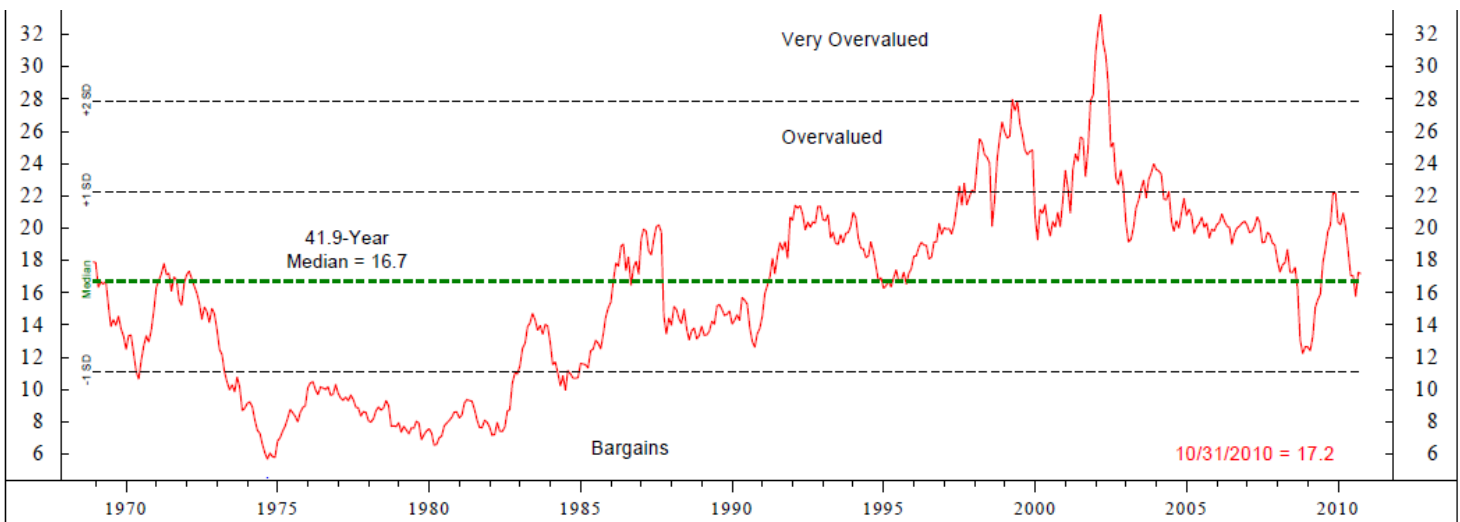


But wait a minute, instead of looking at recent price action on the S&P 500 and drawing 200-day moving averages (sorry again to technical investors); **let's look at fundamental valuations which may support this price level now and in the future**.

Price Earnings (P/E) Ratio

This is probably the most important and common valuation method for equities. **P/E is basically the current price of a stock divided by the annual earnings (profit) of the company.** It is also called the “Multiple” because it is the number of years the current earnings would pay back the purchase price.

The higher the P/E, the more expensive the stock, implying greater demand and/or superior prospects for earnings growth. P/E ratio is a simple concept, but there are many different versions of actual P/E numbers – don’t expect everyone to agree which P/E ratio is the best to use. The chart below shows the P/E calculation offered by Ned Davis Research, an excellent source of information for many investment firms.



Using P/E Ratio as a valuation, stocks look fairly valued at the moment. The chart shown above is driven by company earnings: as earnings fall, prices tend to drop. Conversely, when earnings rise, prices tend to rise.

Earnings & Earnings Growth

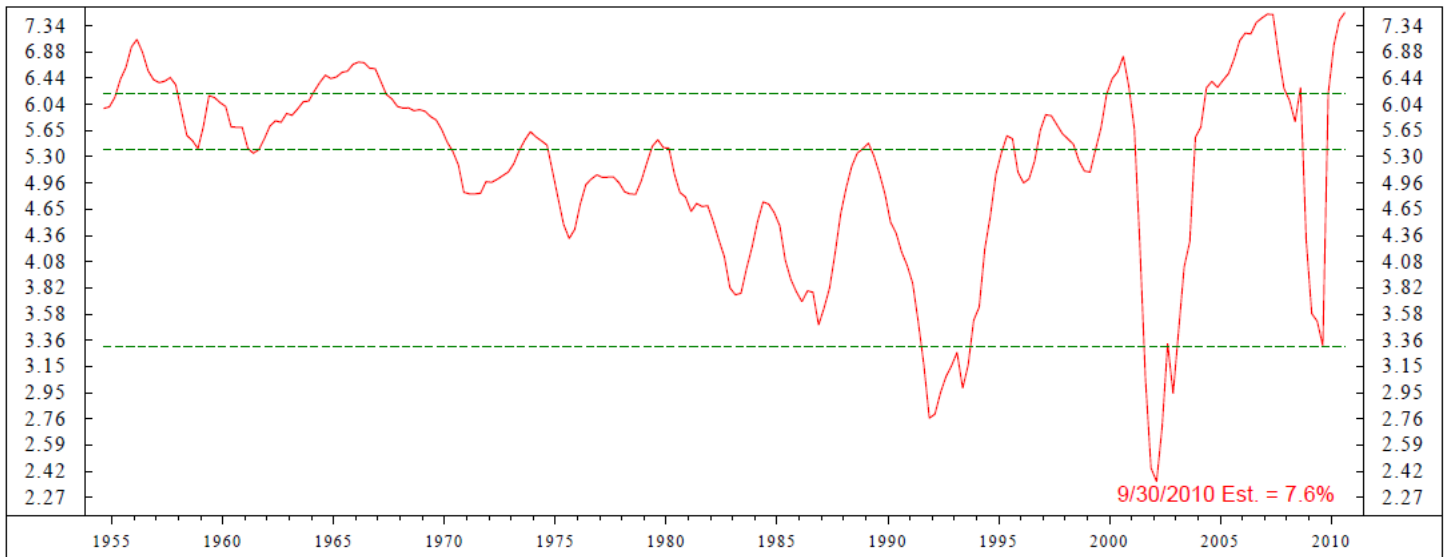
When the outlook for company earnings growth is positive, investors are willing to pay higher P/E ratios to own stocks as earnings growth in future years will bring the P/E ratio down. For example, a stock trading at a P/E of 30 (which may be high for now) which doubles its earnings will trade at a P/E of 15 (which now looks cheap). The Technology bubble of the late 1990’s was driven by investors paying very high P/E ratios for companies that they thought were set to grow exponentially.

What does the future look like for Earnings?

The recession provided many companies with the opportunity to shed expense; particularly staff costs. As revenues have gradually returned, the same companies have kept a very tight rein on spending with the result that they are **experiencing record profit margins (earnings dividend by revenue)** as shown in the chart below. The fact margins are currently at record high levels suggests it will be hard for margins to go higher. Ah, you may say, *“why are you now using historical data to tell us what may happen next when you started the Thought by telling me not to do this?”*



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Because the profit a company can generate for a given level of revenue level tends to be limited. For every business model, there are costs that can only be cut to certain levels. Even if a disruptive technology or productivity dramatically reduces costs, competitive pressures tend to limit margins.

2010 earnings are approximately \$84 per share for the S&P 500; 2011 earnings are expected to be around \$94 per share. The market is expecting earnings growth and may have this priced into current prices.

The story so far:

The S&P 500 looks to be priced at, or around, fair value on an earnings valuation basis, but profit margins look set to 'revert downwards to the mean'. Therefore, for any further significant price appreciation company revenues must improve. If they don't the market may not hit the earnings growth expected for 2011.

So where might the revenue come from??

All aboard the Fed-ship QE2...

With the U.S. Government opening the money supply throttles, revenue growth may be possible for many companies. Moreover, inflation tends to increase corporate revenues.

Although consumer and investor sentiment may cause short-term deviations in the long-term course, **the market now awaits fourth quarter earnings and revenue reports before a definitive stock market direction can be decided upon.**

We can all debate the pros and cons of Quantitative Easing, but **it's rarely a good thing to get in the path of the huge floating hulk that is the U.S. Government.**