Rochester Business Journal
RBJ
VOLUME 30, NUMBER 18 WWW.RBJDAILY.COM AUGUST 1, 2014

Don't fear end of market highs; keep long-term view

VIEWPOINT
Mark Armbruster

Is the stock market overvalued and ready to crash?

I have fielded a lot of questions lately on just that topic. Typically, investors get uneasy when the stock market declines in value. However, with visions of 2008 still in our heads, many investors are increasingly nervous as stocks continue to make new highs.

There are compelling arguments to be made that the stock market is overvalued. Robert Shiller, a finance professor at Yale University and recent Nobel Prize recipient, believes stocks are wildly overvalued. As evidence he cites the "cyclically adjusted price/earnings ratio," which he developed. This shows the value of stocks today versus their historical earnings smoothed over the last decade. This metric indicates that stocks are trading significantly higher than their average level since 1871, when Ulysses S. Grant was president. This is all the more alarming because Shiller correctly called both the Internet and housing crises.

Even scarier, a highly respected research firm recently noted that by one measure, current valuation levels are identical to those of the bull market highs of 2000 and 2007, just before things got really ugly.

In order to have a free market, both sides of a debate must be represented. If everyone thought the market was going to tank, it would already be there. There is just as much heft on the other side of the argument.

Charles Schwab strategist Liz Ann Sonders believes there is more upside for stocks, perhaps a lot more. She notes that stock prices, smoothed over 10 years, trend in one direction for many years. Given that we are only five years into the current up cycle, there could be a lot more room for stocks to run.

Jeremy Siegel, a finance professor at the University of Pennsylvania, also believes stocks have more upside. He uses valuation, as measured by the price/earnings ratio, as his justification. Siegel points out that the P/E ratio generally has been higher during periods of low interest rates, such as we have today. He notes that while the long-term average P/E ratio has been below today's level, it has been 18 to 19 times earnings during periods of low interest rates. Accordingly, he believes the market is currently 10 percent to 15 percent undervalued at today's P/E ratio of about 16.

Investment strategist James Paulsen largely agrees with Siegel, noting that the long-term P/E ratio has had a fairly low average, but since 1990 the level has risen significantly. Thus, comparisons of current valuation levels with the long-term average may lead to an overly cautious forecast. While warning that the "this time it's different" mindset can be dangerous, Paulsen also notes that we have almost 25 years of data in this new environment, on which he bases his analysis.

Clearly, there are strong views on both sides of the overvalued/undervalued stock market debate. Based on the arguments, data, the current economic environment and my own analysis, I think that while valuations are ticking up, the market is probably fairly valued or perhaps modestly overpriced.

Ultimately, I'm not sure it really matters whether the stock market is overvalued or undervalued. Back in 1996, when I was working on Wall Street, some of the veterans in our research department were nervous about lofty stock market valuations and decided to sell out. The data supported their case, and they had many years of experience during previous stock market booms and busts. For the next four years the market rose precipitously, and when the crash did eventually come, the market still never fell to the level where it had been in 1996.

Conversely, market crashes can occur from fairly benign valuation levels. So using valuation as a market timing tool has severe limitations.

Valuation can be a solid indicator of long-run future returns. Investors buying into the market at a high price/earnings ratio have historically earned relatively low investment returns over the coming decade. Investors buying into a market with low valuations have generally enjoyed returns above average. But that doesn't mean you should sit on cash, waiting for the next buying opportunity, which could take many years to arrive.

Just because stocks may generate returns in the future that are below their historical average, that doesn't mean you shouldn't buy them. After all, most of the alternatives look even worse. The 10-year Treasury bond yields a paltry 2.5 percent, and cash yields practically nothing. There are private investments that may offer compelling opportunities, including hedge funds, private equity and real estate investment trusts, but these are not practical for most investors because of their high minimums, high fees and restrictive covenants. So stocks still seem like a relatively solid bet to me.

Besides, there are still some pockets of low valuation to be found in the global stock market. International stocks, for example, look very inexpensive currently. Stocks in most of Europe, Asia and particularly the emerging markets are trading at significant discounts to stocks in the U.S. There are certainly economic risks to investing overseas, but there could also be an opportunity for significant growth. Closer to home, value stocks, as their name implies, trade at much more reasonable levels than their growth stock brethren. They also tend to provide stronger returns over time.

So while investing in the stock market today is not without its risks, it is not a foregone conclusion that the end is nigh. Generally, the best course of action is to build a diversified portfolio that includes stocks and remain invested for the long run, regardless of valuation levels.

Mark Armbruster is president of Armbruster Capital Management Inc.

Reprinted with permission of the Rochester Business Journal.