Investment Update

BNY MELLON
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Another Record High—Time to Sell?

It is hard to turn on the TV, read a business journal or follow Twitter without someone proclaiming that equity markets are grossly overvalued. Rather than being a source for celebration, these new highs have instilled fear of a possible market correction. While good for ratings, selling newspapers or gaining followers, industry experts and spokespeople have been warning us about these elevated valuations for years—all the while watching equity markets rally to all-time highs.

This pushback is not new, however. As I approach my third anniversary at BNY Mellon, the persistent objection has been that markets are overvalued and long overdue for a correction. To offer some perspective, when I joined the firm, the Dow Jones Industrial Average had roughly doubled from its bear market trough of 2009, so the arguments for a substantial pullback seemed justified—even if they turned out to be incorrect. Since then, the Dow has moved from 12,500 to 18,000, up nearly 50%.

Perhaps this bull market is not your father's, or even your grandfather's, bull market. By that, I mean just comparing current levels to the past, whether the Dow, the S&P 500, or the NASDAQ, does not present a complete picture of the risks and rewards or potential return that exist. Looking beyond all-time highs, it is imperative to gain a deeper perspective of valuation in order to determine whether a market is under- or overvalued. While valuation is but one factor to consider in total portfolio construction, it is also important to know when to emphasize certain factors over others. Valuation is the appropriate factor in times like these.

The fact that we are at all-time highs should be nearly irrelevant. Consider the NASDAQ, which is near the 5,000 level reached during the late 1990s/early 2000s. At that time, many technology stocks, included Cisco, were selling at multiples of over 100x earnings (Figure 1a). Today, that is not the case, with large capitalization stocks selling at very modest valuation levels, primarily in the mid-teens. (Figure 1b).

Valuations of Five Largest Stocks

Figure 1a

5 Large S&P 500 Companies (March 2000)			
	Company	Market Cap ($BN)	NTM P/E
MSFT	Microsoft	$553	59.7
CSCO	Cisco	$538	132.9
GE	General Electric	$513	41.7
INTC	Intel	$441	44.8
XOM	Exxon Mobil	$271	22.0

Figure 1b

5 Large S&P 500 Companies (March 2015)			
	Company	Market Cap ($BN)	NTM P/E
AAPL	Apple	$724	13.9
XOM	Exxon Mobil	$356	20.4
MSFT	Microsoft	$333	14.5
WFC	Wells Fargo	$279	12.8
JNJ	Johnson & Johnson	$279	16.0

Source: StrategasRP

A Baker's Dozen

Our friends at Strategas have identified 13 different ways to look at valuation (Figure 2 on next page). Using these valuation ratios, current data are compared to long-term averages to produce a "current relative average" measure. Eight of the 13 measures show the market to be fairly valued, while two show the market to be undervalued, namely Price-to-Free Cash Flow (P/FCF) and the S&P 500 priced in terms of gold. Only three measures show the market to be overvalued, namely the trailing P/E to Growth ratio (PEG), Forward P/E to Growth ratio, and the S&P 500 when priced in terms of oil.

Let's analyze each of the variables that indicates the market is overvalued. Whenever a company's price/earnings multiple is divided by its earnings growth rate, we must compare the current rate of growth to its historic average. Since we have had slow growth over the past few years relative to the average growth rates of the past 10 years, this computation would show the market to be overvalued, which it does. The same is true when you look at the Forward P/E to Growth ratio. If growth is to pick up in the near future, as we expect, this technique would cause the valuation to near its historical norm. The market also looks expensive when priced in oil, which seems natural given that the price of oil has been cut in half recently. If the price of oil were to recover, even modestly, as we believe it will over time, this valuation methodology would also yield a value which is more aligned with historical valuations.

Figure 2—S&P 500 Historical and Current Valuation

	March 2000	March 2009	Current	20-Yr Avg	Current Rel Avg
Trailing P / E	29.6	13.7	18.7	19.2	0.98
Forward Consensus P / E	26.9	10.3	17.2	16.2	1.06
Trailing Normalized P / E	46.5	11.0	25.1	26.1	0.96
Shiller P / E	43.2	13.3	26.9	26.9	1.00
Price / Book Value	5.1	2.0	2.8	3.0	0.96
EV / EBITDA	15.7	10.1	11.9	12.1	0.98
Trailing PEG	NA	1.0	1.7	1.4	1.23
Forward PEG	NA	1.0	1.6	1.3	1.30
P / OCF	20.4	6.6	12.8	13.3	0.96
P / FCF	73.0	11.9	23.0	36.9	0.63
EV / Sales	2.9	1.4	2.1	2.0	1.03
S&P 500 in WTI Terms	54.5	14.4	36.3	31.1	1.17
S&P 500 in Gold Terms	5.4	0.7	1.8	2.4	0.74

Source: StrategasRP

Thus, a small pickup in economic growth and a slight recovery in the price of oil would make these "overpriced" variables look quite different.

Summarizing the data in the figure above also illustrates that "fair" value is very dependent upon the variables used to determine fairness. It is also very interesting that averaging the 13 variables yields a relative number of 1.0015—another indicator that the market is fairly valued. Quite amazing, actually.

Putting It All Together

While the work of Strategas provides a wonderful historical perspective, I've always believed that in order to fully understand markets and historical valuation, it is necessary to do one's own work. For the last two decades, I've utilized multiple regression analysis to determine a valuation technique that has been shown to value markets appropriately in real time. As markets moved from significantly undervalued in early 2009 to undervalued in 2011 and to fairly valued today, this valuation methodology allowed me to actively reap the benefits from these market shifts. By applying this objective historical perspective, removed from emotion, we have maintained an overweight equity exposure in client portfolios when other industry strategists were proclaiming the market to be too expensive.

I learned long ago that valuation is usually not a very good timing tool, as markets have a long history of staying over- or undervalued for extended periods of time. Furthermore, only when valuation reaches extreme levels, either over- or undervaluation, should it be used as an indicator to adjust asset allocation. Since we are not at extreme levels, our Investment Strategy Committee looks at many variables in addition to valuation, such as inflation, interest rates and earnings to determine how we should position client portfolios.

Positioning Portfolios in a Fairly Valued Market

Although indexes are at record highs, valuations are not. And that, as they say in any market, makes all the difference. Rather than sell out of equities, we instead continue to favor stocks over bonds, while recognizing that the market tide will not lift all boats, as it did in the earlier stages of the bull market.

Fairly valued markets favor managers with a prowess for stock picking, as stock performance diverges due to individual company characteristics. So far, after a difficult 2014, 2015 has been more true to form, with many active managers beating their benchmarks by wide margins as a result of strong security selection.

Unlike your father or grandfather's bull market, we believe this one still has some room to run, but investors should anticipate more moderate returns, as well as some increased volatility, as equities ultimately push higher.

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