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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

It is often said that value is in the eye of the beholder. What makes our economy work is that value means different things to each of us. If you think about it, the more diverse the definition of value becomes, the more buyers and sellers we have, and thus the marketplace becomes more efficient. What really makes the definition of value more challenging, is that your own definition of value changes with the ebb and flow of your emotions. One of the key traits that seems to separate bad investors from good investors, and finally great investors, is their ability to stick consistently to their definition of value. Here are few thoughts to consider regarding value.

There is relative value, which has been a major driver of the market in the last few years. A simple illustration would be to compare the yield of a Treasury bond (or CD) to the dividend yield of stocks. When the 10-year Treasury was below 2% and CD's are paying 1%, a dividend yield of 2% on stocks looks attractive, particularly when you consider that the dividend grows over time. Eventually, the value of the stock should also go up. The challenge to this valuation is that the comparison of the 10-year Treasury is a moving target. What happens if the yield climbs closer to 5%, which is its long-term average yield. Then the relative valuation no longer compares favorably.

When the stock market is advancing, many investors see the 'value' in owning stocks simply because prices are rising. This really becomes evident when you consider the flows of money going into stock mutual funds and ETF's. It has been eight years since the market low of the 2009 recession, however, net additions to stock funds have only turned positive in the last few years. If you want the comfort of buying when everything looks great, you always pay more. It may appear tempting to invest when the value of your account will most likely be higher tomorrow, but some refer to this strategy as speculation, not investing.

Another definition of value is earning an attractive annual return on your investment. An extreme example of this is Berkshire Hathaway. Warren Buffett has been successful because he has been able to grow book value by more than 10% for over 30 years. Let's assume that in 1980 you were smart enough to invest $100,000 in Berkshire Hathaway at $275 per share. You would have acquired 363 shares. If you had waited a year, BRKA was now up to $500 per share so you could only afford 200 shares. For those of you who don't remember, the previous decade was a difficult time to be an investor in the stock market. The 1980's bull market started in 1980. Waiting one year was costly. If you were lucky enough to hold your BRKA investment and not do anything for the next 37 years, your 1980 investment of $100,000 is now worth $92,000,000. Waiting one year cost you $41,000,000. The 1981 investment is 'only' worth $51,000,000. This is obviously an extreme example, but it illustrates the benefit of investing at attractive prices verses investing after the market is well into an advance.

That brings us to our present environment. The chart below shows that valuations are near the historic highs. Investors are paying more for a dollar of earnings. One point to always remember is that charts showing excessive valuations are not effective as timing tools, but they are predictors of multi-year future returns. Markets have been driven recently more by relative valuations, as opposed to economic valuations. A higher earnings yield means that you are paying less for the same dollar of profits. It is hard to be patient when it appears that the next day will be rewarding. However, as you can see, the earnings yield for the market in 1981 was 11%, it is presently at 4%, which has not been an attractive starting point in the past.