SUNDAY, FEBRUARY 10, 2019

Volatility Will Continue, But Stocks Are Going Higher

After an historic January run, the S&P finished the first full week of February in what looks to be a consolidation phase. As we thought might be the case, the S&P 500's 200-day moving average has proven to be a level of resistance for the market with a sharp pullback off the moving average in the middle of the week. Still, an impressive intraday rally took hold on Friday to see the market close well off its morning lows. Late Friday rallies have been a good sign during the last couple of years and continue to suggest that buyers abound at these levels. So while stocks may face a battle as they try to work through the 200-day moving average, the outlook is constructive for the longer-term and there are decent levels of technical support close by. This is born out by the surge in the percentage of stocks above their 50-day moving averages, which typically results in strong returns over the next 6 to 12 month time frame. Importantly, strong stock gains in January's tend to beget strong full-year performance.

Economy and Bonds

From a macro standpoint, the economic data continue to be more mixed, but that is probably the best case scenario for stocks grinding higher. US economic data softened significantly at the tail end of 2018, but a small rebound in the Mfg. PMI and last week's stellar jobs report have tempered the recession talk. Still, consumer confidence has taken a hit, and business investment is rolling over a bit. With the recent mix of data and little inflation in sight, the Fed is probably on hold, and the cacophony of economic naysayers has been quieted. On that note, credit spreads have stabilized and more of a risk-on attitude has been evident. What is perhaps most striking in the recent upleg in stocks has been the behavior of US 10-year bond yields. One might think that a more lax Fed would allow inflation and growth expectations to creep higher, taking interest rates with them; but global economic woes are keeping inflation expectations and bond yields in the US well anchored. The US's expected GDP growth in the 2%-3% range for the year ahead looks downright rosy compared to much of the rest of the developed world. We believe this realization has not been lost on foreign investors.

Trade

Trade remains an issue as gamesmanship has once again emerged between the US and China as tariff deadlines draw near. Of great concern is the February 17th deadline with the Eurozone that could lead to the imposition of tariffs on European autos. These tariffs have the potential to wipe out a good deal of the incremental tax cuts in 2019. This is an area to watch as well.

Earnings

Here's a quick update on fourth quarter earnings: With 66% of companies reporting, earnings have surprised by an average of around 3%. Revenue growth of 6.5% has contributed to earnings growth of 14% year over year. Fourth quarter earnings continues to look better than expected; however, expectations for Q1 earnings growth have softened. This is likely a symptom of the slower global growth. Still, there are pockets of strength that are relatively immune to the global slowdown. In our next blog we will discuss a few of the superior operators.

Finally, our overall valuation model says stocks are still in a sweet spot and should end the year higher than they closed on Friday.

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Labels: bonds, earnings, Economy, Market Comments, The Fed, valuation

FRIDAY, MAY 11, 2018

The Great P/E Debate: A Stopped Clock and Other Wild Eyed Guesses

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BLOG ARCHIVE

▼ 2019 (1)
▼ February (1)
Volatility Will Continue, But Stocks Are Going Hig...

We have shown in previous blogs that much of what academia and Wall Street tell us about how to calculate the most foolproof price-to-earnings ratio for the S&P 500 at any point in time is . . .well, foolish.

1. Professor Robert Shiller, the creator of the CAPE method of valuing stocks, which has many academic adherents, says that stocks are wildly overvalued. The only problem is he has been saying that for nearly six years, and in interviews, he cautions that CAPE is not a good metric for timing. But, professor, what good is a valuation metric if it is correct only once every decade, or so? That sounds a bit like the accuracy of a dead clock: it's correct twice a day but fails at telling time during the other 23 hours 59 minutes and 58 seconds of the day. CAPE currently suggests that the S&P 500 P/E is approximately 80% above it fair value.

2. There is another crowd of soothsayers who hold to the idea that the long-term average P/E of the S&P 500 is the correct metric to determine its fair value. These folks argue that a P/E of 16x is the right multiplier, and, that being the case, at 21.3x, stocks are currently about 33% overvalued. History shows us that if you would have bought every year when the S&P 500 was below a 16x P/E and sold or shorted every year above that level you would have crashed and burned a long time ago.

3. Many on Wall Street believe that the best way to calculate the normal P/E for the S&P 500 is to subtract the rate of inflation from 20. In our judgement, this crowd has had a better track record over the last 50 years than Dr. Shiller or the 16x crowd, but we have previously shown, there is a more statistically significant way to determine the *right* P/E at any point in time. That methodology is what we call the *earnings yield to inflation' ratio.*

Our work shows that since the 1960s, earnings yield (the inverse of P/E) minus core inflation has averaged 3.35% with a correlation coefficient of .70. For our calculations, we use earnings before extraordinary additions or subtractions and the core personal consumption deflator inflation (PCD, the data most favored by the Fed.) The current reading for these two data points are as follows. PCD is 1.6% and the trailing 12 month earnings yield is 4.70%, or a P/E of 21.3.

To determine where the model says the current earnings yield, (P/E) ought to be, we add the current PCD rate of 1.6% to the long-term constant of 3.35%, or 4.95%. Converting this back to P/E, we find the model predicts the correct P/E is now 20.2x. With the S&P 500 now trading at 21.3 times earnings, that would suggest that stocks might be about five percent overvalued. But there's more. The stock market is a discounting mechanism. That is, it is always looking ahead and pricing in where it believes current financial and economic data will be in the future. Currently the consensus view of analysts and economists is that the PCD inflation rate will climb to 2% by year end and S&P 500 earnings will grow to approximately 160. If these estimates come to pass, that would put the fair value of the S&P 500 at about 3200 by year end.

With the S&P 500 currently sitting at 2727, that would mean it is about 17% undervalued. That's my best guess and I'm sticking with it no matter how much volatility we see over the next few months. I'll update the model in the coming months.

Earlier, I said the correlation coefficient on our P/E model is approximately .70. Being less than 1.00 means that it has not perfectly predicted annual stock market moves (surprise, surprise). I offer it here because the model is simple and has done a reasonably good job of predicting stock market action over the last few years. We have another model that has more complexity and with an even higher correlation coefficient that also predicts stocks are undervalued by double digits. I'll show it in a future blog.

Labels: Dividend Growth Tracker, earnings, Economy, Market Comments, P/E ratio, The Great P/E Debate

MONDAY, OCTOBER 30, 2017

The Great P/E Debate: The End Is Not Near, Stocks Are Going Higher

The cacophony of “the end is near” cries from the doom and gloomers is much with us as stocks have marched unrelentingly higher over the last few years. The doom and gloomers do a lot of talking and shouting, but they don’t seem to do much actual research. For if they did, they would have discovered a relationship between earnings yields (the inverse of P/E) and inflation that suggests that at a P/E of 21.7x stocks are selling just about where they should be.

The picture below is a screenshot from my Bloomberg terminal showing the historical spreads of the S&P 500’s earnings yield and the personal consumption deflator, the measure of inflation that the Federal Reserve says is most accurate. Earnings yield, which I define as S&P 500 operating earnings divided by price, or the inverse of P/E, is quoted as a percentage, as is inflation. This produces a visual representation between the two data series that is easy to analyze.

I have written about this relationship as the most important driver of the S&P 500 and Dow Jones 30 price-to-earnings ratios for many years. I first discovered the relationship between earnings yield and inflation in the 1990s via some data that Value-Line provided their subscribers. I was surprised that of all the data that I studied, inflation was the most highly

► 2018 (1)
► 2017 (2)
► 2016 (2)
► 2015 (8)
► 2014 (20)
► 2013 (27)
► 2012 (15)
► 2011 (26)
► 2010 (49)
► 2009 (44)
► 2008 (67)
► 2007 (81)
► 2006 (61)
► 2005 (54)
► 2004 (4)

LABELS

- Bond-Like Stocks (7)
- bonds (11)
- Company Comments (36)
- Credit Crisis (6)
- Dividends (57)
- earnings (9)
- Economy (34)
- Fed (4)
- hidden value of rising dividend stocks (4)
- Interest Rates (37)
- John Burr Williams (7)
- Market Comments (40)
- Market Corrections (24)
- Market Forecast (23)
- municipal bonds (1)
- Philosophy of Investing (13)
- rising dividend investing (7)
- secret of dividend investing (3)
- Stocks (58)
- Take Aways (1)
- The Fed (29)
- The Rising Dividend Story (17)
- Webcasts (2)
- World Markets (16)

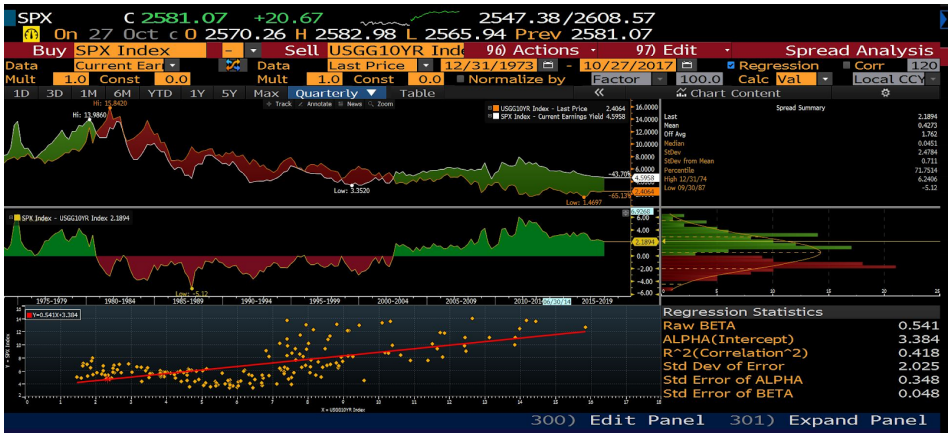
correlated with earnings yield. I would have bet almost anything that interest rates would have proven to have had the best correlation. (I will show the current picture of earnings yield and interest rates later.).

In the upper left-hand side of the picture, you can see the movements of inflation versus earnings yield charted on a quarterly basis going back to 1973. The difference between the two data series is shown in green. During this time, you will note that the two lines have moved almost on a tit for tat basis and now stand at about 4.6% for earnings yield and 1.4% for inflation. The data box at the top right of the picture shows that the average difference between earnings yield and inflation during this 43- year period has been about 3.4%. Right above that data-point is the current difference of about 3.3%. There is a lot of other data on this picture, but let me direct your attention to two other important indicators. I have drawn a red arrow (lower right) pointing at R^2 (Correlation). You can see that the R^2 between the two data series is very high at .705. R^2 is a statistical measure of fit between two or more data series and calculates that quarterly movements in inflation have been able to predict just over 70% of the movements of earnings yield and thus P/E. At our firm, we have more complex models using a wide range of other data series that can raise the R^2 up as high as 95%.

The second important indicator to consider is contained in the red circle I have drawn around a faint red asterisk on the lower left-hand side of the picture. The red asterisk shows the current differential between earnings yield and inflation, and it is sitting just about where we would hope it would be -- on the fair value line.

In summary, trading at 21.7 times operating earnings, stocks are not wildly overvalued, using inflation as the measure of value, and there is no other single data series that I know of that is able to pinpoint P/E with such statistical accuracy. I think the doom and gloomers are howling in the wind and their doom and gloom will continue to build as stocks go higher. *In my judgement, if the current earnings growth continues, inflation would have to rise nearly one percent to roughly 2.5% before stocks would begin to feel headwinds.*

Below I have copied a picture of the relationship between earnings yield and interest rates. You will note the fit between the two data series is much less convincing than that of earnings yield and inflation. Indeed, the two data series flip flopped positions in the late 1970s and thus have an R^2 of only about .42.



Labels: Bear Market, Bull market, P/E ratio, Stocks too high, The Great P/E Debate, valuation

FRIDAY, OCTOBER 20, 2017

Black Monday: The Worst Day of My Professional Life, The Best Thing That Ever Happened To Me

I have not written a blog in awhile. I have been working on a book about the history of my firm's Rising Dividend Strategy. As I was doing a final front-to-back proof this morning, I realized that the Rising Dividend Story had it's beginning on Black Monday. Here is a sneak preview of the first four chapters of the book, which should be out in 2018.

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Chapter 1

Black Monday

The stock market crash of 1987, or "Black Monday," was both the worst day of my professional life and the best thing that ever happened to me. The largest one-day market crash in history happened on October 19 when the Dow Jones Industrial Average lost nearly 23 percent of its value, or over $500 billion in the United States alone. In the midst of the devastation, most of my illusions about investing were destroyed, sending me on a quest to find what ultimately became a life-changing investment strategy.

Before Black Monday, if you asked me what stocks to buy, my answer would have been quick and confident and best summed up as B.I.G. Trend investing -- *Big* companies that were *Industry* leaders and *Growing*. Trend meant I invested only in B.I.G. stocks whose prices were trending higher. By sticking with big companies that were widely covered in the media, I believed I could know as much about them as the Wall Street analysts. Industry-leading companies were typically very large and often had the highest profit margins. Yet surprisingly few of them had faster sales and earnings growth than the average company. Thus, the basis of my investment strategy was that earnings growth was the dynamo that propelled price growth. In addition, since the markets were driven by very bright people with lots of tools for uncovering successful investments, the final component of my strategy was to wait until those investors started buying and pushing stock prices higher, confirming that they believed the earnings growth was sustainable. Once this convergence of the trend of earnings growth was confirmed by the trend of price growth, I bought the stock and owned it until its price and earnings growth trends diverged.

A key to my strategy was *Trend* investing. My theory was that the millions of investors making buy and sell decisions would create a so-called "mind-of-the-market" where everyone was looking at the same price and earnings trends. This would pull more investors into the zone and push particular stocks and industries higher. My approach had been successful for many years. I was confident that if I watched the markets closely enough, I could see which trends held the most promise. I believed that my best chance of success depended on watching which way the trends were flowing, so I paid little attention to company fundamentals, such as price-to-earnings (P/E) ratios or growth in sales and dividends.

On Black Monday, the price of every stock suddenly collapsed. It was especially confusing because there was little negative economic or political news during the day to fuel the crash. The companies my clients owned were still big, industry leaders and growing, but all were headed straight down along with all the other stocks. The Trend investing strategy I had used for years was screaming to sell everything, but I found myself recoiling from that idea. It made absolutely no sense to throw good stocks at collapsing prices. Something seemed very wrong with the markets, not the companies. Yet, at the moment I decided not to sell everything, I cut myself adrift from any experiential confidence I possessed. If I ignored today's sell signals, then *when* would I sell? And if I was not willing to sell, should I be taking advantage of the collapse and start buying? A strange sense of unknowing swept over me. The crash had revealed that my B.I.G. Trend strategy was really a fair weather investment tool, and now the weather was anything but fair. With the help of other portfolio managers at our firm, I decided I would hold all the remaining stocks that were in my clients' portfolios.

Although there was no way to escape the crash, I knew I needed to minimize my emotional responses to the carnage as best as I could. Short of another Great Depression, the companies we owned would make it through these times, and when things calmed down, they would be the first to rebound.

Black Monday wore on and the telephone calls from frightened clients kept coming. I had few answers for them. Even if they insisted on selling, I had no idea where most stocks were trading. The electronic market on my quotation terminal was running as much as an hour behind the actual trading. It was anybody's guess what clients would receive for the sale of a stock.

At that time, a big day for the Dow Jones Industrial Average was a positive or negative change of 20 points. The market opened on Black Monday down 200 points before rallying back to 80 points down by mid-morning. When it again fell by over 200 points a few hours later, I knew the market was going a lot lower before the day ended.

As stocks continued to fall, it became clear that the crash would do as much psychological harm as financial. It also posed a serious threat to the existence of the small investment firm I had helped start the previous year. This would be a battle not only to protect my investors' assets but also to save my company.

The crushing of my B.I.G. Trend strategy threw me into slow motion. I was anxious and worried, but since I had decided not to sell, I wasn't chasing around trying to decide what to do next. If any companies were going to weather Black Monday, the companies we owned would do so, although by the end of the day most of them would be nearly 25% percent cheaper. Their rising price trends were gone, but they were not going to just dry up and blow away.

The phone calls poured in the entire day. I spoke with nearly every client I served, one after another. Sometimes, up to four calls awaited my attention. I ended my last call of the day

around midnight. Considering the circumstances, people remained relatively calm, and they agreed with my decision not to sell into the crash.

As I spoke with each person, “Black Monday Talking Points” began to take shape. I was convinced from watching the action of the market that the collapse was, at least in some way, a structural problem. The normal interaction between buyers and sellers was corrupted because of the wild swings in stock prices. As an example, General Electric opened 15 percent lower than its previous close. It then retraced the entire loss before falling again by 25 percent, a swing of over 50 percent for the day. GE was a 100-year-old company that manufactured a wide range of products used all over the world. There was no way the fortunes of this company could change that much in a day even though GE’s price swings for the day were wider than would normally happen in an entire year.

My talking points about not joining the selling frenzy were that most of our portfolios were full of “essential services” companies in industries such as banks, food and beverage, health-care, energy, transportation, and utilities. No one knew what these companies would sell for in the coming days and months, but their existence was not in danger. Since they had strong balance sheets and were already the leaders in their industries, there was good reason to believe their businesses would improve at the expense of weaker competition. At a time like this, it was important to remember that we owned companies and not stocks. The U.S. economy had been strong going into Black Monday, and it was inconceivable that it could fall apart in such a short time. It was becoming clear that the violent action of the market was only marginally connected to the underlying values of most companies.

I realized that while the “*Trend*” part of B.I.G. Trend investing was dead, the B.I.G. part was going to save the day because big companies that were industry leaders and growing were holding up much better than small and highly leveraged companies. While this was good news, I was careful not to offer false hope to my clients, choosing to say that the crash was going to take a long time to fix.

As Black Monday wore on, I began to formulate a new investment strategy, the name and concept of which I would have scoffed at just hours earlier. On that day, The Rising Dividend strategy, as it would later be called, was set in motion by three phone calls I received. Each one was surprising and went against the grain of the day’s events. In the end, each one helped me see a way out of the wreckage of that bleak day by presenting an opportunity and asking me to consider it from a new perspective.

Chapter 2

The Three Calls

"When you pass through the waters, I will be with you; when you pass through the rivers, they will not sweep over you. When you walk through the fire, you will not be burned; the flames will not set you ablaze." Isaiah 43:2

A friend of mine gave me a daily prayer journal just days before Black Monday. On that morning, I opened it to October 19. The above verse from Isaiah was written across the top of the page. I realized how much I needed to hear that passage. Before trading opened in the U.S. on that date, the financial storm had demolished the Japanese and European stock markets and would soon slam ashore in the U.S. I tried to pause and meditate on the scripture, but phones began to ring. So I just bowed my head and uttered, "Lord, give me your strength and your wisdom this day."

Among the scores of calls I received that day, three in particular changed my perspective of investing forever and set me on a quest that I still follow to this day.

The First Call - A Self-Made Woman

Mildred Hagedorn was a remarkable woman, aside from giving birth to 12 children, she and her husband built a very large farming operation in southern Indiana and western Kentucky. After her husband died, she added coal and oil to her business interests. I had the privilege of working with her for many years, primarily on her municipal bond portfolio.

Because she owned few stocks, I was surprised when I recognized her voice around mid-morning. Her bond holdings were relatively unaffected by the carnage in the stock market. But I was surprised even more by what she wanted to discuss. Fully aware of what was happening in the stock market she came right to the point and asked me how much money she could borrow from her bond account to buy stocks. I tried to dissuade her by saying that buying into the crash was not a good idea and that it might take weeks, even months, before the market could put in a solid bottom. She then explained that she and her husband, Erwin, had accumulated thousands of acres of prime farm ground by buying when everyone else was selling. She had continued that strategy after he died, and it had always eventually resulted in large gains. Her tone with me was direct and confident. "Greg, I know what I am doing, and I am a big girl. If I am wrong and it doesn't work out, I won't blame you. And while I have no intentions of losing this money, if I do, my life will not change."

I was awed by this self-made woman's strength and resolve at a time when uncertainty prevailed. When I asked her what she wanted me to do, she requested that I compile a list of what I considered to be the best companies -- companies that would come out of this bad market perhaps stronger than they went in. I asked her whether she was thinking of buying these stocks to take a short-term profit if the market bounced back or to hold them for a while. "I want to buy

companies that I can own for the rest of my life," she said unequivocally. "That's the way I buy farm ground; that's the way I buy bonds; and that's the way I'm thinking about these companies."

In between calls that day, I thought about what it meant to own the best stocks. Before the crash my definition of the best stock was one that made the most money in the shortest time. But I quickly realized that this way of thinking about "best" was only possible by looking back. In this case, Mrs. Hagedorn wanted to know the best companies on a present and forward-looking basis. She was not asking me to pick companies with the best value or those defined as winners. Rather, she wanted me to pick a small group of the *best* companies.

There was no clear answer to her request. There were companies that were great values and those with the best risk/reward ratios, but "best" was just too relative a term to apply to companies. For awhile I was confused about what kinds of companies to recommend to her. Then I thought about what she was asking me to do according to her perspective in the world of farming. I grew up in a farming town. I had friends and relatives who were farmers. If I were to ask them what the best farm ground in their county was, they would use terms like lay of the land, richness of the soil, length of the rows, and yield per acre. They would take into consideration location, access points, creeks, drainage, and out buildings. But this line of thinking was not completely helpful either because farm ground is tangible and stocks are not.

Is anything tangible about a company? Stocks possess a book value, but that is not what truly gives most companies their value. Book value is just an accounting term -- a measurement of the depreciated value of the firm's investments in its plant and equipment. In the stock market, what gives a company its value is how much its products and services are prized by consumers, the company's ability to successfully extend its products, new and old, to new markets and, finally, the company's ability to convert sales into profits.

Then it hit me. At the county fair, the best animal wins the blue ribbon, and the most attractive girl in the beauty contest wins the crown. A man gives his best girl a diamond. A great athlete becomes a star. In all societies, the best are given the prize and are prized. So what companies in the U.S. were most prized? Immediately Coca-Cola came to mind, then Disney (it was a much different company then than it is now), General Electric, Wrigley, and Johnson & Johnson. They were not just blue chips but icons that had stood the test of time, defeated all comers, were very profitable, and had star quality. They were what some people called their "brand." The strength of a brand was as close as a company could get to being tangible.

I called Mrs. Hagedorn and gave her my line of thinking and the shortlist of names. I asked her to wait a few days. The market was coming apart, and I had no idea where these stocks were trading. She agreed. We did start to buy some of the "best" companies by the end of the week. It did not feel right to me at the time, but it was what she wanted. Regardless of how it made me feel, I realized that she had shared with me a priceless bit of investment wisdom. It was an axiom on Wall Street that buying low and selling high was the secret to success. But here in the

teeth of the biggest sell-off in U.S. stock market history it took guts to buy stocks as Mrs. Hagedorn was doing. But she hadn't just called me on a whim. She wanted to be a buyer of stocks because she had learned to buy low through scores of farm ground purchases that turned out to be big winners. She had learned that big sell-offs were tremendous buying opportunities for top quality investments. That kind of thinking went against the grain of ninety percent of the people, including me.

Chapter 3

The Second Call -- Valuing bonds blindfolded

Shortly after finishing my call with Mrs. Hagedorn, I received a call from a friend and fellow employee of the Indianapolis-based investment firm I was with at the time. He was a broker, and I was in the money management department. He explained that he needed to sell some Indiana University bonds for a customer who was in a panic about the crash. When I asked him why he called me and not the bond desk, he said it was shut down. Actually, what was happening was that the stock market crash overloaded the quotation systems, and no one knew if the prices of stocks or bonds we were seeing on our Quotrons were current or hours old.

The collapse in stocks had caused a flight to the perceived safety of Treasury bonds, which caused them to soar in price. Under normal circumstances, municipal bonds trade with a spread to U.S. Treasury bonds. Thus, prices of municipal bonds like the Indiana University bonds should have been rallying along with Treasury bonds. But correctly valuing municipal bonds in the middle of a stock market crash was next to impossible. Additionally, no one knew if the normal spread between Treasuries and municipals was holding steady. As a result, many bond desks at firms across the country suspended operations.

When I heard the news that our bond desk was not bidding on bonds, my heart sank. It further opened my eyes to how big the crash was. It was starting to shut down the whole system. Shutting down the bond desk was like the power company shutting down one of its generating plants; the only reason they would do that was to salvage the system.

Stocks were collapsing and bond desks nationwide were suspending trading. Momentarily, I was seized with the notion that maybe this was another 1929-type crash, and everyone would lose everything. I quickly shook off that thought and steadied myself. The fact was that the economy was strong. And, since only about 25 percent of Americans owned stocks at that time, most people would wake up the next day, shower, brush their teeth, get dressed, get in their car, and stop for an Egg McMuffin on their way to work. Life would go on as usual. I paused right then to add Colgate, Procter and Gamble, and McDonald’s to Mrs. Hagedorn’s “best company” list.

My friend said that the seller of the bonds was a long-time client who was convinced a 1929-type depression was imminent and he wanted to raise his level of cash. He stressed that he really needed the favor. I told him I could not do favors with other people's money. "All I want is a bid to show my client, not necessarily a favorable one," he said.

I asked him how I was supposed to know where the market was trading if the bond desk didn't even know. He responded that he thought maybe one of my firm's money management clients might be interested in his client's bonds. In fact, several of my clients had told me during the day to keep an eye out for bargains on bonds. I agreed to think about it and asked him to call back within the hour.

By law, the State of Indiana cannot have direct debt. The law was the result of the Wabash and Erie Canal debacle of the 1840s, which forced the state into bankruptcy and produced an 1851 statute prohibiting any future issuance of debt by the state. The prohibition meant that Indiana had one of the strongest financial conditions of any state in the nation.

As I thought about the bonds, I realized that Indiana University was as close to state debt as you could get. The good citizens of the Hoosier state would sell off their family jewels before they would let Indiana University go under. In addition, Bobby Knight and his Hoosiers basketball team had won the NCAA basketball championship the preceding March, and the state would likely have sold off the Capitol rotunda rather than give up the basketball arena. The bonds were safe. But what were they worth?

In valuing the bonds, the toughest hurdle to get over was that they were 20 years from maturity. Life and taxes would go on no matter what happened in the crash, and the tax-exempt interest the bonds paid would always be prized by investors in high income tax brackets. U.S. Treasury bonds had started the day yielding about 10.25 percent, and bond prices were rallying, so the yields were probably near 10 percent. If I could buy the IU bonds to yield the same amount as U.S. Treasury bonds, I would have a real bargain because in normal times tax-free bonds yielded approximately 80 percent of Treasury bonds.

When the broker called back, I told him I would buy the bonds to yield 10 percent, then told him to call the bond desk and get their approval before he told his client about my bid. The head of the bond desk called me immediately and began to explain what was happening with the bond market and his inability to bid. I stopped him and said I was aware of what was going on and was willing to buy the bonds if he approved it. He said he thought 9 percent might be a better level for the bonds, but I held firm at 10 percent and said my bid was good until the close of business. The broker called back in minutes to say the bond desk would not approve the 10 percent level but would allow it at 9.40* percent. I agreed to buy the bonds at that level, then called the bond desk to say I would offer a bid for any other bonds people wanted to sell.

I had budged on the yield I was willing to take on the bonds but reasoned that getting 94 percent of Treasury yields was still a good deal. I was also confident that buying Indiana

University bonds when no one else would make a bid was sure to be a good buy, ultimately. In addition, the destruction of hundreds of billions of dollars by the stock market crash was a deflationary event that I was convinced would cause interest rates to fall.

As I returned to my blinking phone, I paused for a moment. I had just done something that I had never done before -- value a bond in the absence of a trading market. I had just committed my clients to up to 20 years of ownership of this bond, and I had done it in the middle of a panic unlike anything I had ever witnessed. What surprised me was that I was almost intuitively able to clear away all of the clutter and zero in on just the few details I needed to make the decision. But that wasn't all. Without realizing it, I was following the investment strategy Mrs. Hagedorn said she and her husband had used for many years: Buy the best when nobody else wants it.

Chapter 4

The Third Call -- A Good Argument

The third call I received on Black Monday that set me on a different path came just as I was going to bed. It was from a client whom I had not spoken to during the day. He was very troubled. After trying to calm him with rational arguments, I realized that he could not hear me over the sound of his extreme fear and agitation. The more I tried to reason with him the further apart we drifted, like two people receding into a dense fog.

Billy Behr was, in his own words, "large and loud." He had one of the keenest minds of anyone I had ever known and was a voracious reader, student of history, and the owner of a very successful information technology consulting firm. He often reminded me that he did not need a money manager, but I continued to manage a seven figure portfolio for him for more than 20 years.

Billy was a mystery. He was my best friend one day and my interrogator the next. He delighted in telling me that the portfolios he managed were outperforming the one I managed for him. When asked why he kept doing business with me, he would only say that he needed me to manage his conservative money.

On Black Monday, I missed calls from Billy all day. These were the days before cell phones, and he was on a business trip around the Midwest, hop-scotching across the countryside from pay phone to pay phone. He knew I was not selling into the crash. My assistant had informed him of this decision when he had called the first time. He agreed with that strategy but needed to speak with me as soon as possible. So, just before I left the office, I called his home and left a message saying that he could call me at home any time up until midnight.

When my phone rang at 11 p.m., I did not recognize the voice on the other end. It was very faint and strangely childlike. "Gregor," the voice said. "Glad I caught you. I just got in and I'm shell-shocked at my losses. How far down is my account with you?" I told Billy somewhere between

20 and 25 percent. He said he was down much more than that in his other accounts, which were fully margined. He was sure he would have margin calls in the morning, and he wanted to know what I thought was going to happen in the next few weeks. I told him my best guess was that the market would continue its volatility, and that I would be surprised if it did not go at least 10 percent lower before finding its footing. I added that big sell-offs are usually followed by a rally, then a retesting of the bottom.

Billy said he was stunned by the day's events and feared he had probably lost a million dollars. He asked me to remind him why I had decided not to sell into the crash. I repeated the talking points that I had been using all day -- we owned many of the greatest companies in America, and it was not prudent to throw good companies at bad prices, particularly when there seemed to be no economic reason for the selloff. Furthermore, it was becoming increasingly clear that Black Monday's crash had been caused by a structural malfunction in the market that had been set in motion by computerized trading. The financial media were full of stories of how this programmed trading had careened out of control. And there was talk that the New York Stock Exchange was going to suspend such trading before the market opened in the morning.

Billy said one of the gurus whose telephone hot line he subscribed to was calling for a bottom of 400 points for the Dow Jones 30. That was more than 1,300 points lower than Black Monday's close of 1,738 for the Dow. I asked who was making the prediction. When he told me who the advisor was, I said the guy had never seen a sunny day in his life and had been predicting the sky would fall for 20 years. Billy said that the advisor had been predicting a crash for a long time, and he should have listened to him earlier. It was clear that Billy was not listening to me.

"If the Dow Jones 30 falls to 400," Billy sputtered, "I will be wiped out, and I just can't take the chance of staying in the market." Talking about the advisor's doomsday prediction had sent him into a downward spiral. The fear in Billy's voice caught me by surprise. Finally, after more disjointed chatter, he told me to sell everything at the opening of trading on Tuesday.

It was now 11:30 p.m. After a hard day of dealing with everyone's emotions, including my own, and speaking with clients for nearly 17 hours, my voice and energy were spent. Billy's irrational and morbid mood had begun to have a negative effect on the clarity and confidence I had felt all day. I knew that Black Monday would be the first of many long days and nights for me. In order to maintain enough mental and physical energy to make it through this dark time, I could not exhaust myself on one person. I muttered, "If that's what you want, Billy, I'll do my best…" but I immediately realized that I was doing him no favor. As the captain of one of his financial ships, I knew better than he did how to navigate this storm. I knew in the current market that there was a complete disconnect between prices and values. I did not know what the correct price for the Dow Jones 30 was, but I was sure that bailing out now was wrong. I also knew that trying to have an intelligent discussion with Billy in his present state was useless. So I decided to try another tactic.

“Billy, you realize in giving me these instructions to sell everything, you are firing me. We will never work together again.” He tried to protest, but I interrupted him. “If I am being fired I want you to understand that I think what you are doing is dead wrong, and you will soon be sorry.” He did not respond, so I continued. “As we have been talking, something keeps coming into my head. I’m not sure you will agree with it, but I cannot let our relationship end without telling you what I’m thinking.” He said that he was so worn out that he could barely stay awake but would listen as long as he could.

“Billy, you know there is a drought in this part of the country. Corn and bean crops are in bad shape and some farmers have plowed under whole fields. Have you seen that field at the corner of Highway 57 and Kansas Road?” “It’s burned up,” he replied. “Yeah, I know the farmer, and he said he’s going to plow it under. There is nothing to harvest. The sun has just roasted the beans. What do you think the odds are of anything ever growing in that field again?” I asked. “Better yet, are you willing to bet me that that field is somehow broken and will never produce crops again?” Billy wouldn’t take the bet because he knew that the field would grow crops next year. I asked him on what basis he believed that. “It’s only natural,” he said, “Billy, think of everything that has to go right for that field to produce crops -- the right amount of rain all year, not too much or too little; the absence of a blight and destructive insects; the right seed; the right fertilizer; and the skill of the farmer.”

I asked Billy if he thought the value of the field had fallen because of the poor crop this year. He said he did not think so because in nine out of ten years the field would produce a crop, and some big crops would make up for the shortfall this year. “So from what you’ve just said, Billy, you have faith that the forces that have produced good harvests ninety percent of the time will re-establish themselves, and this year’s losses will be made up in the years to come?”

“Gregor, I know where you are going, but I’m just too tired to play logic games with you. Just do what I told you and sell all my stocks at the open tomorrow.”

“Billy, you hired me to manage a big portion of your assets, and I am going to do that until you tell me I am fired. I need to convince you that your cut and run action is not the right one.”

Billy’s temper flared. “Hey, man, don’t make things worse with cut and run talk. I’m not cutting and running. If this market keeps falling, I’ll be wiped out. I’ve worked a lot of years to build the assets I have. I don’t want to start at zero again.”

I then asked him why he was predicting a different ending for the stock market than he was for the farm ground. Fully awake now, Billy blurted out, “Because they are completely different animals. Farm ground did not fall by 23% today, and farm ground is a necessity to our way of life; stocks are not!”

“Billy, you are wrong when you say that farm ground and stocks are completely different animals. All farm ground is valued as a means of production for food, a basic necessity. How is that different from Southern Indiana Gas and Electricity? (SIGECO was the local electric and gas

utility at the time. It is now Vectren.) SIGECO is a means of production of electricity, a basic necessity. Our society can no more live without electricity than it can without food. And how about Johnson and Johnson? It is one of the world's largest pharmaceutical companies. If JNJ were to dry up and blow away, millions of people's quality of life would go down hill in a hurry. Some might die. And how about Proctor & Gamble, Exxon, and General Electric? The fact that farm ground is tangible and stocks are not has nothing to do with how either one is valued or what they are ultimately worth. I recently saw where the total rate of return for farm ground in the United States over the last 50 years has been just modestly higher than inflation, whereas the rate of return for stocks during this same period has been five percent higher than inflation on an annual basis."

"Farm ground and stocks are not the same thing," Billy shouted. "Stocks fell today by 23%; farm ground probably did not move a penny."

I shot back that "probably" was the operative word in his argument. "In the stock market, we live in a real-time quoted world. You can find out what any stock is selling for just by hitting a couple of buttons on a computer or reading it in the newspaper, and you can buy or sell millions of dollars worth of almost any stock on almost any day you choose. Write the check and you own it, or sell it and a check arrives in your mailbox in a week. It's a real-time quoted live market; there is little or no 'probably; about it. Farm ground is all about 'probably.' There is no real-time place where you can get a true selling price for that farm ground at Highway 57 and Kansas Road. There is no billboard on the corner showing the land's moment-by-moment selling price, and there is no difference between tangible farm ground and intangible stocks.

"The moment-by-moment quoted market works for stocks 90% of the time, but because we humans are hardwired to fear loss, a sort of reverse alchemy occurs every time stocks go into a tailspin. Cascading markets transform our heretofore golden portfolios into junk. Almost magically vibrant and growing companies become nothing more than prices on a ticker tape, heading south. They are sold indiscriminately of their recent results or their prospects.

"Billy, you didn't build a business as big as the one you own by cutting and running when the times got tough or someone threatened to sue you or run you out of business. Why are . . .

Billy interrupted me. "If you don't stop this cut and run talk, I'm going to hang up this phone," he growled. "You are preaching to the choir here, man. You know that my company is as big as it is because in recent years every time the IT market took a dive I stepped up and made acquisitions. I know how fear and greed can turn you into an idiot. That is why I keep an ongoing valuation metric for all of my important competitors in the Midwest. If any of them want to sell, I know exactly how much I will pay without stepping foot on the premises. If I get my price, I can clean up any problem they have."

"Now we are talking," I said with renewed fervor. "Would you mind sharing your valuation methodology with me?"

“Good grief, Greg, it’s midnight. You win, at least for tonight. Forget that I said sell everything. I’ll sleep on it and call you in the morning if I change my mind. But here is something that is non-negotiable. I’ve got enough risk in my trading accounts and in my businesses. I want you to reshape my portfolio to be entirely comprised of basic necessity companies. That is the only thing you have said tonight that has made sense to me.”

With that, Billy hung up. I lay in bed with questions running through my mind. I could not drive the race in front of me and read the roadmap at the same time. My purchase of the Indiana University bonds provided a yield above 9 percent, completely free of all taxes and backed by one of the most conservative states in the union. If that wasn’t a good buy, then what was? The next morning, I was going to tell the firm’s brokers to buy municipal bonds. Everyone would want to know what stocks to buy or sell, but it did not feel right to be jumping into the stock market until the bottoming process was further along, and it was too late to sell.

Then I began to think about the people I had spoken with that day. Among the scores of calls, the conversations with Mrs. Hagedorn, my friend with the IU bonds, and Billy Behr stood out. I knew they were seminal and would ultimately reshape my understanding of investing. Eventually, I would dig deeper into the impact of each call, but the one from my friend who wanted to sell the IU bonds took center stage. As I replayed the events surrounding the purchase of the bonds, I was struck by the fact that I’d been in the investment business for 12 years without knowing how to value a stock apart from its selling price on the exchange. Prior to Black Monday, I believed the market price dictated what a stock was worth. That is what I had been hearing for nearly a decade. On the night of Black Monday, I realized that the prevailing wisdom was nonsense. The average stock had fallen 23 percent. It was clear that investors were not trying to make informed decisions about the value of companies; they were just running from the storm. I was convinced of that, but I had no way to value a stock. Yet, today, I had priced a bond in the absence of a trading market.

Just before I dozed off, the only question on my mind was, “Is it possible to turn stocks into bonds?”

Labels: Dividends

WEDNESDAY, APRIL 27, 2016

C’mon, Man: There Is No Such Thing as a “Normal” P/E

And now for the most exaggerated, overblown, annoying, and ignorant claim in the financial media today: “The stock market is dramatically overvalued and headed for a fall.”

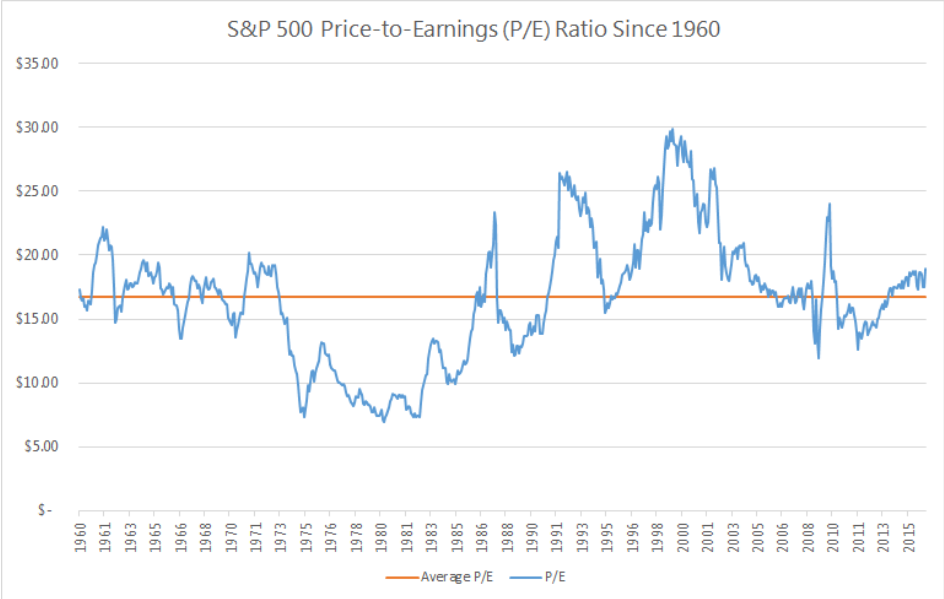
The financial media from the Wall Street Journal to CNBC and everyone in between would have us believe that the S&P 500 is dangerously overpriced. Stocks are currently trading at a P/E

ratio of nearly 19, which is 15% higher than the long-term "average" P/E ratio of 16.5.

[Cue the financial media freakout]

C'mon man (woman). You don't know what you're talking about. Using the average P/E to determine whether or not the market is fairly priced is like using a thermometer to determine how fast the wind is blowing. A thermometer is a useful device for measuring body temperature, but useless for measuring wind speed. As we will soon show, using the average P/E alone to value the market is also useless.

The chart below alone is enough to prove that average P/Es don't tell you a thing. The blue line shows the actual P/E ratio vs. the long-term average P/E shown by the orange line.



Can any useful information be derived from this chart? Does the orange line tell you anything about the blue line?

There are; however, a few things we can glean from the chart.

1. Stocks Almost Never Trade at "Average P/E" Levels

With the frequency that "average P/E" is thrown out at us, you would think stocks often trade at the average P/E. But they don't. In fact, stocks have traded at or near their long-term average in just 9 out of 676 months going back to 1960. That's 1.3% of the time. **The other 98.7% of the time, stocks did not trade at their long-term average P/E.**

Can we just get the message through to the financial media: stocks almost never trade at their average P/Es. In effect, **there is no such thing as a "normal" P/E.** Please stop referencing it. It doesn't exist.

2. Today's P/E Ratio Isn't Particularly High

Look at the far right of the chart showing where P/Es stand today vs. the historical average. Does it look all that high to you? It's not.

The S&P 500 has traded at a P/E of 19 or higher nearly 30% of the time. Are P/E ratios higher than they have historically been? Yes. But it's not like 19 is uncharted territory. It is still well within what we have seen before.

3. Stocks Can Still Go Up from "Elevated" P/Es

Even when the media are proclaiming that P/Es are "elevated" compared to historical averages, stocks have produced good results. Since 1960, when stocks have traded at a P/E of 19 or more, they have produced positive price returns more than 66% of the time over the next 12 months.

Do P/E Ratios Make Any Sense?

Historical P/Es look completely random, don't they? Why did stocks trade at 7 times earnings in 1980 and then 30+ times earnings in 1999? Let's see if we can find anything that would suggest why P/Es traded where they did over the last 50 odd years. If we can, we would have an honest to goodness valuation tool.

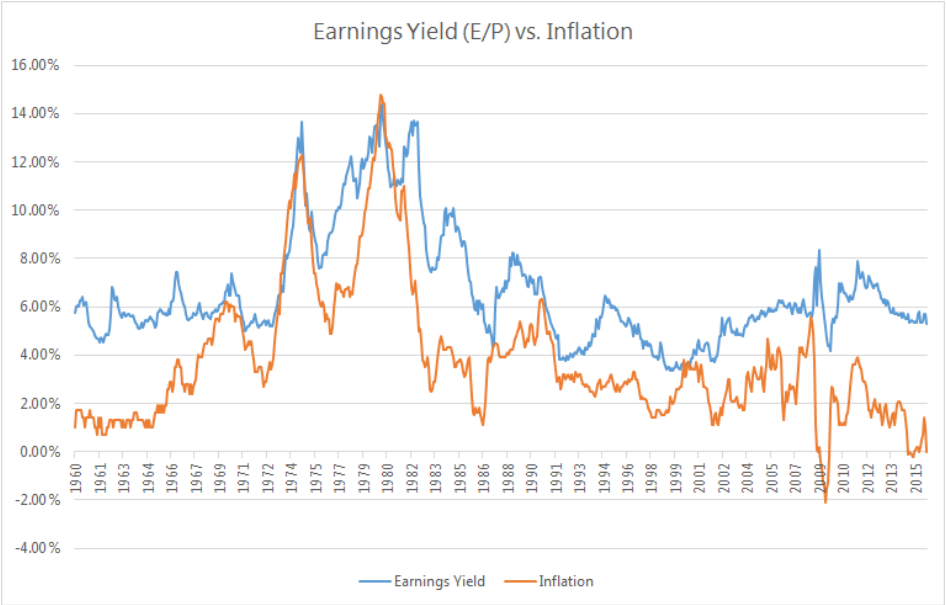
What is the "Right" P/E?

We've seen that stocks almost never trade at their average P/E. So that's obviously not the "right" P/E. But if not the average, then what? To determine that, we need to flip our thinking

upside down. We're going to look at what is called the "earnings yield," which is simply the P/E ratio flipped into an E/P ratio. If you buy a stock for $100 that generates $8 per year in earnings, you have paid 12.5 times earnings (P/E = 12.5). Flip that upside down and you would see that your "earnings yield" is $8 divided by $100 = 8%.

The "earnings yield" is more useful when comparing stocks (and businesses) to alternative investments that are quoted in percentages. When earnings yields on stocks are higher than bond yields - stocks are a better bargain. When bonds are yielding more than stocks - you might be in favor of buying bonds, instead.

Our research shows there is a high correlation between earnings yield (P/E upside down) and inflation. The chart below shows earnings yield as the blue line and inflation as the orange line.

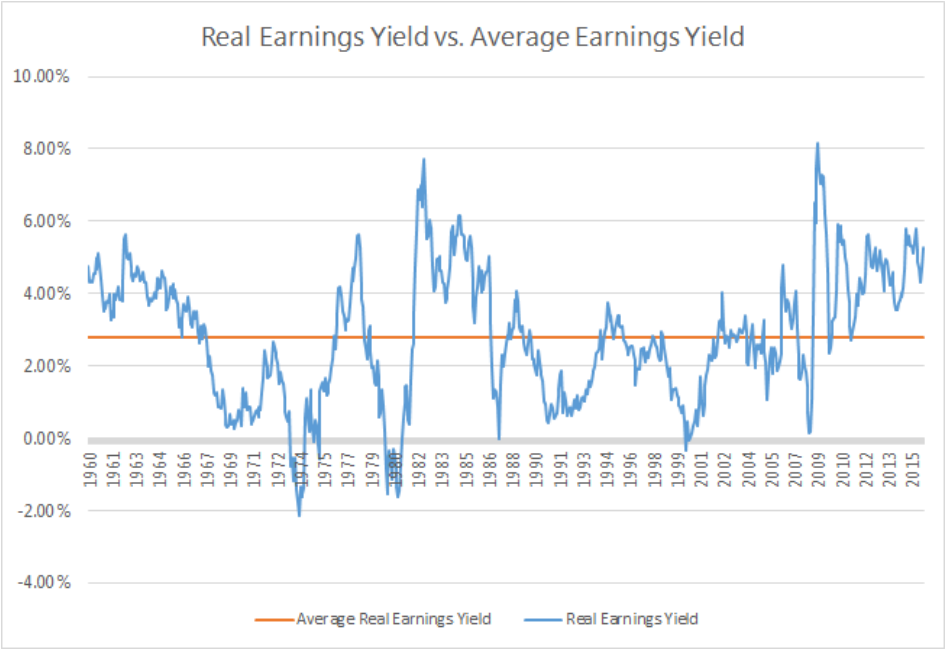


There is a clear relationship between earnings yield and inflation. When inflation goes up, the earnings yield also increases (meaning the P/E ratio goes down). The statistical correlation between the two data series is more than 70%.

In the 1970s and 1980s, inflation was higher than we've ever seen it. At one point, inflation reached nearly 15%. At that time, the earnings yield for stocks reached nearly 15%. If you flip a 15% earnings yield back into P/Es - we calculate 1 / 15% = 6.7. So high inflation means high earnings yield (low P/E ratio).

The reverse is also true. When inflation is low, earnings yields should also be low (P/E ratios high). And that is what we have seen. In periods where inflation has been less than 3%, earnings yields have averaged approximately 5.2%. Flipped upside down, that means the P/E in those low inflation periods was 1 / 5.2% = 19.

So that brings us to one last chart. This shows the "real" earnings yield for stocks, which is simply the earnings yield (E/P) minus inflation. According to our research, this metric is a much better indicator than the simple P/E for determining the relative value of stocks at any given point in time.



When the real earnings yield (blue line) has been below the long-term average (orange line), that has meant that stocks were overpriced relative to the then current inflation levels. When the real earnings yield have been higher than the orange line, stocks have been a good buy.

You can see that this model correctly predicted that stocks were way overvalued in the mid-1970s, early 1980s, in 1987, during the "tech bubble" in the early 2000s, and during the Great Recession of 2008.

It also correctly indicated that stocks were a great value in the early 1980s and again in 2009.

So… Are Stocks Overpriced Today?

Today's real earnings yield spread is 4.4%, which is significantly higher than its long-term average. If the earnings yield were to trade at it historical relationship to inflation, the appropriate real earnings yield today would be 2.8%. When you add back current inflation of 1%, we see that the appropriate earnings yield for the S&P 500 is about 3.8%. When you flip that upside down into P/Es, we get 1 / 3.8% = 26.3.

Are we suggesting that P/E ratios should go to 26.3? Not necessarily. But we are saying that the current low-inflationary environment should result in stocks trading at higher P/E ratios than the "average P/E." If we were to see inflation remain at 1% for the next decade, it is entirely possible (and reasonable) that stocks could head towards a P/E of 25+. The CNBC broadcasters are starting to sweat at the thought of it.

For those of you that are still skeptical that stocks can go higher from here, just think about this. The current real earnings yield for the S&P 500 is 4.4%. There have been 123 months since 1960 when stocks have traded for a higher yield than that. With those months as a starting point, the average return over the next year was 21.5%.

So can P/E ratios expand from here? History tells us overwhelmingly that they *can*. Not only that, but the current inflationary environment says that they *should*.

Conclusion

Are we saying stocks are going to go up 21.5% over the next 12 months? Maybe yes, maybe no. There is reason to believe that the current slow economic growth will likely reduce future earnings growth and, thus, impact future stock returns. However, it should be clear that stocks are not trading at significant premiums to where they should be. Unless earnings collapse or inflation explodes, stocks could (and probably will) continue to move higher on the back of rising P/Es.

So next time you're out with your friends or watching some talking head on CNBC and the topic of P/E ratios being high – remember that average P/Es are meaningless as a valuation tool. Anyone who says they should trade at 16.5x just because that has been the average doesn't know what they are talking about. There is no such thing as a normal P/E.

Labels: P/E ratio, valuation

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