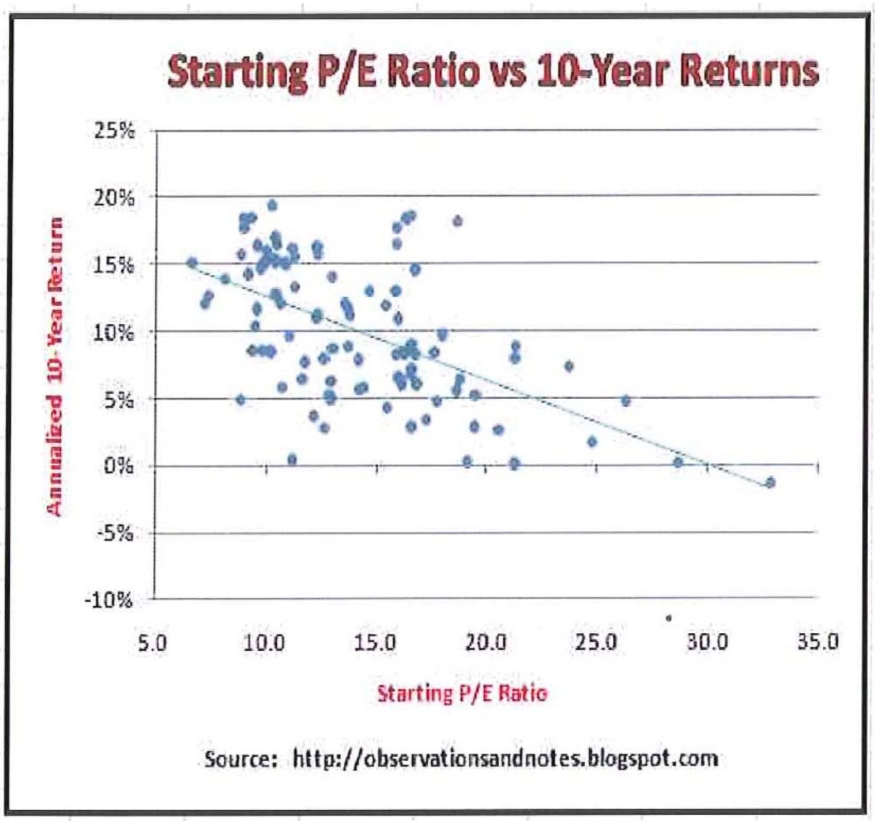
Yes, Virginia, Valuations Matter

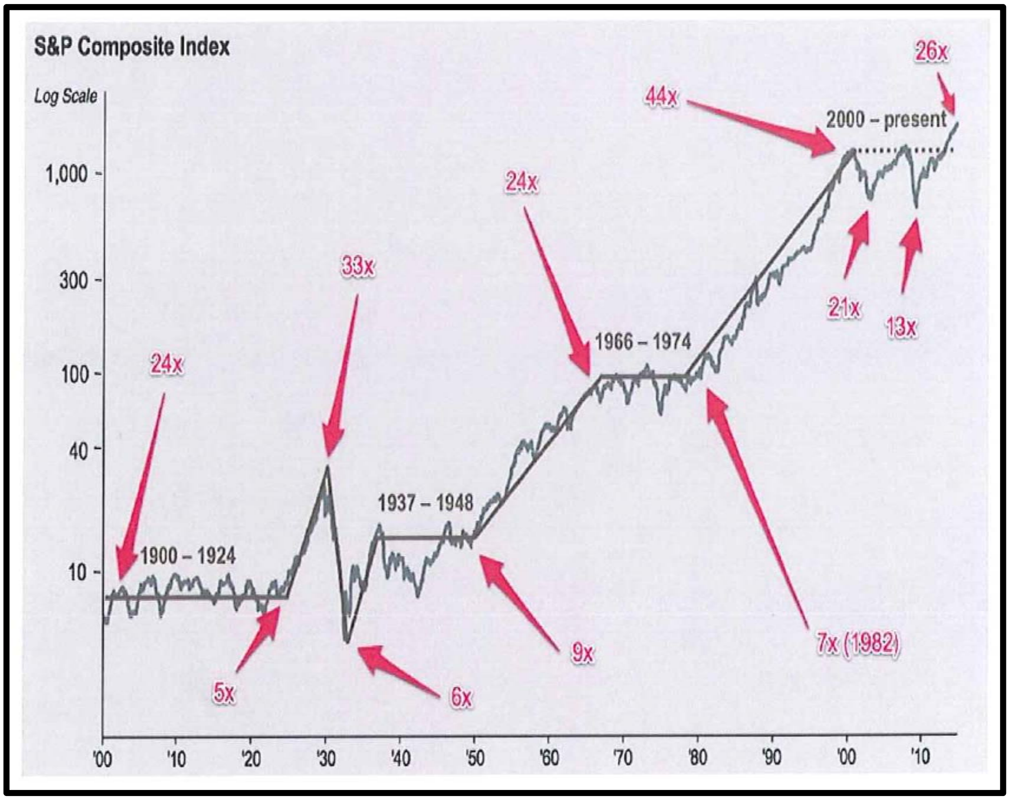
September 9, 2015

Overview: Optivest sold their U.S. stock holdings before the August 24th major market decline based on over-valuation and market deterioration. This is only the third time since 1987 that Optivest has de-risked portfolios to this extent. The below report explains our rationale and our future forecast.

Great returns come from great opportunities; weak returns come from weak opportunities. Specifically, forward multi-year stock market returns are directly linked to how over-valued or under-valued shares are when you buy them. Historically, if you started your investing time period when valuations were at "average" levels, then you would have achieved "average" returns; higher returns come from under-valued starts and lower returns come from over-valued starts. Rolling 10-year performance charts show this time and again.



In 2000, the S&P 500 was at all-time high valuations and over the next 15 years — despite two bull markets after two big bear markets — it gained a meager average of 2.3% per year. The same math is true over other 7 – 15 year time periods after peak valuations. Long, multi-year bull markets have only emerged from periods of low price-to-earnings ratios, not high P/E environments like we are currently in.



In the spring of 2015, the New York Stock Exchange (comprised of 3,287 of America's biggest companies collectively) was at all-time high P/E ratios — near all-time high book/market ratios and at breakout new all-time highs for price/cash flow ratios (see charts below). After 6 years of share price advances that tripled the price of the S&P 500, stocks were simply too expensive, even on a relative basis, to other liquid alternatives.

Chart 2: Median price/earnings multiple for U.S. stocks*

*Based on all NYSE stocks with positive earnings for the last fiscal year calculated in June of each year since 1951 through 2014

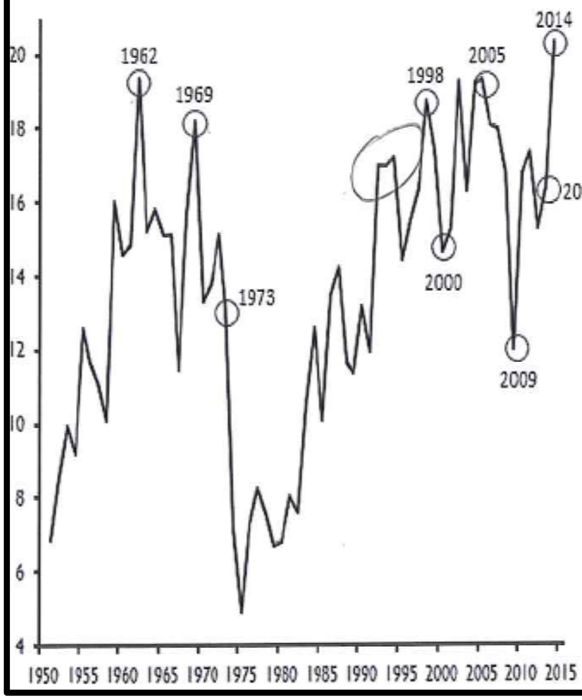


Chart 4: Median price to book multiple for U.S. stocks*

*Based on all NYSE stocks with positive book equity for the last fiscal year calculated in June of each year since 1951 through 2014

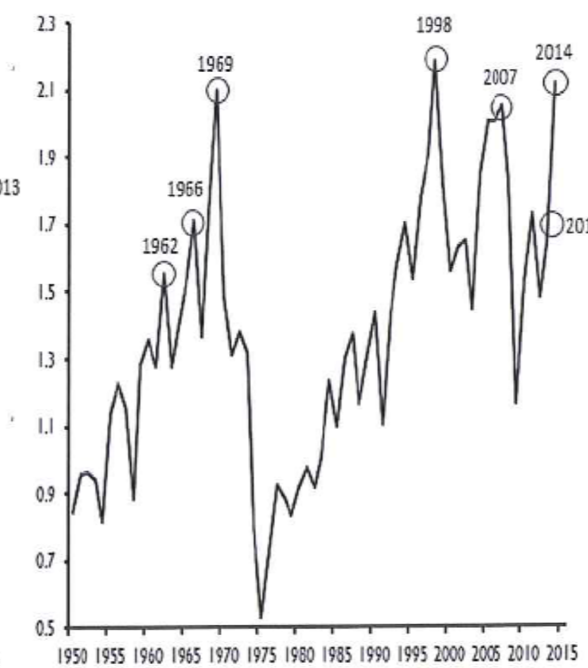
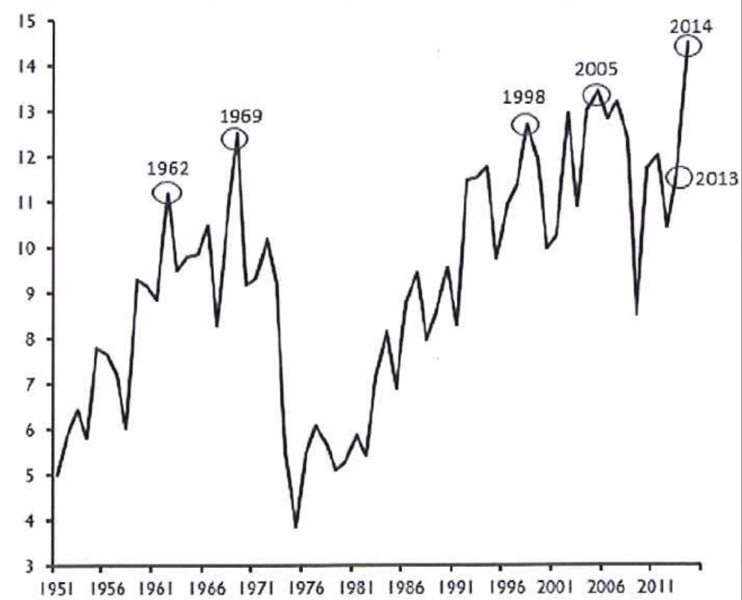


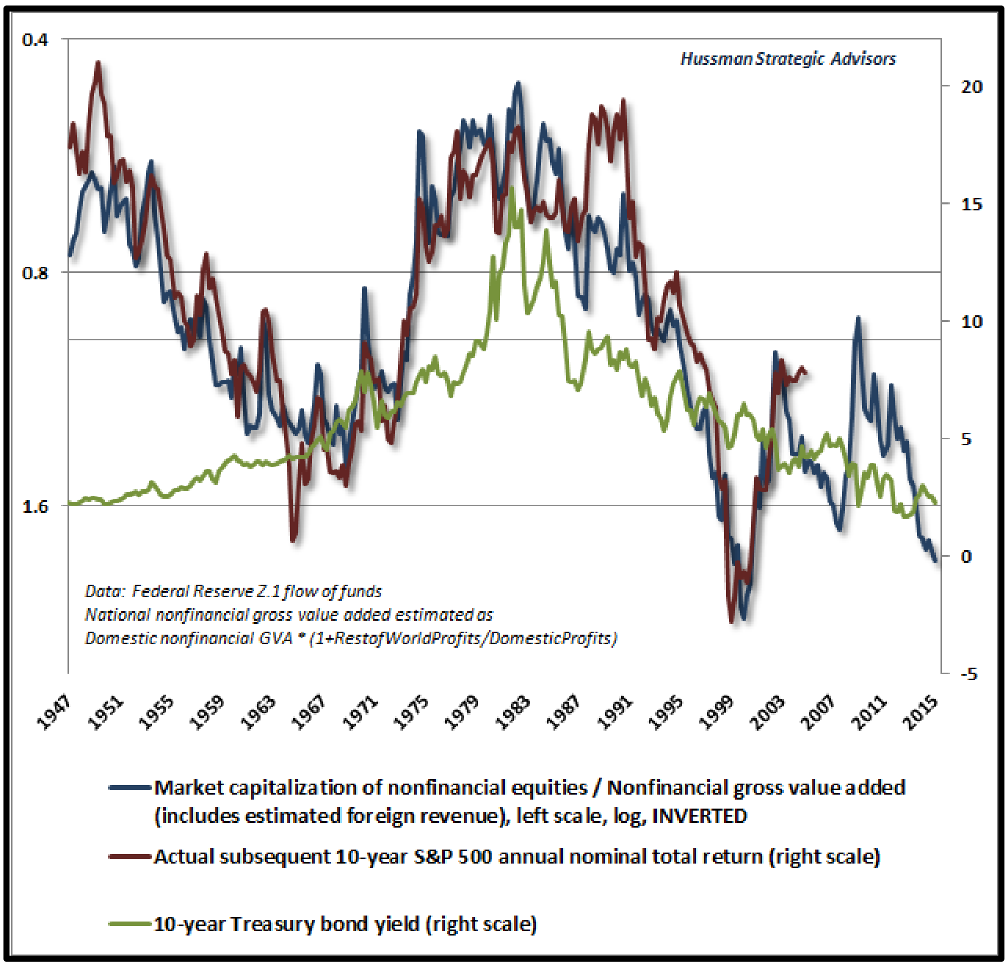
Chart 3: Median price/cash flow multiple for U.S. stocks*

*Based on all NYSE stocks with positive cash flow for the last fiscal year calculated in June of each year since 1951 through 2014



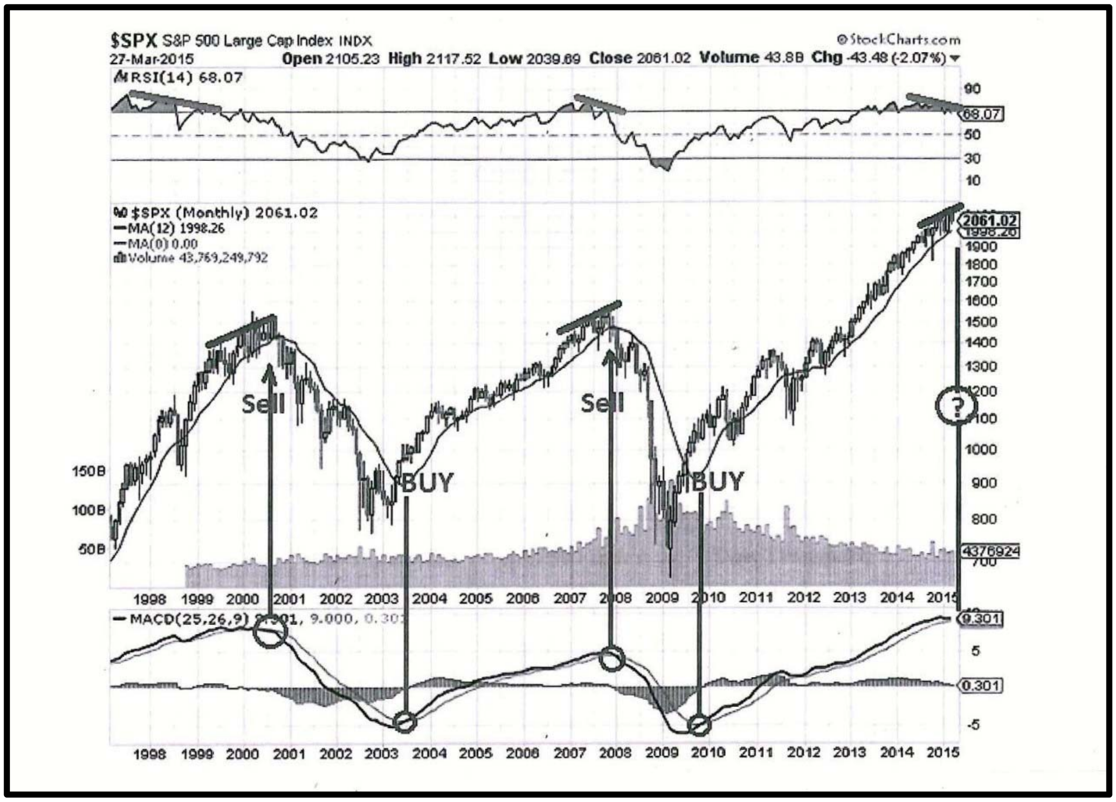
Peak valuations don't last long; either stock prices go back down, or like in 1991 earnings quickly advance. The S&P 500 top-line revenues for 2015 are actually expected to decline slightly. Even so, share buy-backs, low interest rate leverage, low wages and accretive M&A activity will create another year of modest profit improvements. This is not the environment that breeds sudden future growth.

The chart below, courtesy of [Hussman Funds](), is indicative of other estimators of future returns from different value levels over the past years. Historically, this chart has been 92% accurate in predicting future 10-year returns based on starting valuations. The current picture is not bright: 0% returns (less than in 2007) are predicted from today's values. That is not to say that we could not go higher first then drop in the future. But either way, this is no time to expect even average returns from the stock market.



Of course the stock markets will make new meaningful highs in the future. The question is how long and how hard will the future path be? Two 50%+ drops in market values over the last 15 years remind us that the way to new highs can be plenty painful.

Over-valued markets can last a long time before rolling over. This was true in 2000, 2007 and this year as well. The following chart (first shown in our April 2015 newsletter), with its impressive "buy" and "sell" signals, has had zero false calls in 17 years. This past June, it posted its first "sell" signal since the start of this bull market 6 years ago.



There were many other signs of market deterioration this year leading up to the August 2015 drop: higher volume on down weeks than on up weeks; fewer New York stocks hitting highs on every new high for the indexes (bad breadth); crossing over the long-term 200 day moving average; crossing over to the "death cross" when the 50 day average dropped below the 200 day average; the widely followed Dow Theory producing a "sell"; and January lows becoming breached. All of this happened before the Dow Jones dropped 1000 points on August 24, 2015. We then retested the lows, rallied to "fill the gaps," and bounced a perfect Fibonacci ratio back to the lows of January 2015 … then we resumed the decline.

You most likely will not hear this analysis from the major bank/brokerage investment firms because they charge twice as much for equity investments vs. fixed income or cash. Their advice is usually the same: "No one can predict the future. Buy dips. Ride it out. The market always recovers." However, valuations *do* matter and we have mitigated risk in our portfolios until valuations improve substantially and we get a "buy" signal from our multiple indicators.

Strategically, Optivest has been working with our clients to move proceeds from our previous stock allocations to better risk/reward opportunities in non-stock market correlated assets. These include market neutral funds, life settlements and real estate, some of which are up 5% - 11% year-to-date. The other 50% is in cash (or low volatility funds) awaiting a future re-entry point in the stock market. Our initial target for the S&P 500 is between 1670 – 1750 (or down 17% - 23%).

As you can see from the charts above, the current risk/reward ratio for U.S. stocks is not attractive. Further, until valuations reach at least “average” levels, the stock market will likely struggle. It is certainly not too late to take defensive action to protect your holdings and reallocate your assets to better investments. We welcome the opportunity to discuss your individual situation and offer specific recommendations.

Sincerely,

Mark Van Mourick

CEO

Leslie Calhoun

CIO, CCO