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FOCUSED ON WHAT MATTERS MOST.

Is It Too Late To Jump In?

A question that we typically get when the stock market has been going up for a while is, "Is it too late to jump in?" Over the years, our answer has varied depending on the circumstances at the time. Recently however, our answer has been much more cut and dry, and it amounts to this…

Jump into U.S. stocks if you can stomach large losses over the coming months and years and you're willing to extend your investment time frame well beyond what one would generally consider "long-term".

Stay away from U.S. stocks if you couldn't withstand a 40-60% market plunge without selling out at some point on the way down and you wouldn't be able or willing to wait twenty plus years before making your money back and earning a little profit.

Needless to say, our position on the U.S. stock market at the moment is far from enthusiastic. This doesn't necessarily mean that you shouldn't have a slice of your portfolio in stock, it just means it's probably a good time to reduce that exposure based on the risk/reward relationship we're facing at the moment. And as many of our loyal readers and clients well know, this balance has been leaning more toward risk for quite some time. Just because that downside risk hasn't played out doesn't mean it isn't there – sometimes a volcano simmers for a while before erupting. Again, our assessment doesn't mean you shouldn't own any stock, it simply means you should be conscious of how that portion of your portfolio could behave in the coming months and years and how it could impact the whole. For our clients, we've already reduced exposure to stock based on individual circumstances and comfort levels. Everybody's situation is different.

In our opinion, whether just starting out in life or in retirement, investors need to step back from the hype of new market highs, earnings beats, IPO's, and the overall euphoric atmosphere surrounding the markets and focus on the larger picture. In previous letters we've highlighted a number of stats and measures that support our position, but this month we're aiming to keep it simple. It really doesn't matter how academically sound our point is if our audience loses interest or gets confused before getting the whole of it. So our answer to the question "Is it too late to jump in?" is "Yes" in almost every case at the moment and here's why…

When we try to determine how expensive the stock market is, we can't just look at the price of it. Just because the Dow Jones is trading over 20,000 doesn't make it expensive. If the economy is growing and the underlying companies making up the Dow Jones Index are making more money, then the price or level of the index should go up accordingly. Determining value requires looking at the level of the Dow Jones relative to something else. There are a number of things to look at to determine whether the level of the market is rich, fair, or opportunistic, but we'll choose just one - the Cyclically Adjusted Price to Earnings Ratio (CAPE) first introduced by Professor Robert Shiller of Yale University. I know, we promised to keep it simple. If you can get through the next few sentences, you'll be in the clear, so stay with us. We're choosing this metric because it does a darn good job of forecasting returns from the market over the next 10-12 years. In addition, we have data for it back to 1881 which gives us great perspective.

The CAPE ratio looks at the U.S. stock market (S&P 500) relative to the profits of the companies in it. These profits are adjusted for inflation over the prior ten years to help smooth out business cycles and abnormalities in the data. So the price level of the S&P 500 is simply divided by this smoothed out earnings number giving us a ratio. When that ratio is high, it implies that the market is expensively priced. When it's low, there may be opportunity to buy the market at a very attractive level. Where is it now? How does **third highest in over 130 years** sit with you?

Most Expensive Markets per Shiller CAPE Ratio	CAPE
Dec-99	44
Oct-29	32.5
Feb-17	**28.6**
May-07	27.5
Jan-66	24.66
Mar-37	22.04

As daunting as third most expensive might be, there's more to the story. One of the things that affects company earnings greatly is profit margins. In other words, the costs that go into operations can fluctuate over time affecting the bottom line. Some of these costs are outside of the company's control such as commodity costs, while others are firmly within the company's control such as cost cutting and outsourcing. One of the things we know from history is that margins tend to be cyclical which means they go up and down, but over time will have an average level that they tend to fluctuate around. When profit margins are high, it can make profits look bigger, but this bigger number likely isn't sustainable over the long term since margins have a tendency to revert back toward an average level. Margins are historically high right now and we should expect that when they ultimately contract back toward the average, that earnings will be negatively affected. We need to take this into consideration. After adjusting the CAPE ratio to reflect an average profit margin, the picture gets even more interesting.

Most Expensive Markets per Shiller CAPE Ratio	CAPE	Margin % GDP	Margin Adjusted
Feb-17	**28.6**	**9.0%**	**39.8**
May-07	27.5	9.3%	39.6
Dec-99	44	5.3%	35.9
Oct-29	32.5	6.5%	32.7
Jan-66	24.66	7.1%	27.1
Mar-37	22.04	6.5%	22.2

After making this adjustment, we find the most expensive market in U.S. history to be, yup you guessed it, **right now**. There are two caveats here. First, as a proxy for corporate profit margins, we used corporate profits as a percentage of GDP, provided by the St. Louis Federal Reserve. This data provided us with good historical reference back to 1950. Since we didn't have data that encompassed the 1929 and 1937 markets referenced, we assumed average profit margins for those periods. They could have been above or below, but seeing how they didn't even make the top 3 most expensive markets in history, there's a good chance the inclusion of that data wouldn't change the story materially.

So how good is the CAPE valuation ratio at detecting danger? The following chart shows the average market loss from peak to trough, the peak beginning as of the dates listed. Some of these losses happened rather suddenly while others took years to materialize. Each period played out differently, but the end result was the same. The stock market came down – on average, -**55%**.

Most Expensive Markets per Shiller CAPE Ratio	CAPE	Margin % GDP	Margin Adjusted	Subsequent Decline
Feb-17	**28.6**	**9.0%**	**39.8**	**?**
May-07	27.5	9.3%	39.6	54.0%
Dec-99	44	5.3%	35.9	45.0%
Oct-29	32.5	6.5%	32.7	89.0%
Jan-66	24.66	7.1%	27.1	37.0%
Mar-37	22.04	6.5%	22.2	53.0%

What's also important to note is that in the five periods listed here that have already played out, 4 out of 5 of them saw market price levels **lower 10 years later** (all but 2007), while two of them took much longer to get back to even. From the 1929 market high, it took until 1954 to get back to the pre-crash level, whereas in 1966, the market didn't make durable new highs until late 1982. That's 25 and 16 years respectively to get back to breakeven on a price level basis. What we wonder is whether investors at the time had any idea that the stock market could be underwater for so long. Based on the success investors witnessed leading up to the "expensive" points outlined above, we're guessing not.

So in summary, today's stock market keeps company with a motley crew of markets past. On a margin adjusted basis, we're sitting on what could be the most expensive market ever and we have the benefit of knowing how previous periods of overvaluation ended up. Unless this time is drastically different, as I'm sure investors were hoping in the previous episodes as well, we shouldn't be thinking too much about stock market returns, but rather, stock market losses and how to minimize them. Doing this effectively will help us best prepare for much more robust and lasting opportunities a bit further down the road.

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