The Financial Navigator – May Newsletter

In this issue of the Navigator we discuss stocks market valuations. Within the investment community there is a never ending debate on whether the U.S. stock market is fairly valued; for every 10 professionals that believe the market is fairly valued you will find 10 that claim the market is cheap, and 10 that find it expensive. Why may this be important to you? Well being aware of market valuations might help you determine how and when to put money to work in the market. In addition, we discuss the idea of a 'New Normal'. This phrase has been bandied about in the financial press frequently and it refers to the fact that many economist believe that in the new world order stock market returns will be lower in the future. Perhaps, but the long history of previous economic crisis may indicate otherwise, read on for more.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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The U.S. Stock Market - What is a Fair Price?

If you read the Wall Street Journal, or watch CNBC you might have noticed there is an ongoing debate about whether the stock market is fairly valued, undervalued, or expensive. One problem is no one can agree how to measure stock market value. The most often used barometer is the market Price-to-Earnings, or PE ratio. To value the U.S. market one might measure the PE ratio of the S&P 500 and compare that to historical averages. The debate about this seemingly simple calculation revolves around which earnings estimate to use since the price is fairly obvious. Using future earnings estimates is rift with uncertainty as Wall Street analysts' predictions are notoriously inaccurate. Other methodologies run into problems with the accuracy of company provided earnings, potentially fraudulent earnings reports, or creative accounting.

An alternative approach that tries to eliminate the uncertainty was developed by Prof. Robert Schiller of Yale University. He is the author of several books, one being *Irrational Exuberance*, which is pretty well known. In it he outlines the development of what he calls the Cyclically Adjusted Price Earnings Ratio (CAPE) which is basically the PE ratio mentioned above but the E, or earnings, is based on the past 10 years taking out any of the uncertainty of predictions and estimates of future earnings. The current CAPE is 23, while the long-term average is in the 16-17 range. After two years of superb U.S. stock market returns with nary a market correction, this could indicate that the U.S. stock market is a little overvalued, and perhaps due for a correction. The takeaway, if you haven't taken any profits out of the market and rebalanced your portfolio in a few years, now might be a good time to do so. And if you are investing new money into the stock market you might consider spreading the investment out over a period of months, or in other words dollar-cost-averaging the money into the market.

Granted there is much debate concerning the use of historical data, but from Prof. Schiller's point of view it is the only way to eliminate some of the issues mentioned previously.

What's "New" about a New Normal?

The 2008 global market crisis and the struggling economy have left many investors fatigued. Despite two years of strong equity returns, some investors have been slow to regain market confidence. Many are accepting the talk about a "new normal" in which stocks offer lower returns in the future.[1] The concept of a new normal is anything but new. In fact, throughout modern history, periods of economic upheaval and market volatility have led people to assume that life had somehow changed and that new economic rules or an expanding government would limit growth. What they would not see was how markets naturally adapt to major social and economic shifts, leading to new wealth creation. Let's look at other periods when investors had strong reasons to give up on stocks, and consider the parallels to today:

1932: The US stock market had just experienced four consecutive years of negative returns. A 1929 dollar invested in stocks was worth only 31 cents by the end of 1932. Hopes were sinking during the Great Depression, and many people felt as though the economy had permanently changed. Many investors left the market, and some would not return for a generation. Amidst what is considered the roughest economic time in US history, the markets looked ahead to recovery.

US Stock Market Performance after 1932*

	5 Years	**10 Years**	**20 Years**
Annualized Return	15.35%	10.07%	13.19%

*All stock market returns based on CRSP 1-10 Index.[2] **Past performance is no guarantee of future results.** Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

1941: World War II was raging, and the US had just entered the conflict. The US stock market had experienced two consecutive years of negative performance, and the economy had shown signs of sliding back into depression. Although conversion to a wartime economy would revive industrial production and boost employment, investors struggled to see beyond the conflict. Many expected rationing, price controls, directed production, and other government measures to limit private sector performance.

US Stock Market Performance after 1941*

	5 Years	**10 Years**	**20 Years**
Annualized Return	18.63%	16.67%	16.29%

1974: Investors had just experienced the worst two-year market decline since the early 1930s, and the economy was entering its second year of recession. The Middle East war had triggered the Arab oil embargo in late 1973, which drove crude oil prices to record levels and resulted in price controls and gas lines. President Nixon had resigned from office in August over the Watergate scandal. Annual inflation in 1974 averaged 11%, and with mortgage rates at 10%, the housing market was experiencing its worst slump in decades. With prices and unemployment rising, consumer confidence was weak and many economists were predicting another depression.

US Stock Market Performance after 1974*

	5 years	**10 years**	**20 years**
Annualized Return	17.29%	15.92%	14.89%

1987: On "Black Monday" (October 19, 1987), the Dow Jones Industrial Average plummeted 508 points, losing over 22% of its value during the worst single day in market history. The plunge marked the end of a five-year bull market. But in the wake of the crash, the market began a relatively steady climb and recovered within two years. The effects of the crash were mostly limited to the financial sector, but the event shook investor confidence and raised concerns that destabilized markets would increase the odds of recession.

US Stock Market Performance after 1987*

	5 Years	**10 Years**	**20 Years**
Annualized Return	16.16%	17.75%	11.89%

2002: By the end of 2002, investors had experienced the stress of the dot-com crash in March 2000, the shock of the September 11 attacks, and the early stages of wars in Afghanistan and Iraq. Although October 9, 2002, would ultimately mark the market's low point, investors had endured three years of negative performance and an estimated $5 trillion in lost market value. A younger generation of investors had experienced its first taste of old-world risk in the "new economy."

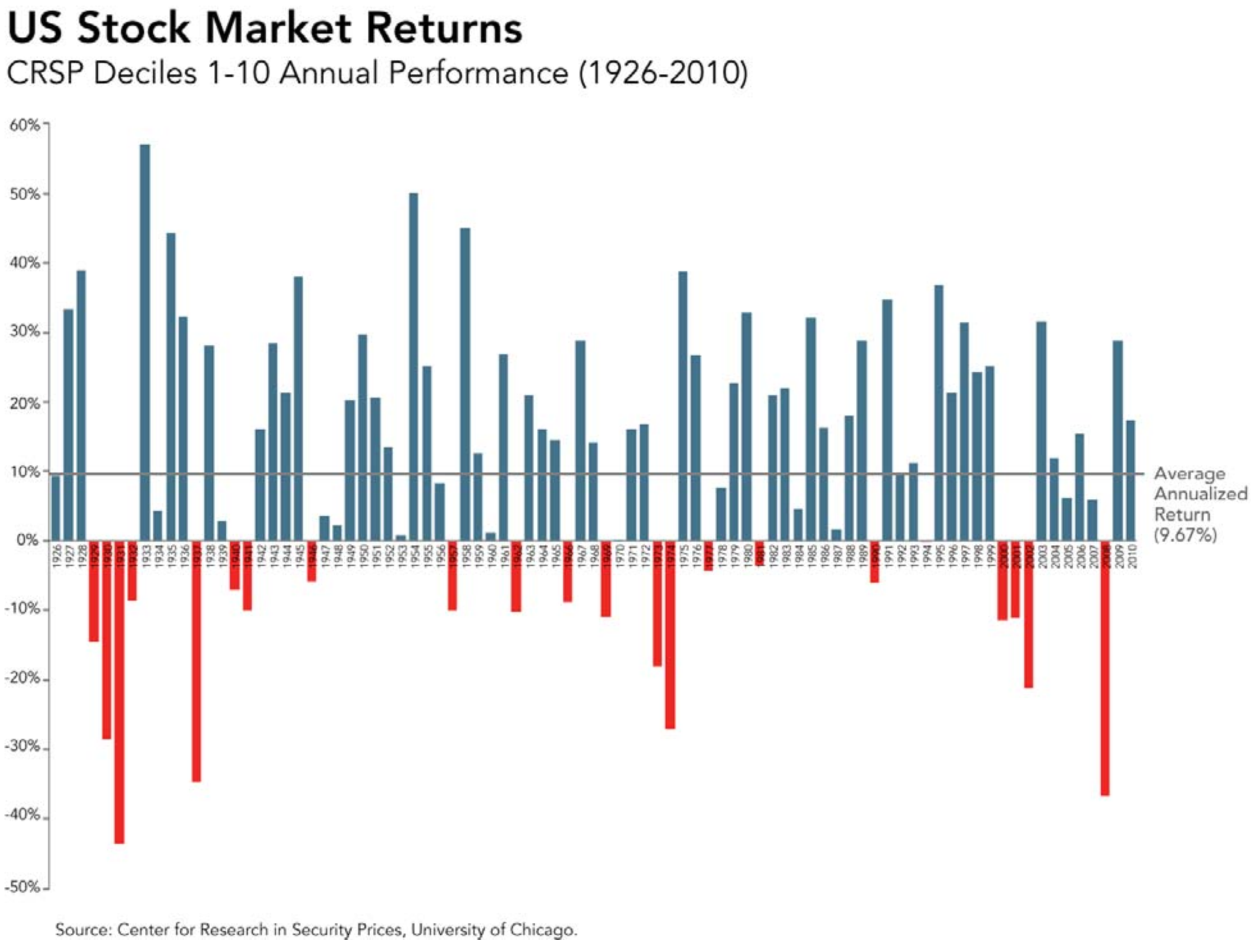
US Stock Market Performance after 2002*

	5 Years	**10 Years**	**20 Years**
Annualized Return	13.84%	—	—

2008–Today: The market slide that began in 2008 reversed in February 2009—gaining 83.3% from March 2009 through 2010. Despite two years of strong stock market returns, memories of the 2008 bear market and talk of the "lost decade" have led many investors to question stocks as a long-term investment. But earlier generations of investors faced similar worries—and today's headlines echo the past with stories about government spending, surging inflation, deflationary threats, rising oil prices, economic stagnation, high unemployment, and market volatility.

Of course, no one knows what the future holds, which brings the concept of "normal" into question. What exactly is the status quo in the markets? The chart below shows the annual performance of the US market. Since 1926, there have been only four periods when the stock market had two or more consecutive years of negative returns. In addition, annual returns are rarely in line with the market's 9.67% long-term average (annualized). The most obvious normal may be that, over time, stocks offer expected returns reflecting the uncertainty and risk that investors must bear.

What's new about that?



Endnotes:

1. Adam Shell, "'New Normal' Argues for Investor Caution," *USA Today*, August, 16, 2010. The term "new normal" originally referred to a post-global financial crisis environment characterized by several years of sluggish economic growth, below-average equity returns in developed markets, high market volatility and risk, high unemployment, and a world in which the range of possible financial outcomes is wider than normal and wealth dynamics are moving from developed to emerging economies.

2. Returns for all periods of the CRSP 1-10 Index are annualized. Data provided by the Center for Research in Securities Prices, University of Chicago. Data includes indices of securities in each decile as well as other segments of NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973). Additionally, includes US Treasury constant maturity indices.

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.