April 2015

CALDER INVESTMENT ADVISORS

Quarterly Update

Calder's Comments

A couple of years ago Dirk Racette spoke at a 401(k) conference out in San Francisco that was sponsored by Fidelity Investments. Alice Lowenstein was in the audience from Litman Gregory, a research firm based just outside of San Francisco. After his talk, Alice introduced herself to Dirk and since then, they have stayed in touch.

Alice recently sent us a report outlining Litman Gregory's market outlook including their analysis of overall market valuations. Their philosophy and current market outlook mirrors that of our firm. Since they do such a good job explaining current market valuation and risk, we thought we would share their research with you this quarter.

U.S. Stocks: Can We Capture Acceptable Returns From Here? - March 2015

We all know that stocks tend to outperform other financial asset classes over long periods of time. On the other hand, there have been some rather lengthy periods when this was not the case, usually occurring after stocks became extremely overvalued. This happened not that long ago when stock prices peaked in March 2000. There were two nasty bear markets in the decade that followed, leaving investors in the S&P 500 underwater until November 2006, nearly seven years after the peak. Even after a powerful market rebound post-2008, annualized returns are only 3.8% over the last 15 years.

Overall, stock valuations are not as bad today as they were in 2000. The tech bubble of the late 1990s made that market, in aggregate, the most overvalued of all time. Nevertheless, based on our analysis and common valuation metrics, today's stock market is quite pricy. Low returns over the next five to 10 years seem probable, and that also suggests heightened risk.

Consider the following two metrics:

1: PRICE-TO-EARNINGS RATIOS

The P/E ratio is probably the most commonly used valuation metric. It measures what an investor pays to own a dollar of earnings. P/E ratios and other metrics are used to assess whether individual stocks are under-, over-, or fairly valued. But we can also look at the P/E ratio for the stock market as a whole to get insight into the overall level of stock prices.

There are many different ways of measuring earnings when calculating a P/E ratio. One method we like is the Shiller P/E (named after Yale professor Robert Shiller). It

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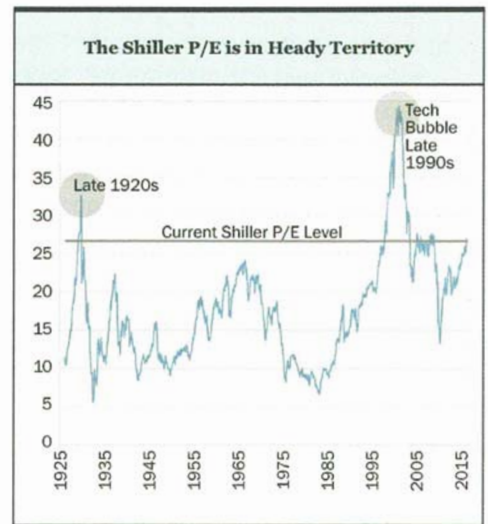
"normalizes" earnings by using a 10-year average of reported earnings (which include write-offs). Normalizing eliminates the potential for funny business that is common when companies use leeway in various accounting standards to dump certain expenses into the write-off category that don't belong there. And, importantly, Shiller's approach acts to smooth out the impact to earnings of sizable cyclical peaks and troughs that occur during the economic cycle. Normalizing earnings isn't a perfect measure but it's a useful one, and a normalized P/E ratio has done a pretty good job of indicating future stock return ranges. With that context, here are some telling facts about the current S&P 500 P/E level compared to history:

- As of the beginning of 2015, the Shiller P/E was at 27.1. That puts it in the 92nd percentile, or the 10th and most expensive valuation decile. In other words it has been higher only 8% of the time going back to 1926 (the period for which we have data).
- The only times the Shiller P/E was significantly higher than it was at the end of last year was during the tech bubble, when it surged much higher, and just prior to the 1929 stock market crash. It was equally as high prior to the 2008 stock market crash.

A high market P/E ratio is only a concern if it foreshadows poor stock market returns. Does the record suggest that is the case? With respect to the Shiller P/E the answer is yes over the intermediate to long term. It is less reliable over shorter periods.



The Shiller P/E has only been higher than its current level (27x) in two other periods: 1929 and the late 1990s. It is on par with P/E levels in 2007–2008, immediately before the bear market. Source: Robert J. Shiller. Data as of 1/31/2015.

S&P 500 Returns From Different Starting Shiller P/E Deciles

	Median Returns	
P/E Decile	**5-Year**	**10-Year**
1 (Lowest P/Es)	17.5%	16.2%
2	15.3%	15.4%
3	13.8%	15.3%
4	13.2%	13.4%
5	10.4%	12.6%
6	9.5%	9.5%
7	10.1%	8.7%
8	7.9%	7.7%
9	4.0%	4.2%
10 (Highest P/Es)	-0.2%	2.9%

Source: Robert J. Shiller and Litman Gregory Analytics.

The adjacent table shows the data broken out into groups of the lowest P/E ratios ranging up to the highest P/E ratios. There are 10 P/E groups. What we see is that the lowest group of P/E ratios preceded the highest subsequent 10-year returns, and the highest P/E ratios (most expensive) preceded the lowest subsequent 10-year returns. The ordering was perfect. Low P/E ratios preceded high returns and high P/E ratios preceded low returns. The same ordering pattern is nearly present over five-year periods as well with just two of the 10 P/E groups in reverse order.

So far we've focused on median returns within each P/E group. There are some examples of decent return periods that occurred in spite of preceding high P/E ratios. For example, the best five-year annual return from the highest (most overvalued) P/E group was 10.7% and the best 10-year return was 8.9%. These are decent returns. However, they were the exception from the highest P/E group and happened only because stocks surged to extremely overvalued levels that in turn were followed by major stock market collapses in the early 2000s and in 2008. *So capturing decent returns from already high valuations required stocks to move to excessive and unsustainable valuations and levels.*

The historical range of outcomes from current valuation levels is not encouraging. We looked at the range of historical P/E ratios from 25.1 to 29.1 (the current P/E is 27.1). The median five-year return when the stock market was in this P/E range was very low at less than 1% (0.7%). A high percentage of the time (73%) the subsequent five- year return was under 3%, and 34% of the time *the return was actually negative in the following five years.* There were strong returns too-16% of the time returns exceeded 10%-but these all preceded ex-

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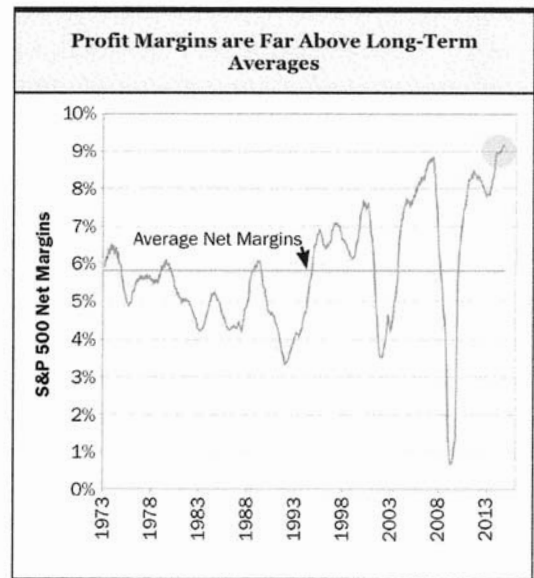
treme overvaluation and were followed by major bear markets.

2: PROFIT MARGINS ARE NEAR RECORD HIGHS

So the Shiller P/E is sounding an alarm. (Other P/E measures suggest prices are stretched, too.) We are also concerned that not only is the P (price) of P/E ratios high, but the growth rate of E (earnings) could be subpar in coming years as well. The S&P 500 is at near-record-high profit margins compared to the past 40-plus years, as shown in the chart to the right. Profit margins tend to be mean-reverting and, historically tend to be inversely correlated with five-year earnings growth. So when margins are high, subsequent earnings growth tends to be low, and vice versa. And while there are many arguments, some of them credible, for why profit margins might not revert back to long-term averages, we believe we will see some margin slippage over our investment horizon. That is because high margins encourage businesses to expand, increasing supply that pushes down prices and reduces margins. And, high margin industries attract competition that also ultimately brings margins back down. Moreover, most of the rise in margins has been driven by lower interest rates (borrowing costs) and declining taxes. Those will not immediately turn into headwinds, but at some point that will likely happen. So record margins do not bode well for future earnings growth. Looked at another way, according to the *Bank Credit Analyst,* if margins over the past 10 years averaged what they did in the 1990s, the Shiller P/E would come in at 36 instead of 27.



Historically, very high profit margins have been followed by sharp declines in company profitability. Source: Robert J. Shiller and Standard & Poor's. Data as of 9/30/2014.

Stock Allocations in our Portfolios

We do our own assessment of the equity market that takes into account valuations and earnings growth under different scenarios, and there are many other factors that feed into our analysis, including interest rates and foreign earnings. But the two metrics presented above align with our conclusions and do a good job of explaining why we are not optimistic about the outlook for U.S. stocks over the next five-plus years. This does not mean that stocks will not continue to do well over the next year or longer. Interest rates remain very low and this has led investors to take on more risk rather than accept the minimal returns in bonds or cash. This could continue, even with some Fed tightening.

Importantly, when it comes to allocating our portfolios, the lack of compelling alternatives makes this period very different from the tech bubble. Back then REITs, small caps, and value stocks offered pockets of opportunity (i.e., fat pitches). That is not the case today. So though we are underweight U.S. stocks, we still have meaningful exposure because other asset classes are also unattractive. This is important. It is very possible that U.S. stocks will generate low returns over the next few years but that these will be better returns than most other asset classes.

While we are underweight U.S. stocks, and this has hurt relative performance recently, we are at nearly a full weighting to foreign stocks. Despite risks there that have led us to temper our position sizes, valuations are much more attractive and, based on our analysis, the potential returns are more in line with what we want to see given the risks we are taking. Overall, our portfolios are somewhat defensively postured but not excessively so, largely due to our full weighting to foreign stock markets and exposure to more credit risk in

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our bond portfolios compared to our benchmark.

Looking forward we continue to expect a challenging environment due to the lack of great investment opportunities. Our positioning is very different from our benchmarks and so return patterns will likely be quite different (than our benchmark) from year to year. We are counting on adding value over the next five years on the back of our eclectic fixed-income exposure, and our underweight to U.S. equities. We may also be presented with fat-pitch opportunities along the way that could open up new investment options. Given high valuations in many asset classes and macro risks, it would not surprise us to see market declines that create attractive investment ideas.

We are hired to make thoughtful, well-researched, unbiased investment decisions that stay true to our investment philosophy and process, and are in the best long-term interests of our clients. This is the primary driver of our decisions as opposed to investing against a benchmark, following market momentum, or chasing hot asset classes. Sometimes it can take a while for our views to play out. That was the case during the tech bubble in the late 1990s when we started writing about overvalued stocks several years before the market peak. But ultimately our analysis proved out and over the entire period our clients were well rewarded relative to the market averages. In the more recent period we understood that stocks might generate strong returns given a Fed-induced low-rate environment, and if that happened our portfolios would likely generate healthy absolute returns, but lag their benchmarks. However, we would never have assumed that U.S. stocks would surge into the highest decile of valuation. That happened. Looking forward we are highly confident this level of valuation won't continue indefinitely, but we can't know when it will end. We can be patient though, and past market cycles tell us our patience will pay off.

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