August 27, 2015

"Zones of Reasonableness"

Our 2015 Investment Outlook was built around the following expectation: "… 2014 concluded with the U.S. economy on as solid a foundation as it has been in years, though we continue to expect markets to be weak and volatile compared to the economy. It is important to remember the economy and the stock market do not necessarily move in tandem."[1] We first introduced this idea in our 2014 Outlook premised on how the stock market's outstanding 2013 "borrowed" returns from future years. This was explained as follows:

> One reality we all must accept is how great years in the stock market tend to borrow from future returns, rather than enhance them. Heading into 2013, one could have reasonably expected to earn an annualized return of 6.67% – on par with the market's average since 1925 – over the course of the next decade.[2] The S&P 500 started 2013 at 1426. Factoring in a 6.67% annualized return the index would be at 2720 at the end of ten years. Assuming that despite last years' near 30% return, this 2720 ten year S&P index target does not change, the expected return over the next nine years would be 4.39% annually, instead of 6.67%.[2]

As of this writing, since that time, the S&P has returned a total 8.9% (inclusive of dividends) for an annualized return of 5.3%. We have often highlight how today's index or stock price (hereinafter just index, as we're discussing the S&P) can be broken down into two components: earnings and the earnings multiple, commonly referred to as the P/E ratio. In equation form we have Stock Price = E x P/E. When the market goes down it is because earnings are going lower, the multiple is going lower, or both (note: the market can go up with P/E going lower, though it requires the earnings growth outpace the multiple contraction). In 2007-09 both headed, driving the severity of the decline. Today, while the energy sector is a major drag on earnings growth, S&P earnings are not actually declining. This leads us to conclude that the market's P/E has taken a dive in this recent volatility. We can show this in visual form as follows:

[1] http://www.rgaia.com/december-2014-investment-commentary-our-2015-investment-outlook/

[2] http://www.rgaia.com/december-2013-investment-commentary-our-2014-outlook/

RGA
INVESTMENT ADVISORS LLC

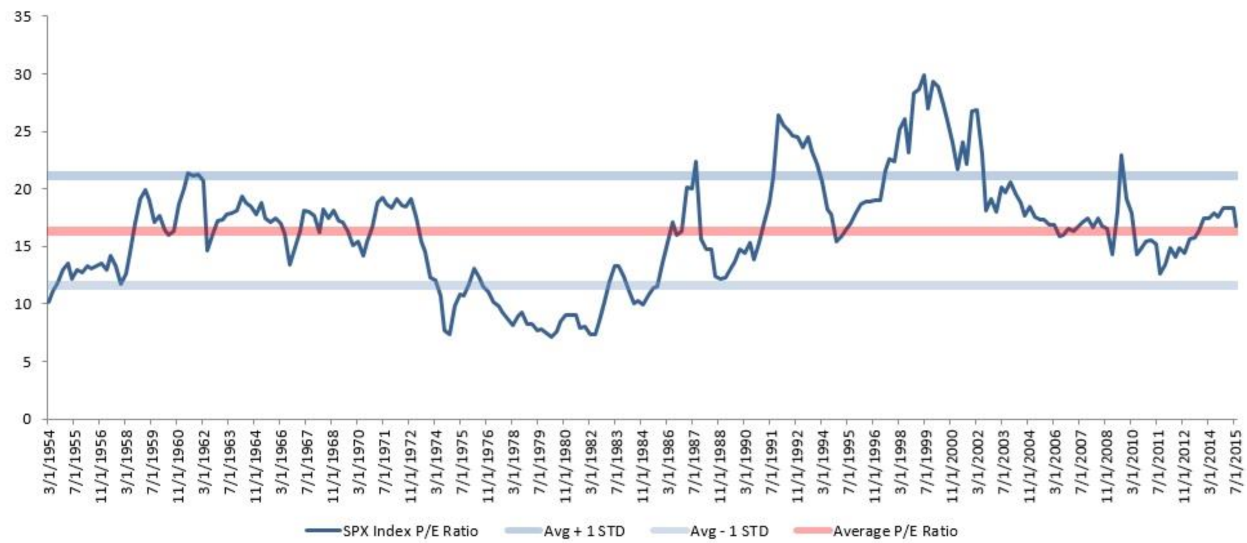
The chart above shows the market's P/E over the past 5 years. You can see the impact in 2011 from the combination of the Debt Ceiling and European Crisis on the S&P's multiple. That was an acute "repricing of risk" as the market attempted to handicap the likelihood of a U.S. default or the breakup of the European Monetary Union. 2013 was the year the S&P methodically priced in the likelihood of normalization in the U.S. economy following the crisis period. Note that the down moves are swift declines over very short timeframes while the expansions take their sweet time. This is the reality behind the cliché that "markets go up on an escalator and down on an elevator."

For the rest of this commentary, we try to piece together the context around today's market multiple. In a soon-to-follow interim commentary, we will take a look at the "E" component of our Price = E x P/E equation. A P/E tells us how much investors are willing to pay for each dollar of earnings. A 16.9 P/E implies investors are willing to pay $16.9 for each $1 in earnings. In other words, investors expect an earnings yield on their investment of 5.91% (=1/16.9). So long as the multiple stays constant over our holding period, this would be our expected annual real return excluding any growth or change in the share count. Over the long-run, S&P earnings have grown nicely; however, we will leave the additive nature of growth for our follow-up piece on the "E" side of the equation. The multiple also happens to be the means through which emotions influence market prices. When Benjamin Graham told the parable of the "Mr. Market" as a manic-depressive business partner, he essentially he was saying that the "very pessimistic" Mr. Market was offering low multiples, while the "wildly euphoric" was offering high ones. Certain macroeconomic factors can and do influence multiples; however, no one force is as influential as the "Animal Spirits" (or lack thereof) in the investor community.

There are tools we can use to figure out justified multiples given variables like the return on equity, growth and the cost of capital (we used one such formula to work backwards and figure out the market's implied growth, as laid out in our February 2014 Commentary).[3] These are helpful and give us a general sense of where fair value might be. The challenge however is that all of these calculations are done in a dynamic world with countless feedback loops, where inputs are constantly changing and no one output is a "right" answer. As a result, we analyze these situations in terms of "zones of reasonableness" and look for ranges of possible outcomes. This is especially helpful as it pertains to multiples. When we look at specific stocks, ultimately our goal is to buy a good earnings stream, with a multiple that is near the low-end of a range of possible outcomes, leaving the P/E more likely to expand rather than contract over time.

We look for this to be the case independent of where the market's multiple is; however, we must embrace the reality that in the short to medium-term our stocks move with the market. Consequently, the market's multiple is a useful gauge for determining whether we are likely to be working with a tailwind or headwind from Mr. Market. The following is a helpful visual:

[3] http://www.rgaia.com/pockets-of-momentum/



This chart shows the market's P/E on a quarterly basis over the past 60 years relative to the average P/E over the timeframe. The shaded blue upper and lower lines show the average P/E plus and minus one standard deviation. Somewhere within these upper and lower lines is what we would call "the zone of reasonableness" for the market's multiple. The market spent most of the 1970s beneath the lower end of this zone—that is extreme cheapness. This is what happens when stocks confront rampant inflation. Meanwhile, the market spent most of the 1990s above the upper band. That is what "irrational exuberance" looks like in visual form. Following August's severe correction, the market is sitting right near its 60 year average P/E of 16.37. In other words, the market went from an above-average P/E to an average P/E over the past week. You may have noticed that the right side of the chart has higher P/Es than the left. Over the past 20 years, the market has averaged a 19.25 P/E, so in this light, today's number looks on the low side of normal.

Interest rates and inflation are important factors influencing the direction of market P/Es. When inflation and interest rates are high (low), P/Es tend to be low (high). Right now, we have low inflation and low interest rates which would justify P/Es that were either at or above the longer-term average. The economy has continually strengthened, with initial jobless claims at their lowest level since 1973, strong corporate and household balance sheets, and manufacturing output humming along.[4] The "excuse" for this market action is directed at China's collapsing stock market and multi-day depreciation of the Yuan; however, in the grand scheme of things China's stock market remains up on the year, the

[4] http://www.reuters.com/article/2015/07/23/us-jobless-idUSKCN0PX1EO20150723

Yuan's move was hardly steep in contrast to other emerging market depreciations, and US exports to China in 2014 amounted to a mere 0.71% of GDP. Meanwhile, US imports from China accounted for 2.7 of GDP.[5] With the Yuan getting cheaper, the net effect of Chinese troubles and a cheaper currency should ultimately benefit US consumers who buy plenty of goods made in China.

Think of what happened in markets this August like an earthquake where what cracked was the market's multiple. We had a big initial shock, followed by a series of aftershocks. These aftershocks get progressively smaller over time before equilibrium is restored and normalcy resumes. Out of this all, we have the most ripe opportunity set we've seen since early 2013 and that won't be going away fast. In other words, it takes time for these things to work themselves out but markets ultimately will find their footing and start working for us again sooner rather than later.

[5] https://www.census.gov/foreign-trade/balance/c5700.html

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-1945
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, CFA
Managing Director
O: (516) 665-1945
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com