Action Plan for an Expensive Stock Market

By most measures, the market looks expensive, and a disciplined approach to investing has become increasingly important. Our conversations with clients continue to revolve around a core set of considerations including the potential need to rebalance portfolios, diversify investments, hedge risk, and revisit financial plan assumptions.

The below graphic provides a current view of some of the more commonly followed stock market valuation metrics, and while it is far from an exhaustive list, the overall message is clear: The market looks expensive.

S&P 500 Valuation Metrics

Percentile Ranking Relative to History

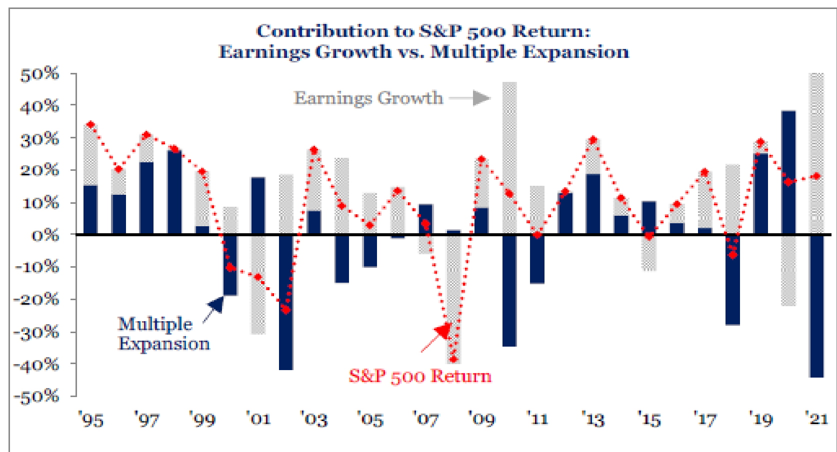
Source: Strategas Research Partners

First, a few observations on the current environment and why alarm bells may not necessarily be warranted:

1) To battle the economic impacts of the pandemic, fiscal and monetary policymakers deployed a powerful combination of low interest rates and massive spending programs. More capital is flowing through the economy while interest-bearing investment opportunities like savings accounts, CDs, and government bonds look less attractive due to lower rates. Consequently, investors seem willing to pay more for stocks.

2) This is not the 90s. It is easy to try to make the comparison, though the reality is that not only have valuations not broadly eclipsed those from '99-00, but this is a different market, in a different time, with different circumstances (see #1 above). In monitoring various economic, market, and sentiment indicators, we have not generally seen the same broad-based euphoria that fueled the late stages of the tech boom.

3) Earnings growth is a pivotal storyline. Illustrated on the right are S&P 500 returns since 1995 and the two fundamental drivers behind those returns: Earnings (gray) and Valuation (blue). The red line shows annual performance while the bars indicate how much of the advance or decline was attributed to earnings growth, what investors were willing to pay for those earnings, or both.



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The prior two years proved extremely rewarding for stock market investors, but returns were not driven by earnings growth. Especially in 2020, speculation took over as investors were willing to pay more for stocks in anticipation of higher future earnings even as 2020 figures plummeted due to the pandemic. The reverse is happening in 2021 with stunning quarterly earnings growth so far this year and declining multiples.

Earnings are growing into elevated stock prices; hence, referencing a different valuation metric that incorporates growth into the equation like the PEG (Price/Earnings-to-Growth) ratio, for example, the market sits comfortably under the peak levels seen in the 90s, 00s, and 2020 pre-pandemic.

While reasonable explanations exist to justify higher-than-average valuations, we acknowledge the market at least appears to be on the expensive side relative to history. The more important question: Should you do anything about it?

Valuation metrics like price-to-earnings (P/E) ratios are in every portfolio manager's toolkit and can be incredibly helpful when comparing one investment to another since they represent the price investors are willing to pay for each dollar of earnings. They offer a quick and easy way to compare one stock, sector, or geographic region versus another. On the contrary, using valuation to attempt to gain a market-timing edge may prove less effective.

Using data going back to 1950, an analysis from Strategas Research explored the relationship between forward returns for the S&P 500 and its CAPE ratio (Cyclically Adjusted Price/Earnings). Briefly defined, the CAPE smooths out the variability of annual earnings over an economic cycle by moving beyond the last twelve months to instead encompass 10 years of earnings data. How valuable was it in forecasting future performance?

In the short-term, it proved unreliable at best. There was little correlation between the valuation of the market and the ensuing performance over the next year. Expensive markets can and often do become more expensive, a trend known as momentum. A reversion to the mean, though likely over time, is not always swift.

What about longer-term? The relationship proved much stronger and more reliable when looking at annualized performance over the next 10 years. Lower valuations historically corresponded with higher annual returns over the next decade, and vice versa, which is logical. Cheaper markets would presumably offer higher return potential.

Is this the only piece of information you need to make a major financial decision? Absolutely not. The CAPE ratio itself has weaknesses, and we would caution against putting too much emphasis on any one indicator. Nevertheless, we deem its historically high level noteworthy and thus ask, what can we do with this information?

A knee-jerk reaction might be to abandon ship and hoard cash, but that seems imprudent for many reasons, not the least of which being the loss of purchasing power due to inflation. Maybe that was of less concern in prior years, but with inflation currently a very real issue, the value of idle cash could fall by 2% or more in the next year. Moreover, if your primary expenses revolve around healthcare and education, which over the past 30 years have roughly doubled and quadrupled the general rate of inflation, respectively, you are losing even more to inflation.

Importantly, we would also add that adhering to a strategy of selling stocks every time the market was dubbed "expensive" would have kept you sidelined for some of the best stock market runs over the last few decades.

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Instead, we propose considering the below:	
Rebalance	With the S&P 500 rising ≈15%/year over the past decade, your equity allocation may have drifted well above the longer-term target set in your financial plan. Consider rebalancing by trimming stocks and directing proceeds to investments with lower correlations to equities. Contemplate the tax impact, of course, but otherwise this is an easy risk-control lever to pull.
Diversify	Opportunities still exist in the bond market to potentially keep up with or outpace inflation, international equities look attractive due to lower valuations and often higher dividend yields compared to the U.S., and private market alternatives (equity, credit, and real assets) offer different paths to add exposure to asset classes beyond traditional stocks and bonds.
Hedge	Invest cash periodically and systematically as a measure of disciplined risk control. It may not end up being a winning strategy since stocks statistically rise more than they fall, but it does hedge entry points and reduce angst. Additionally, consider a hedged equity allocation to participate in the stock market but have some built-in protection against a decline.
Reassess	Most importantly, if your personal financial plan assumes stocks will grow indefinitely at a pace similar to that of the past decade and your spending and other financial goals depend upon it, revisit the plan to reassess needs, objectives, and expectations. The sunny side of an expensive market, though, is that you may very well be in a better position than anticipated.

Managing wealth is a process and adhering to a financial plan requires constant vigilance. Your plan should adapt to fluctuating market dynamics just as it should to major life events, economic cycles, and tax policy changes. We encourage you to talk with your advisor about how the valuation of the market impacts your plan.

DISCLOSURE: The information above is for illustrative purposes only and nothing herein should be interpreted as investment advice. It should not be assumed that future performance of any specific investment or investment strategy will be profitable. Different types of investments involve varying degrees of risk, but all investments carry the risk of loss, including the permanent loss of principal. Past performance is not a guarantee of future results.