# JAM JOLLEY ASSET MANAGEMENT, LLC

**Investment Outlook** **Volume 1, Issue 65• Fall 2014**


> *"The more dependent the valuation becomes on anticipations of the future – and the less it is tied to a figure demonstrated by past performance – the more vulnerable it becomes to possible miscalculation and serious error."*
>
> *Benjamin Graham*

The S&P 500 index rose for the seventh consecutive quarter, tacking on another 1.13% and bringing its year-to-date return to 8.34%. According to the Wall Street Journal, since 1950 there have only been three streaks longer. But in the quarter just ended, the markets were not quite as rosy as they appeared on the surface. The S&P 500 index had negative returns in two of the three months. Ironically, the markets posted large gains in August (down in September and October) as investors wanted all in before the annual Federal Reserve love fest in Jackson Hole, Wyoming. As the chart below shows, there were a lot of cross-currents in the markets this past quarter with the small and mid-cap indexes posting losses of 7.36% and 3.98%, respectively. We have discussed for some time that valuations in the small-cap universe had become extremely high and that the shares were vulnerable. In the most recent quarter, the tech-laden NASDAQ composite was the best performing index, advancing by 1.93%. The excitement around the initial public offering of Alibaba and the new iPhone 6 launch buoyed the technology sector which helped the growth indexes trump the value indexes. According to Bank of America/Merrill Lynch, for the quarter the "nifty-fifty" (top 50 names by market cap) advanced by 2.36%, while the "not-so-nifty 450" (bottom 450 names in the S&P 500) declined by 1.50%. The commodity markets were quite volatile in the quarter, with copper falling 5.7%, gold dropping 8.4% and oil down by 13%, largely in response to the strong U.S. dollar which rose by more than 8% against the euro and the yen.

| Index | 3rd Quarter 2014 | YTD 2014 |
|---|---|---|
| **DJIA** | **1.86%** | **4.56%** |
| **S&P 500** | **1.13%** | **8.34%** |
| **S&P Mid Cap** | **-3.98%** | **3.22%** |
| **Russell 1000/Growth** | **1.49%** | **7.89%** |
| **Russell 1000/Value** | **-0.19%** | **8.07%** |
| **Russell 2000** | **-7.36%** | **-4.41%** |
| **NASDAQ Comp.** | **1.93%** | **7.59%** |

## Stock Valuations

The S&P 500 currently appears to be fully valued, with the index trading at 19.07 times trailing earnings and approximately 16.4 times forward earnings. The median stock in the S&P 500 currently trades at 20.9 times trailing earnings. A recent Ned Davis Research report put things into perspective by comparing current S&P valuation metrics with the 2000 market peak and the 2007 peak. The chart below shows that the current median price/earnings ratio is somewhat higher than the 2007 top but slightly below the 2000 top. Other metrics such as price/sales ratios, dividend yield and price/book value show the current market to be somewhat cheaper than in the two previous tops.

**Market Valuations**

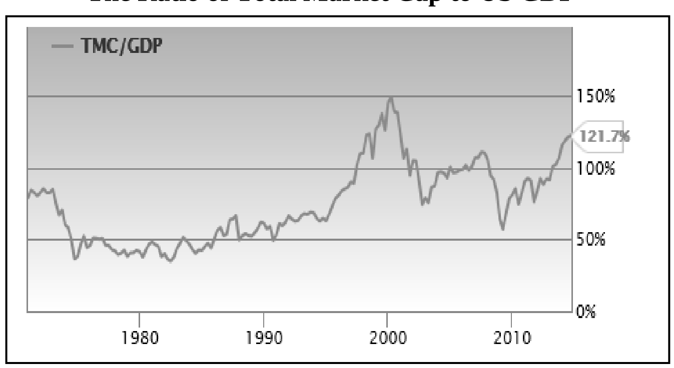
| *Metric* | *3/24/00* | *10/9/07* | *9/5/14* |
|---|---|---|---|
| *Median P/E* | 21.2 | 19.7 | 20.9 |
| *Price/Sales* | 2.2 | 1.5 | 1.7 |
| *Div Yield (%)* | 1.1 | 1.6 | 1.9 |
| *Price/Book* | 5.1 | 3.0 | 2.7 |

*Source: Ned Davis Research*

Robert Shiller of Yale University wrote an editorial to the NY Times in August 2014 warning that his CAPE ratio shows the market to be trading at a level of 25 times versus an average of 15.2 times. The CAPE or cyclically adjusted price-earnings ratio essentially tries to smooth real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical business cycle. Shiller stated that "The United States stock market looks very expensive right now. The CAPE ratio, a stock-price measure I helped develop—is trading at a worrisome level." Shiller goes on to state that while the ratio is worrisome, it has been a "very imprecise timing indicator". Essentially, the ratio has been at high levels for most of the past two decades except in the 2007-2009 recession, when the ratio bottomed at 13.32 times.

In 2001, Warren Buffett stated in Fortune Magazine article that the Total Market Capitalization/GDP indicator "is probably the best single measure of where valuations stand at any given moment." As the following chart shows, the ratio is below the 2000 peak but well above the 2007 peak. While Mr. Buffett stated that this valuation metric had certain limitations, it appears obvious that this indicator is currently flashing a warning signal to investors.

**The Ratio of Total Market Cap to US GDP**




*Source: GuruFocus*

In summary, the markets are valued at levels not seen since 2000. While ultra-low interest rates do provide support for higher valuations and multiples, markets definitely appear to be flashing a "yellow light".

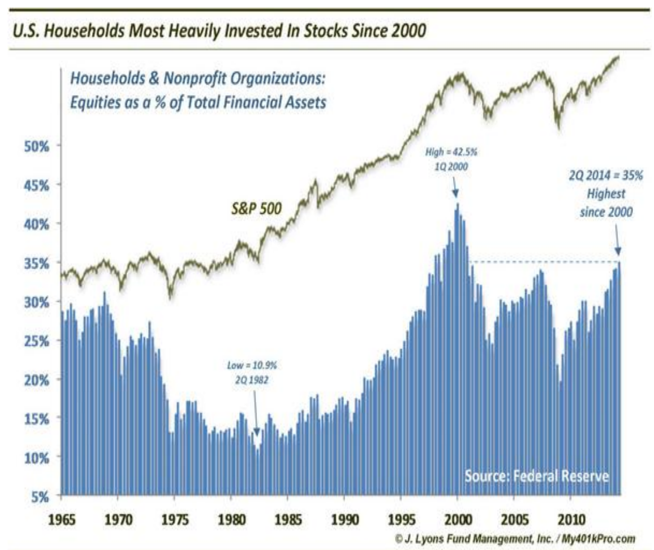
## Buyback Party

Through the first half of 2014, corporate America repurchased approximately $338 billion worth of stock, which is the most for any six-month period since the first half of 2007. Bloomberg estimates that in 2014, companies in the S&P 500 will spend $914 billion on share repurchases and dividends, or approximately 95% of projected earnings. A study by Barclays PLC estimates that companies with the largest buyback programs by dollar value have outperformed the broader market by 20% since 2008. Jonathan Glionna, head of U. S. equity strategy at Barclays said, "There are a couple of reasons why companies do buybacks. One is that it seems to work; it makes stocks go up." Share repurchases also increase earnings per share which has been an important driver in the market since this bull market began some six years ago. Ironically, while companies are buying in record amounts of shares, corporate executives are not. The ratio of insider buys to sells is at one of the lowest levels in the past fourteen years. Keep in mind that most executive compensation is based on stock performance and earnings per share levels, both of which are inflated by share repurchases. Corporate share repurchases are not a function of management buying at "bargain price levels" but instead a type of financial engineering driven by the Fed's zero interest rate policy. Purchases by corporate insiders, on the other hand, typically indicate that shares are on the bargain counter—they are staying on the sidelines.

While buybacks have helped drive the bull market, they are not without their critics. At some point, companies will need to start plowing money back in their businesses. According to Bloomberg, the average age of fixed assets reached 22 years in 2013, the highest level since 1956. David Lafferty of Natixis Global Asset Management recently stated, "The reality is that capital expenditures come with risk, significant amount of risk, especially in a slow-growth world. Buybacks offer a lot of flexibility." In summary, share repurchases of approximately $2 billion since March of 2009 have helped fuel a bull run of over 191%. The repurchases have also been one of the factors that the S&P 500 has gone three years without even a ten percent correction. Albert Edwards of SocGen recently warned that the buyback party is ending. Data shows a dramatic decline in buybacks in the second quarter of 2014 on both a quarter-over-quarter and year-over-year basis. He attributes this decline to the end of quantitative easing and states, "The pro-cyclical process always ends in tears and is regarded in retrospect as typical end of cycle madness. For when the funding for corporate bond issuance stops (for whatever reason, i.e. QE ends), share buybacks also stop and one of the biggest drivers for the equity bull market is removed."

## Everybody Aboard

As of June 30, 2014, data from the Federal Reserve showed that U. S. households were the most heavily invested they have been in stocks since 2000. Equities as a percent of total financial assets totaled 35% at mid-year which is higher than 2007 but below the pre-bubble peak of 42.5% reached in 2000. Bernanke and Yellen have succeeded in moving households into riskier assets as they have given investors essentially no other investment alternatives. We discussed T.I.N.A last quarter in our *Investment Outlook—Summer 2014*. In case you missed that, T.I.N.A stands for there is no alternative (to equities). The zero interest rate policy has essentially forced investors in stocks regardless of their risk tolerance.




## Summary

In summary, valuations in the market have reached levels not seen since the peak during the internet bubble of 2000. While price earnings multiples are supported by the Fed's zero interest rate policy, stocks could be vulnerable to higher interest rates or an economic shock. Buybacks by corporations continue at a frenzied pace in 2014, but have recently shown some signs of slowing. Buyback activity has been an important driver of this bull market, which is now approximately five and a half years old. Central bank policies and easy money around the globe have buoyed U. S. stocks which have now gone some three years without as much as a ten percent correction. Stocks typically correct ten percent every eleven months. Just as Fed policies have encouraged "financial engineering" by U. S corporations, they have also forced U. S. households into equities in a search for returns in a zero interest rate world. Clearly, the risks are rising in the marketplace. It will be interesting to see what tricks Yellen & Company pull out of the bag if the markets begin to decline. QE 4 anyone?

*Frank G. Jolley, CFA*

JAM JOLLEY ASSET MANAGEMENT, LLC

**210 Bryant Street, Suite A**
**P.O. Box 7967**
**Rocky Mount, NC 27804**
**(252) 451-1450 Toll Free (877) 4-JOLLEY**
**Web Site: www.jolleyasset.com**
**E-Mail: fjolley@jolleyasset.com**