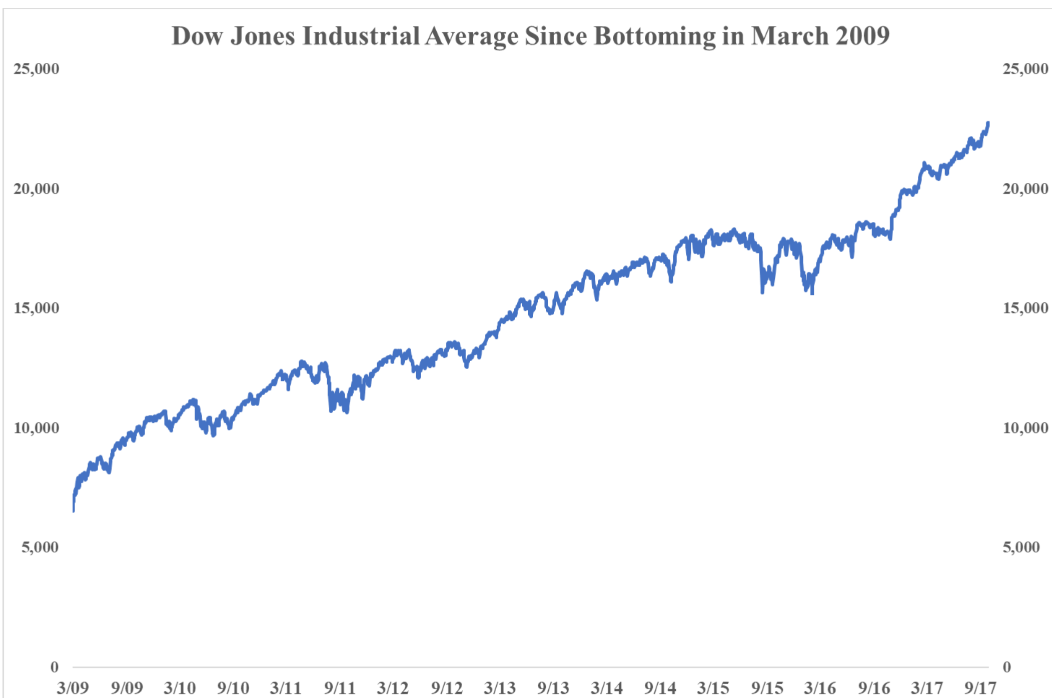
Third Quarter 2017 Commentary

This quarter saw a number of destructive hurricanes which caused widespread damage in parts of Texas, Florida, and Puerto Rico. Not to be outdone by Mother Nature, dysfunction in Washington seemed to reach new levels with ongoing investigations, legislative failures in a Congress controlled by one party, and bellicose rhetoric with nuclear-armed adversaries.

So, how did the stock market react to all this news? The same way it has for the past eight quarters: it just kept grinding higher. For the quarter, the S&P 500 advanced by 4.5%, while the Dow Jones Industrial Average gained 5.6%.

As of this writing, the Dow is trading at a record high of just under 23,000. So far this year, it has closed at a record high on 46 separate occassions, which averages out to a bit more than one new record high every week this year. But this upward trend for the market is nothing new. In fact, as the graph below shows, since the Dow hit a closing low of 6,547 on March 9, 2009, it has soared for more than eight years with very few hiccups along the way. From the depths of the Great Recession, the Dow has returned more than 330%.

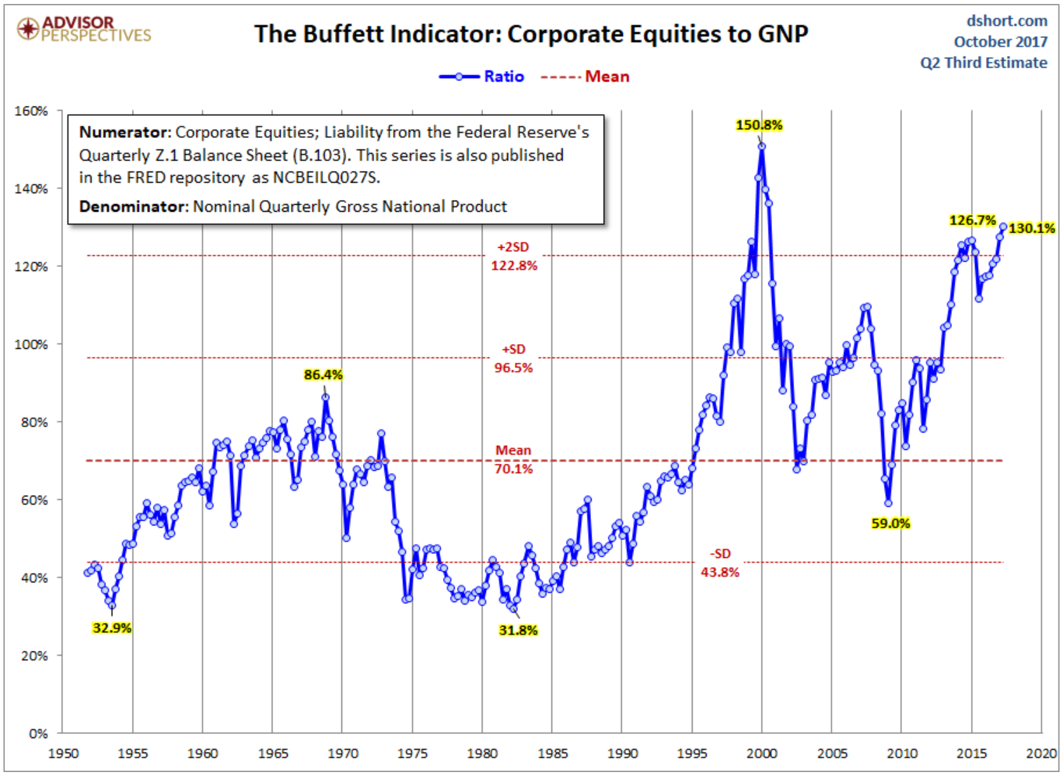


Source: Yahoo! Finance

In times like this it may prove worthwhile to explore how the current environment compares to the past, especially those periods that preceded big market declines. Below we examine three indicators that suggest that investors today may be too complacent and that stock market valuations may currently be over-stretched.

The Buffett Indicator

In a 2001 speech that was converted into a *Fortune* magazine article, Warren Buffett gave us a rare glimpse of his views on the valuation of the stock market. There, he mentioned a metric that he called *"probably the best single measure of where valuations stand at any given moment."* What came to be called the "Buffett Indicator" is a ratio that measures the market value of all publicly traded securities divided by the country's gross national product (GNP). It is like a price-to-sales ratio for the market as a whole—how much investors are paying for the universe of public companies for each dollar that they contribute to the economy. The chart below shows the trend of this ratio from the 1950s to today.



Source: Advisor Perspectives

For the last six decades stocks have traded at an average of 70% of GNP; since 1995 the average has been about 100%. Under this valuation methodology, stocks right now are trading close to the all-time high reached just prior to the bursting on the Internet bubble in 2000.

The Professor's Ratio

Robert Shiller is an economist from Yale University and a recipient of the 2013 Nobel Prize in Economics. He is best known for his book *Irrational Exuberance* that warned about a stock market bubble in March 2000; the book was published literally a few days before the Nasdaq stock index began its nosedive.

One of the tools that Professor Shiller developed to warn us about how expensive the market was is a metric he called the 'cyclically-adjusted price-to-earnings' ratio, or CAPE for short. To calculate the CAPE ratio for the market, you take the average of the last ten years of earnings for the S&P 500 index, adjust them for inflation, and divide that into the current price of the index. The thinking behind this calculation is that by taking an average of the last ten years of earnings, you smooth out earnings from really good years and really bad years, providing a better picture of earnings through an entire economic cycle.

Professor Shiller demonstrated, using more than a century of data, that future returns for the stock market were inversely correlated to the CAPE ratio. In other words, if the CAPE ratio was high that meant that stocks were overvalued and they were likely to produce poor future returns; on the other hand, if the CAPE ratio was low, stocks were likely to generate healthy returns.

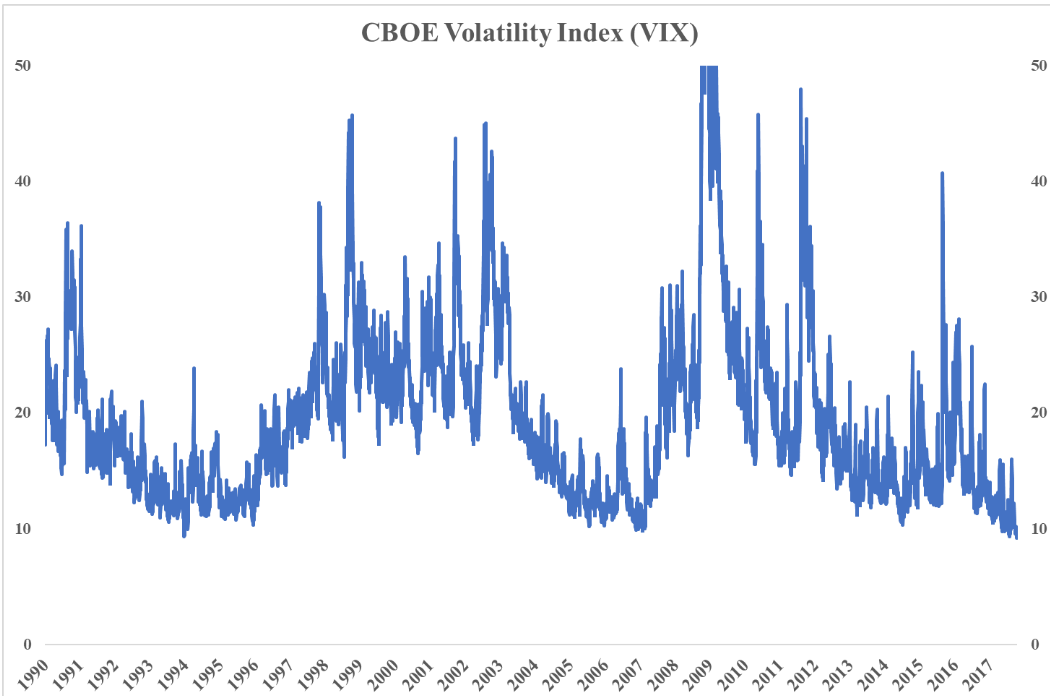
The graph below shows the CAPE ratio for the U.S. stock market from the late 1800s to today. As can be readily observed, this metric peaked just before two of the worst stock market crashes in U.S. history: the crash of 1929 and the meltdown of 2000 following the Internet bubble. The CAPE ratio today stands at 31 versus a historic median of 16, being exceeded only by the two instances just mentioned.

Source: multpl.com

The Fear Index

Volatility is a statistical measure of how stocks move up and down: the more their prices fluctuate, the more volatile they are. The Chicago Board Options Exchange (CBOE) has developed a measure called the CBOE Volatility Index—better known as the VIX—that measures the implied volatility of S&P 500 index options. The mathematical details of the VIX are too complex to get into here, but suffice it to say that the VIX measures how investors are feeling about the market. When the VIX is low, investors are predicting tranquil markets, and when it is high they are expecting major movements. It is for this reason that the VIX has been called the "complacency index" or the "fear gauge."

The graph below plots the value of the VIX since its inception in 1990. It currently stands at its lowest-ever level, meaning that investors today are more complacent than they have been at any time in the last 27 years. The last time it was this low was in the early 1990s when there was less turmoil in the world and we were experiencing faster economic growth. This naturally leads to the question asked recently by investor Howard Marks: *"Should people really be as complacent now as they were then?"*



Source: Yahoo! Finance

Some Caveats

It is important to note that the measures above are not perfect prognosticators and they have their flaws. For instance, as we discussed in a May 2015 article, the Buffett indicator does not take into account the fact that today's companies are much different than the companies of past decades. Back then, capital intensive industries such as energy and utilities had a bigger impact in the U.S. economy. Those companies had much lower profit margins than today's tech behemoths that require very little capital to operate.

Additionally, the CAPE ratio has not been without criticism. As Jeremy Siegel of the Wharton School has argued, recent changes in accounting rules have made current CAPE readings less comparable to the ones from prior decades. Also, the accounting treatment of catastrophic recessions, like the one experienced in the financial crisis, artificially raise the CAPE ratio.

Conclusion

Given all that we've discussed, what's an investor to do? Does this set of data mean that we should sell everything and go to cash which is earning virtually nothing? No, that is not what we're suggesting. Timing the market is almost impossible to do. As Peter Lynch once said: "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."

Our plan of action is to—once again quoting Howard Marks—move forward, but with caution. We are fully cognizant of the fact that you have entrusted your hard-earned money to our care, and we will do our best to manage it as sensibly as possible. We thank you again for that trust, and we look forward to reporting to you again in another three months.

Sincerely,

FELIPE

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