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INVESTMENT

Insights

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+ We believe that controlling volatility and downside risk—within the construct of each investor's unique risk/reward tolerance—is an important step in meeting long-term financial goals.

+ We are true believers in the concept of diversification, both within and among the various asset classes and strategies that are available to our clients.

A MONTHLY INVESTMENT COMMENTARY FROM YOUR TRUSTED INVESTMENT ADVISORS AT MONETA GROUP

by BILL HORNBARGER,
CHIEF INVESTMENT OFFICER

For Asset Valuations: Price Matters

In our everyday lives we are very conscious of what we pay for things. We look for the best value we can, whether shopping for a new car or a new home. Inherently, we understand the concept of "price matters," and we know, for example, that the less we pay for a new home today means a larger potential gain when it's sold in the future. Another way to think about it is the pleasure shoppers feel when they buy something and think they got a "good deal."

Momentum vs. Valuations

The concept of price matters can also be applied to the investment world. One of the most difficult things to overcome as an investor is managing your emotions, particularly panic and euphoria. Every potential investment idea has the same disclaimer, "past performance is no guarantee of future results," and yet many people will allocate funds to the recent strongest areas of the market.

Extreme examples include the fascination with technology stocks in 1999 and real estate in the mid-2000s. Assets flowed to those sectors, valuations ballooned and significant corrections followed in the ensuing years. This is an investment style often referred to as "momentum." It pays less attention to fundamental valuations and more to short- to intermediate-term trends. Momentum investors are often buying investments that are considered

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Price Matters, continued...

"expensive" by common metrics. Holding periods tend to be shorter (and turnover higher), and risk management takes on heightened importance.

If one doesn't follow a purely momentum style of investing, then the concept of price matters (more commonly referred to as valuation driven) becomes more important. While predicting markets and returns consistently is impossible, particularly in the short term, what one pays for an asset (price matters) has historically impacted future returns. An easy way to understand this is to think about fixed-income returns.

The starting yield (another form of price) historically has been a very good predictor of future returns. For example, if one invests in a bond with a 5% yield to maturity and holds it until maturity, the return will be around 5%. Applying this to equities produces somewhat similar results. When one invests in equities at lower valuations (a low price-to-earnings ratio, for example) one historically has realized higher returns over the intermediate and longer term (three to five years), and vice versa.

Valuation's Role

It's important to remember that valuations and valuation metrics tell us nothing about timing. John Maynard Keynes famously stated that, "The market can stay irrational longer than you can stay solvent." And zero and negative interest-rate policy on a global basis has distorted risk premiums (in our opinion) across a variety of markets and asset classes. We would stress that being conscious of valuations is a single data point that tells us little in the short term.

If valuations aren't particularly useful in the short term, is there a way that they can be additive to portfolio management? The answer is, of course, yes, and we apply it through a process of disciplined rebalancing, which incents good investor behavior through a process of buying low and selling high. When an asset holding appreciates significantly beyond its strategic allocation, it typically is accompanied by an increase in valuations and is ripe for harvesting gains.

Another way that valuation information can be helpful is from a planning perspective, again over the intermediate term. Most of us have financial goals that we think about in terms of an asset or dollar level (our own unique "number" that we use as a gauge on the path to our life goals). If we are entering a period where valuations suggest slightly lower returns, investors could use that information to alter saving and spending habits to help achieve their goal or even possibly alter their asset allocation (although adding risk at a time when valuations are extended has the potential to lead to less-than-optimal outcomes). A good example is the role of fixed income in portfolios today. With the 10-year U.S. Treasury currently yielding less than 2%, it's unlikely that over the next three to five years fixed income will generate returns in line with the past 15 years (i.e., 5.01%). Most investors inherently understand this and have made planning and/or asset allocation decisions in response.

> "The market can stay irrational longer than you can stay solvent."
>
> John Maynard Keynes

What about valuations? What (if anything) do they tell us today? First, it's important to determine what metric you want to use for valuations. Many people use the price to earnings (PE) ratio while others use the cyclically adjusted price earnings (CAPE), which looks at current prices vs. 10 years of inflation-adjusted earnings.

We tend to look at both of those measures as well as markets vs. trend, and a simple four-factor model that equally weights price to book, price to cash flow, price to earnings and price to sales. We have looked at each of these metrics relative to their own history and relative to a market benchmark (global stocks or the S&P 500).

Our simple analysis shows that combining those four factors equally and looking at the current measure vs. history can give you a decent idea over a three- to five-

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Price Matters, continued...

year period of how a market will perform relative to its own long-term average. It doesn't predict actual returns but reaffirms the idea that when markets are "expensive," forward returns tend to be slightly lower and vice versa. In other words, price matters.

It probably comes as no surprise that after the very strong gains of the past six years and befitting a market near all-time highs, most categories of equities—small-cap, mid-cap, large-cap, international and emerging markets (EM)—are above long-term averages. Looking at just those five categories shows that U.S. large cap has the highest valuations while EM has the lowest. None are at what we would consider extreme valuations, but all are above-average except for EM, which is in the 41st percentile. In terms of fixed income, bonds remain influenced by the Federal Reserve's extraordinary easy monetary policy and, by just about any metric, are expensive.

As we mentioned previously, predicting markets is a near-impossible undertaking. However, with the tailwind of accommodative monetary policy beginning to shift and most asset classes "fully" valued, we would expect that forward returns will be more muted for a period. Valuations and emotions aren't so extended that we would worry about another 2008 type of market environment but it's worth noting that corrections are a normal part of investing. It's also worth noting that pronounced corrections (10% or more) have the potential to change valuations enough to impact forward returns, and while it's somewhat emotionally difficult to accept, corrections actually reduce the risk of an asset class.

Please note, these materials were prepared for informational purposes only and do not take into consideration your individual circumstances. This not an offer to purchase/sell securities. Past performance is not indicative of future returns. Alternative investments possess features and risks distinct to the individual investment vehicle, and any decision to invest in such vehicles should be made based on your individual circumstances in consultation with appropriate financial professionals.

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1.314.726.2300
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