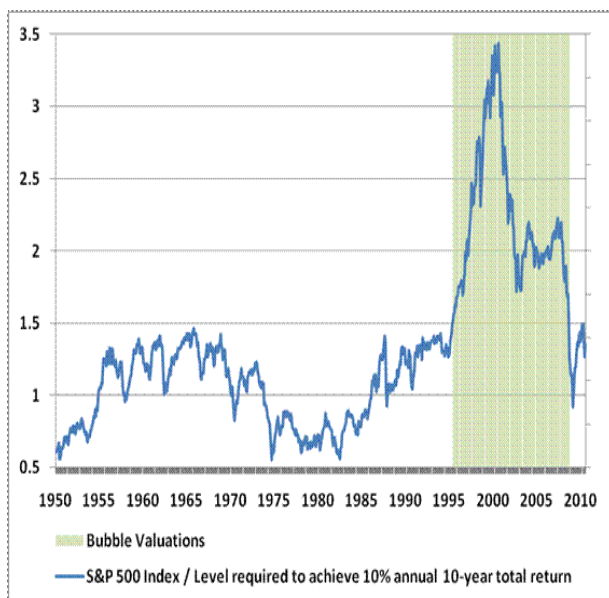


DOES VALUATION MATTER?

What should investors expect during secular bear markets? This is a concept I wrote about in my September 2009 article entitled, “Where’s the tipping point?” (<http://www.guardianca.com/finarticles>). As most long-term clients are aware, it is my belief that the economy and markets are embattled in a multi-year secular bear market that began in 2000, and using historical comparisons might end between 2016-2020. That’s the bad news. Here’s the good news – there will be plenty of opportunities to profit during this period for those who are *prepared* and *patient*.

Most pundits of “the worst is over” camp argue that since stocks have had a decade of no returns that logically they must go up. While I hope that turns out to be true, I wouldn’t bet on it. Why? Because historically, stocks were SO overvalued (in hindsight) that even with the past decades decline they are still at the high end of historical valuation. This can be seen using the following chart, courtesy of John Hussman of the Hussman Family of mutual funds (www.hussmanfunds.com).



This graph shows where valuation *WAS* and where valuation currently *IS* considering expectations of 10 year forward company earnings compared against today’s stock prices. So if historically the stock market has been considered overvalued when the valuation multiple has reached 1.5, how should investors feel when after all the recent pain of the past ten years, valuations are still near that historical level? As John commented in his July 26th article:

*“If there is one thing that is singularly responsible for the abysmal returns of the S&P 500 over the past twelve years, it is the ludicrous set of valuation “models” that Wall Street has repeatedly foisted onto an uninformed public in order to **sell them** [emphasis mine] on the notion that dangerously overvalued markets were actually “cheap.” Knowledge is your best defense. Valuation matters.”*

I concur. While it is impossible to know what markets will do in the short-term, I believe there is greater risk of prices declining over the coming years than making new highs. In my humble opinion, I only see one significant scenario that would propel stocks to new highs in the years to come, but that will be discussed in my next article.

I want to conclude on a positive note for my clients and readers. While I believe it will be all too easy to lose money in the years to come, I also believe the coming volatility will offer great investment opportunities for those who are prepared and able to take advantage of them. I believe a “buy and hold” approach using passive investments (i.e. index ETFs and Funds) will not be the most effective strategy in the current environment.

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