



*"Unequaled Personalized Service"*

**July 2008**

## **Market Commentary: Valuations in the Late-1990s and Today**

Experience tends to be a marvelous teacher in life; except when lessons learned are ignored. We are referring to an investor's inability to consistently view the stock market in terms of where it is going rather than where it has been. Let's retreat to the late 1990s; back to the good old days when stocks went up, oil prices were ½ of this year's *increase*, and home prices were still ascending. Many large cap growth stocks traded at 35-40 times earnings, some much higher. Technology and internet stocks soared as operating losses increased. Many investors thought the future was bright, because their then-recent experience had been so lucrative.

The truth is that the future couldn't shake the high valuations it inherited from the late 1990s. Earnings are up more than 80% for the S&P 500 over the last 10 years, yet the Russell Top 200 Growth index shows a negative annualized return for the period. The S&P 500 is up 2.9%, annualized, over the last 10 years. Many companies have performed well, yet their stock prices have not.

Today offers a much different outlook and starting point for valuations. Sixteen-year-low consumer confidence numbers paint a bleak economic picture. Investors are weathering high oil prices, a cheap dollar (relative to other currencies), record grain and food prices, and a fractured stock and bond market. Not exactly a rosy economic backdrop. But it gives us a tremendous starting point for valuations (low price-to cash flow, earnings, sales, book value, etc.), just the opposite of 10 years ago. This favorable pricing gives us great optimism at a time when many in the media are extremely pessimistic.

Historically, valuations have been better predictors of future stock returns than have earnings estimates. Market peaks reached in 1929, 1966, 1987, and 2000 were all associated with excessive valuations (greed) and strong earnings outlooks (optimism). Each subsequent period experienced significant market declines. Cisco Systems, the largest company in terms of stock market capitalization on the NYSE in March 2000, saw its sales triple and earnings double over the ensuing eight years. The stock fell by more than 70% over the same period. Strong earnings and sales could not overcome excessive valuations.

A question we have been asked frequently of late is: "why don't we sell now and wait for better times ahead?" Selling is the easy part; getting back in is the tough part. If the market heads south from where you sold, you will likely have even less desire to buy back in at the lower prices—when fear is typically greater. If prices head up after you have sold, it is even more difficult to buy back in as you are likely to believe that the appreciation will not last. It is possible to miss a significant part of a given year's market returns by "waiting for better times

ahead." In some years, just a few days make up an entire year's result. Our industry experience suggests that market timing is not a winning strategy over the long haul.

What then should one do when economic times are tough and may even get tougher? In our opinion, stay the course. Stock valuations are in most cases very favorable. The world is not coming to an end. Our experience tells us that both stock prices and the economy will revert back to the mean. Said another way, low valuations will rise and tough economic times will subside. Rare is the investor who can pick a top or bottom. Even rarer are times when the economy and equity markets do not improve.

EUBEL BRADY & SUTTMAN  
ASSET MANAGEMENT