



AUGUST 10, 2011



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Expensive Markets and Cheap Stocks: Two Verities

In early May, my newsletter described a set of super-exposed market conditions compounded with a general abandoning of common sense (click here: [Distance to Safety](#)). Since then we've had an uncomfortable May and June from which stock prices nonetheless recovered, only to suffer a quick mid-summer crackup with the S&P 500 falling 17% in the last 13 trading days, almost a bear market in miniature.

You don't have to look far to find likely suspects for this upsurge in volatility. "It's those Europeans and their debt crisis" or "It's those jerks in Washington and their debt ceiling" are favorites. But Europe's sovereign debt problems have been staggering from lamppost to lamppost for almost two years now. And the mess in D.C. has been multiple election cycles in the making.

Other blameworthy candidates include Standard & Poor's U.S. credit rating downgrade. However, the nation's AAA rating was already, at best, a fiction agreed upon – plainly said, no entity that can conceivably come within hours of default is a triple-A credit. While this wasn't "new" news, it became dangerous partly because suddenly everyone knew that *everyone else knew* the rating was fictive, and also because someone had the temerity to say so, violating the consensus of "let's not fight so loud, dear, the children will hear!"

Or you could point to poor economic data, as we've been guilty ourselves of doing. Yet there's nothing about the new numbers that's catastrophically worse than the ones preceding them.

Perhaps most compelling is the argument that the market panic has come from all these factors

combining into one big rogue wave, a dire coincidence of malevolent energies.

Even so, while all the above were catalysts for the dip, they don't address the necessary precondition of stock valuations which were rich on a normalized basis (see again, [Distance to Safety](#)).

So I propose this simpler, encompassing explanation: eventually, bad things happen to expensive markets. Said another way, a market's overvaluation makes it vulnerable to bad news, no matter what form the bad news arrives in. I take this to be a verity, albeit one that's hard to exploit – the challenge lies not in determining *whether* but *when* things will break; getting the "when" right is a trick few if any investors can pull off consistently.

So now that stocks have backed off from their cycle highs, have the super-exposed conditions cleared, and have valuations become attractive? In answer to the first question, yes, the super-exposed conditions have partly cleared for stocks, especially as regards the quality of equity risk assessment (heedlessness has migrated instead to the U.S. Treasury market, which now looks priced to deliver negative real yields at most maturities). In answer to the second question, about valuation, we answer "no" for the broad market (whose Shiller P/E of 20 is still running about 20% above its historical median of 16, and whose collective 2.2% dividend yield is still low by historical standards), but "yes" for select big, high quality companies – ATC's bread and butter.

Which brings me to the second verity promised in our title today: eventually, good things happen to inexpensive stocks. Likewise here we can't count on being able to identify *when* values will gravitate toward where they belong, which is why equity investing, of necessity, requires a long time horizon. We are again starting to find stocks which we think will profit nicely to the far horizon, and no matter their price behavior in the interim, which we think can keep paying us better in dividends than any Treasury will pay us in interest at today's paltry rates.