INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST COMPANY

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Another Red Flag for US Stock Valuations

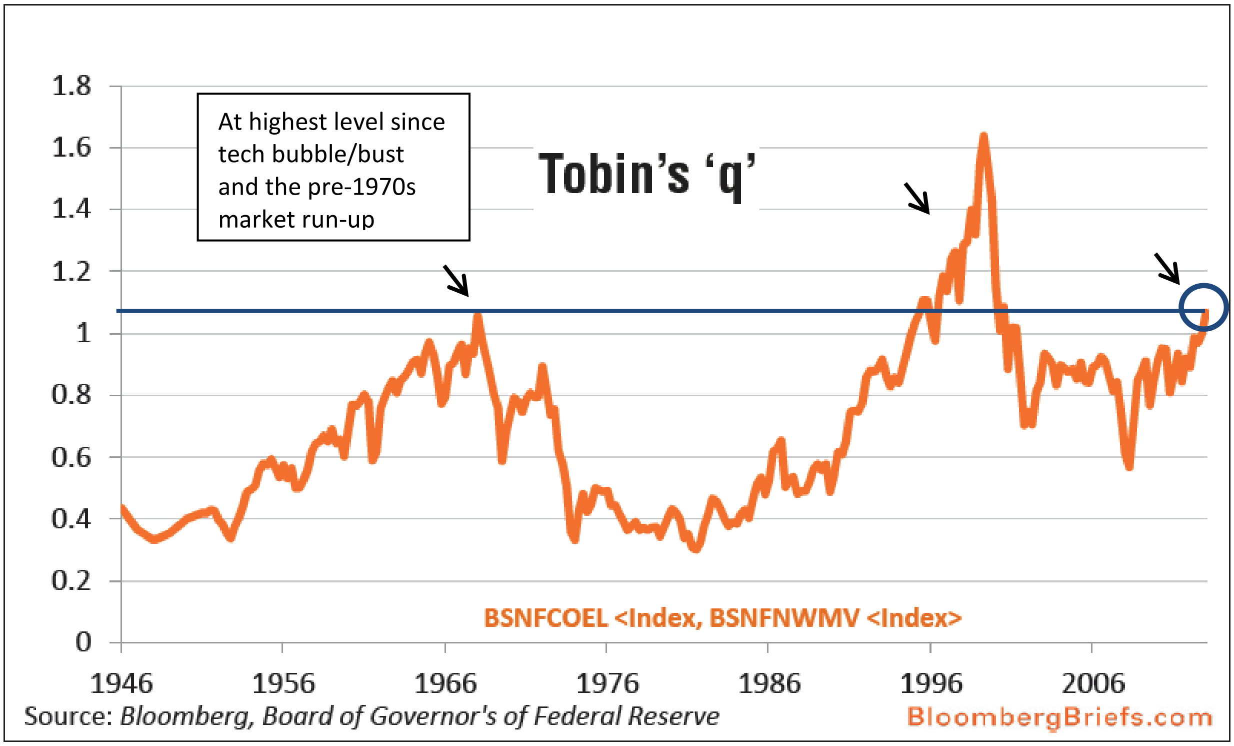

Chart adapted from Bloomberg, March 13, 2014

Last month's letter voiced our concern that rising U.S. stock prices have compressed dividend yields to levels we associate with prior periods of market overvaluation; put another way, stock prices have run ahead of their underlying companies' capacity to distribute cash to their owners. You may also recall our ongoing monitoring of how much US stock prices have detached from their inflation-adjusted, normalized earnings history. This month, we consider a third measure that gauges stock market valuation relative to the replacement cost of the company assets which underlie it, and here too, we find cause for concern.

Tobin's Q is a simple ratio – market value divided by replacement value of corporate assets. A market Q-ratio of less than 1.00 means that stocks overall are priced below replacement cost, while a ratio of more than 1.00 means stocks are priced above replacement cost. Important: We don't use Tobin's Q as an equilibrium model whereby we'd think that market value "should" equal replacement value. Rather, we use it as a relative measure to track where valuations are now compared to where they've been in the past. Currently, the Q ratio is at 1.07 versus an average value of 0.71 since 1946 – roughly a 50% premium; seldom in the post-war era has it been this high. Also important: The Q ratio is a blunt summary statistic and <u>not</u> a precise market timing tool; even so, considered in ensemble with low dividend yields and high normalized price/earnings ratios, its deviation from historical norms signals caution.