



Does Value Matter?

Sigma recently completed a study of the perpetual stock market question asked by the title. After describing in recent newsletters certain speculative bubbles, we thought it would be useful to review what “value” means and why it is important. Table 1 on the accompanying sheet compares the current market with the market peaks in 1973 and 1987 and the market lows in 1974 and 1982, using three traditional valuation measures applied to the Standard & Poor’s Industrial Average.

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By all three valuation measures, the stock market is now more overpriced than it was before the 1987 crash and the 48 percent market decline in 1973-74. But what does this mean for subsequent stock market

performance? Markets that are expensive can stay expensive for a long time. The current market has been “expensive” by these measures for several years. It may make sense that a market that is “cheap” relative to earnings and dividends should subsequently perform better than a market that is “expensive,” but has this actually happened? Sigma took the average annual values for the three valuation measures and compared them to the subsequent total returns from the S&P 500 for the years from 1926 through 1995. Table 2 on the accompanying sheet shows partial results from our study, with “cheap” markets defined as the lowest 25 percent of valuation readings and “expensive” markets defined as the highest 25 percent of valuation readings. Over the past 70 years, expensive markets have been followed by subpar equity returns for a surprisingly long period of time. Some of the statistical measures in Sigma’s study indicate that expensive markets are actually better at predicting low returns over the long run than they are over the short term.

Bullish analysts argue that these measures are not relevant to the current market: (1) earnings may grow rapidly in a low-inflation economic environment; (2) book value is an archaic accounting concept that has no applicability to real asset values in a knowledge based economy; and (3) companies are loath to subject their shareholders to double taxation by paying dividends, so they repurchase shares instead. Of course, there are counter-arguments to these counter-arguments: (1) economic growth is below the post-World War II average; (2) the market is expensive even relative to asset replacement costs; and (3) share repurchases are more than offset by new share issuances in financings, while taxes on dividends are lower than they were for much of the period of our study. It is possible all three valuation measures simultaneously became obsolete for the reasons mentioned above. It seems more likely, however, that the simple analysis is correct -- the market is historically expensive relative to earnings, dividends and book value.

If you are worried about a market decline in the near future, what kind of equity investments should you hold? Table 3 shows how different U.S. equity investing styles have done in the last three significant market downturns. In general, rapidly growing companies tend to sell at relatively high multiples of their current earnings and dividends, emphasizing future investor expectations rather than current values. These expectations tend to collapse in market declines, resulting in relatively poor performance for both large and small growth company stock prices. In contrast, “value” companies sell at relatively low multiples of earnings, book value and dividends and have less room to fall in market declines. Most market observers regard small companies as inherently risky, but small company value stocks have, on average, performed the best during the market declines in the table.

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Despite recent pooh-poohing of traditional valuation measures, Sigma’s study tells us the stock market at current levels is relatively richly priced. History does not necessarily predict an immediate market decline, but it does suggest U.S. equity returns for the next several years may be disappointing to investors spoiled by the buoyant markets of the past several years. If there is a market decline, history also suggests that stocks or mutual funds emphasizing value will tend to give up less ground than growth investments.

So does value matter? Our answer is an unqualified “yes,” with respect to both overall market levels and the types of equity investments you make. We hope this gives pause to people planning their retirement nest egg using the incredible returns touted by the crazed bull market pundits we described in our recent newsletters. Plugging 20 or 30 percent returns into your retirement assumptions is akin to leaving on a ten day trek across the desert with a three day supply of water -- there is likely to be a severe disappointment down the road. If you would like to make it to your desired financial destination by creating a rational long term investment plan, contact us.

Does Value Matter? -- July 1996

	Standard & Poors Industrial Index				
	1973 High	1974 Low	1982 Low	1987 High	7/5/1996
Dow Jones Industrial Average	1,052	578	787	2,722	5,588
Price/Earnings	19.70	7.50	7.50	19.20	22.00
Price/Book Value	2.31	1.07	0.95	2.94	5.10
Price/Dividend Yield	41.84	19.46	16.29	44.84	49.26

Subsequent Performance of the S&P 500 Average				
Valuation Measure:	One Year		10 Year Average	
	Cheap	Expensive	Cheap	Expensive
Price/Earnings	20.62%	10.79%	16.02%	6.61%
Price/ Book Value	22.70%	6.42%	15.83%	3.82%
Price/Dividend	20.97%	12.95%	15.38%	6.16%

Data sources: Value Line Investment Survey (valuation measures); Ibbotson Associates (stock market returns)

Bear Market Style Analysis			
	April 1981 - July 1982	September 1987- November 1987	June 1990 - October 1990
Large Company Growth	-22.15%	-31.57%	-16.36%
Large Company Value	-7.41%	-23.25%	-15.59%
Small Company Growth	-21.36%	-37.11%	-34.91%
Small Company Value	8.56%	-21.20%	-21.86%

Data Source: Wilshire Associates