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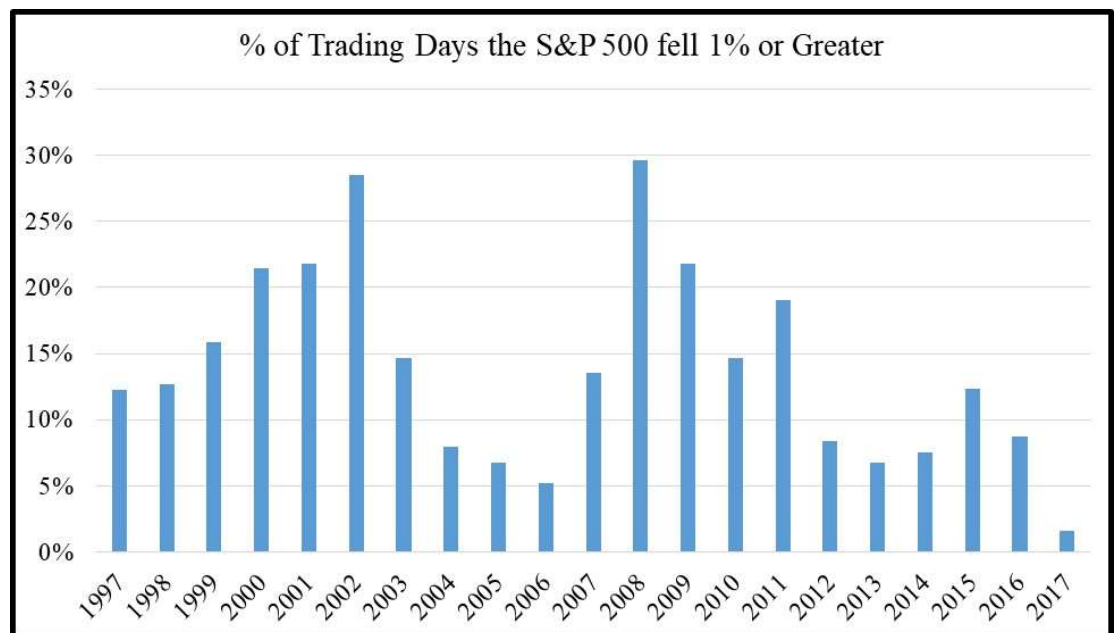


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What a year for the markets! U.S. stocks finished the year up nearly 22% after a strong fourth quarter.¹ Not only did economic growth improve, but the prospects for corporate tax reform also helped push the market forward. But this wasn't just a U.S. story. Indeed, international stocks did even better, with foreign developed markets up 25.6% and emerging markets up 37.8% on the year, reflecting a combination of strong local market returns and a slight weakening of the U.S. dollar.² Bonds returned 1.1% in the year on the back of continued low interest rates.³

Calm Markets

Not only were returns strong, but volatility was incredibly low. The graph below shows the percentage of trading days in each calendar year when the S&P 500 fell by 1% or greater over the past twenty years:



In 2017, the S&P 500 fell more than 1% on only four days, out of 251 total trading days! This 1.6% incidence rate is well below the twenty-year average of nearly 14%. 2017 was the first calendar year in history when the S&P 500 was up every single month.

Investors are excited about economic growth and corporate tax reform. But remember that markets are *forward looking*, which means that the disciplined investor must ask: How much is already priced into markets? The answer could be “a lot of it.”

¹ As measured by the S&P 500 index.

² As measured by the relevant MSCI international indices.

³ As measured by the Citigroup 1-10 Year Government Bond index.

P/E Ratio

Consider the markets' price-to-earnings (P/E) ratio. You may have heard us reference this ratio before.⁴ The P/E ratio is the most popular measure for the cheapness or expensiveness of the stock market. The lower the ratio, the cheaper the market – you want to get as much earnings as you can get for each dollar you invest in stocks. The chart below plots the S&P 500's P/E ratio since 1950:



[Note that we use *peak* earnings. We do this in order to normalize for recessionary periods, when reported earnings often drop materially on big corporate write-downs, but actual earnings often soon recover to a level consistent with prior earnings levels.]

So what does this chart say? Stocks are currently the most expensive they've been since 1950 with the exception of the dot-com bubble in the late 1990's.⁵ Of course like any single data point, this should be taken with a grain of salt. Two big caveats jump to mind.

Context Matters

First, stocks should be valued based off of forward earnings, yet the chart above uses historical earnings. What matters for stock prices today is what companies will earn *in the future*, not what they've earned *in the past*. The problem with future earnings is that they are hard to forecast. We can directly observe historical earnings, and usually historical earnings have a decent correlation with future earnings. That being said, tax reform and economic growth could mean future earnings – in 2018, 2019 and beyond – might be well above prior earnings. If that is the case, the market may not be as expensive as the chart above suggests.⁶

⁴ The P/E ratio measures how much it costs to buy \$1 in annual earnings per share. So for instance, if the market is trading at a P/E ratio of 10x, it costs \$10 to buy \$1 of earnings per share.

⁵ Interestingly, the aggregate P/E measure that we show is a weighted-average, meaning stocks with really high P/E's can have an outsized influence on the metric. If we look at the median P/E ratio for stocks in the S&P 500, the current market is the most expensive ever, even more expensive than the dot-com bubble when a minority of tech stocks really distorted the aggregate P/E ratio.

⁶ Although it is worth noting that at least on 2018 expected earnings, stocks still look expensive relative to historical levels.

Second, and more importantly, context matters, and as we've written many times before the fact that interest rates are so low means stocks *should be* more expensive. Investing is all about opportunity costs and trade-offs: investments are judged *relative to one another*. In a world where U.S. Treasuries yield less than 3%, as is the case today, it makes sense that investors are willing to pay more for stocks. This is a very different environment from the early 1980s, when U.S. Treasuries yielded well into the double-digits.

So these two caveats mean that yes, stocks are expensive, but perhaps not too expensive. Regardless, it's important that investors temper their expectations – stock returns over the next five to ten years are highly unlikely to match the returns enjoyed over the past several years. And with stock prices as high as they are, the margin for error could be small if the winds change. For instance, although tax reform might be a boon to corporate earnings, the impact could be less than expected if greater competition takes hold and pushes down corporate profit margins, which are near all-time highs. And if inflation actually begins to take root and leads to higher interest rates, the investment context could change quickly. We like to remind investors that if we all woke up tomorrow and could buy a ten-year U.S. Treasury bond that yielded 8% or 10% instead of 2.4%,⁷ stock prices would be much lower than current levels. Now it doesn't seem too likely that we will have Treasury yields that high anytime soon, but it's an important point to keep in mind.

Exercising Caution

So what's an investor to do in such an environment? We think Howard Marks, Co-Chairman of Oaktree Capital Management, put it extremely well in a memo that he composed this past fall:

If it's true, as I believe, that (a) the easy money in this cycle has been made, (b) the world is a risky place, and (c) securities are priced high, then people should probably be taking less risk today than they did three, five or seven years ago. Not “out,” but “less risk” and “more caution.”

All I'm saying is that prices are elevated; prospective returns are low; risks are high; people are engaging in risky behavior. Now nobody disagrees with any of the four of those, and if not, then it seems to me that this is a time for increased caution...It's maybe “in, but maybe a little less than you used to be in.” Or maybe “in as much as you used to be in, but with less-risky securities.”⁸

This is essentially the mantra we've adopted around the office. We are not prepared to proclaim that investors should reduce their stock exposure. But we are working hard to be cautious and reduce risk at the margins when and where we can. As opportunities arise or as stocks continue to ascend, we will look to increase our level of caution. As Warren Buffett put it, “The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.”

Firm Update (from Mike)

As we look forward to the promise of a new year, I am delighted to announce that Jacob has purchased a minority interest in AMI. Jacob first joined AMI as an intern in 2002 while he was still in high school. We normally don't hire interns until they have a couple of years of college under their belt, but I had met Jacob while serving on a non-profit board and I quickly realized that some rules are meant to be broken. His intelligence, work ethic and integrity really made the decision an easy one. Jacob spent parts of the next five years interning at AMI as he completed high school and moved on to Notre Dame on a full-tuition Lilly Scholarship where he graduated summa cum laude and Phi Beta Kappa.

⁷ The 10-year Treasury yield as of December 29, 2017.

⁸ “Yet Again?” September 7, 2017.

Upon graduation from Notre Dame, Jacob had several job offers. He took a job in Chicago working as a financial analyst. His work ethic and desire to learn helped him advance quickly in Chicago. While working full-time, Jacob also found time to put in 300+ hours of study each year for the Chartered Financial Analyst (“CFA”) exam. Jacob is one of the few CFA candidates to successfully complete all three annual exams in only two and a half years by doubling up and taking two exams in one year! While Jacob was working in Chicago, we stayed in contact and in the fall of 2008 I was able to convince him to join AMI on a full-time basis. Over the last nine years, it has truly been a pleasure working on a daily basis with Jacob. His drive and intellectual curiosity have made every step of our investment process better. He has filled bookshelves in our basement research library and his home with volumes of books as he always strives for continuous improvement and life-long learning. He is a critical thinker and never shies away from questioning conventional wisdom.

Jacob has acted like an owner from day one with his passion, work ethic and dedication to our clients’ interests. That is why I am so proud to welcome him as a business partner! I look forward to working with Jacob for many years to come. The decision sixteen years ago to hire a young intern has paid huge dividends to AMI and our clients. Please join me in congratulating Jacob and best wishes for a peaceful and prosperous new year!

As always, we thank you for your continued support.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®

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