PERENNIAL ASSET MANAGEMENT

Perennial Perspectives

December 2016

Value Matters

This past summer, I was out walking and enjoying the beautiful hot weather we were having in Toronto. I couldn't help but notice how calm things were. Traffic was light, the lines at my favourite restaurants were short, and life seemed peaceful. Perhaps not coincidentally, equity markets were also the quietest they've been since 1965. Share prices meandered and the outlook was sanguine.

Now that the autumn has arrived in earnest, much has changed. In the city, activity has picked up and the streets have become hectic and crowded again. In the equity market, volatility is back on the menu. The front pages are dominated by stories about the new U.S. President and how the world will fare under his administration. The financial media is also rife with speculation about what the Federal Reserve, the Bank of Japan and the ECB will do next.

Up until recently, at least, investors have learned to count on central bank support in stimulating a global economy that has not been able to grow sufficiently on its own. They have become comfortable with taking on large dollops of risk and being fully invested in stocks, bonds, real estate and other assets, where prices have risen to rarified heights. Their faith in "lower for longer" interest rates has remained largely unchallenged.

Now, though, it looks like a good time to reconsider the broader outlook and how portfolios are positioned. Based on what President-elect Trump has said so far, the winners and losers in the period ahead may well be very different than what we've seen in recent years. Amid clear signs that central banks are altering their policymaking approach, it also appears that pre-quantitative easing (QE) fundamentals will become relevant again.

Equity Valuation

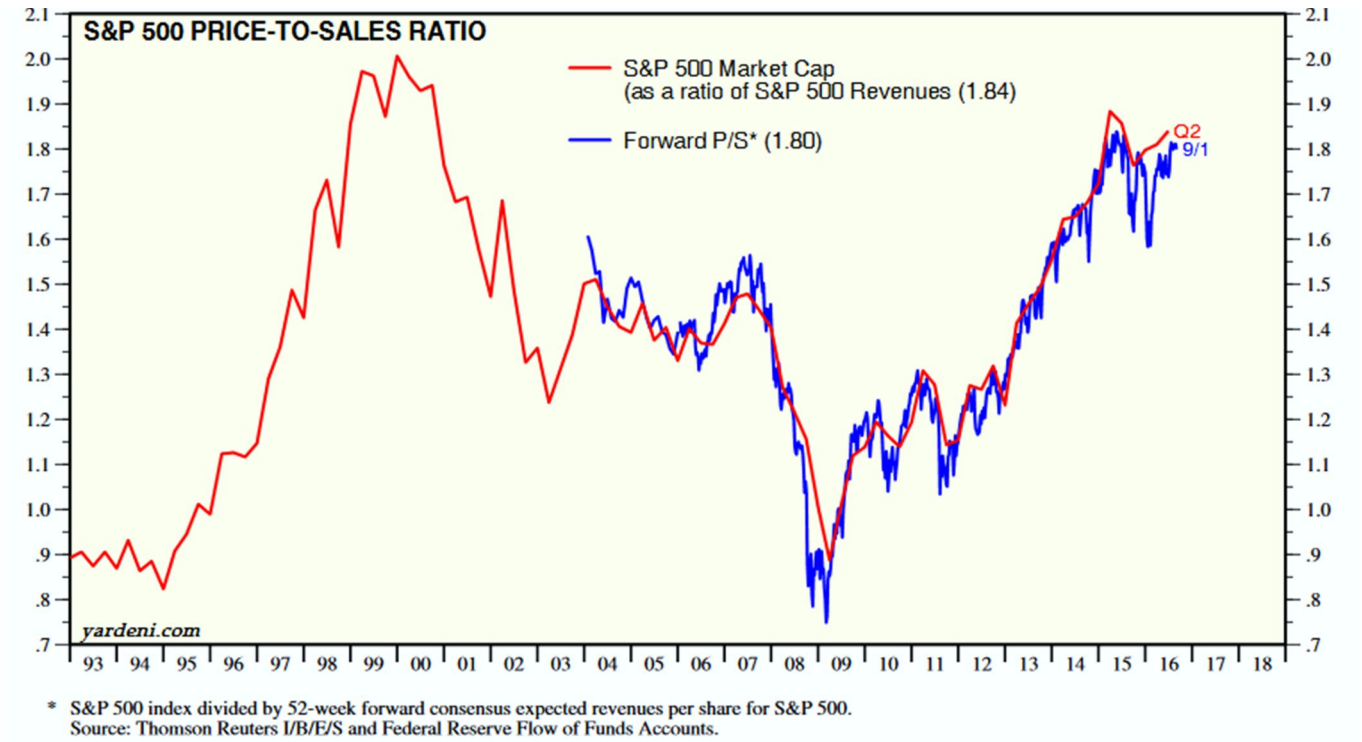
One of the financial world's most quoted maxims is "buy low and sell high." Simply put, that means acquiring investments when their prices represent good value and

selling them after they become overly appreciated. To understand where financial and other asset valuations stand, it makes sense to look at where they are in relation to historical averages. In doing so, we normally consider such questions as "how much we need to pay for a dollar of sales" or "how much we must pay for a dollar of earnings." Regardless of what happens in the short run, research and experience suggest that over the long-term, value matters.

Sales

Generally speaking, sales represent a more reliable metric than earnings because managements typically do not make adjustments to sales accounting. Under GAAP standards, however, public companies have considerable leeway in regard to bottom-line reporting, and few are loath to portray their results in the best possible light. So what does this measure currently suggest when viewed in a longer-range context? As illustrated by the following chart from Ed Yardeni Research, the forward price-to-sales ratio of the S&P 500 is at levels that have only been seen once before–that is, during the heydays of the dot-com bubble.

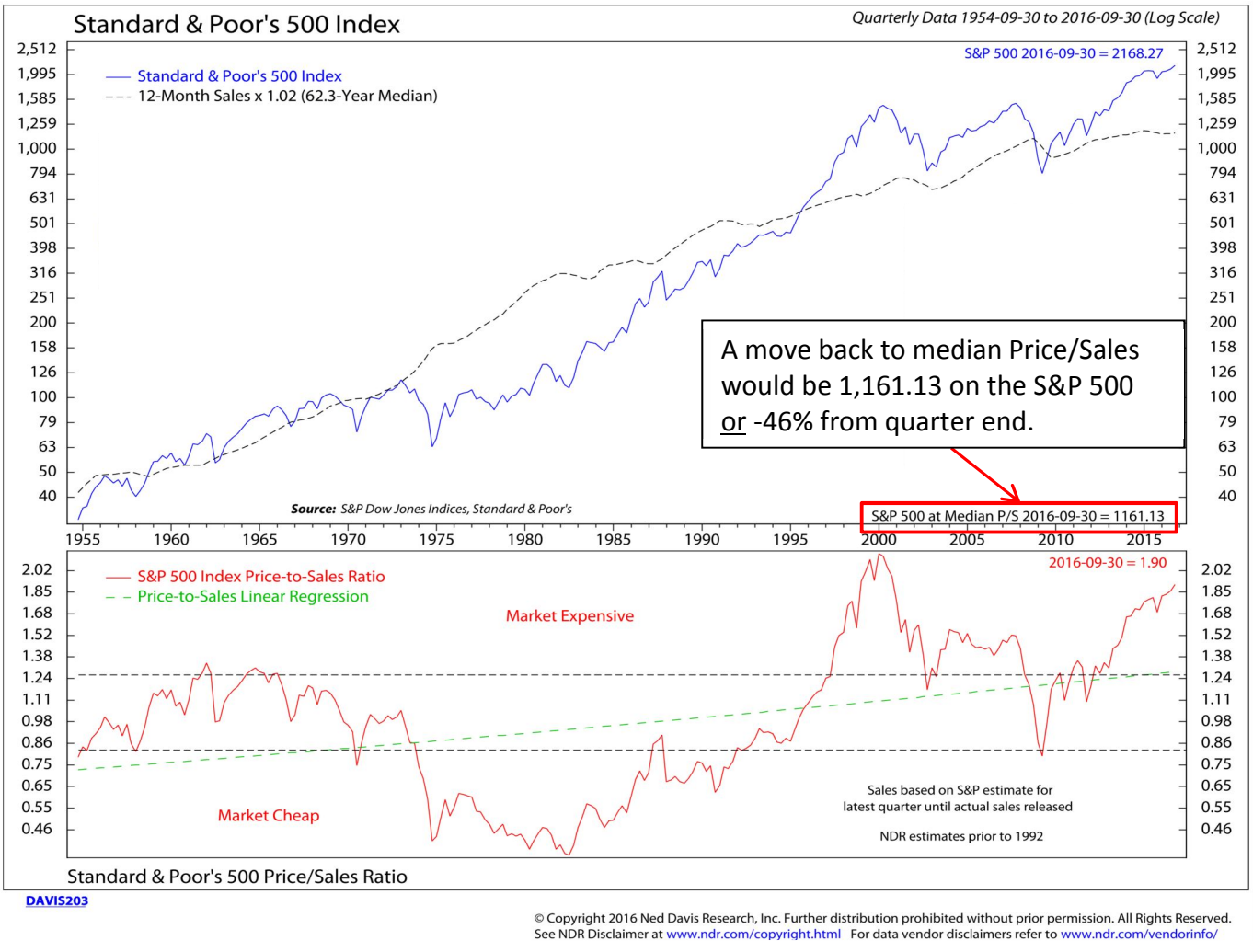
Chart 1 – S&P 500 Forward Price/Sales



Yardeni Research, Inc.

A longer-term chart from Ned Davis research tells the same tale. As can be seen below, this particular gauge has far exceeded its six-decade median. If the U.S. market were merely to return to its historical norms–which may not be such an outlandish prediction if central bank policies are in the process of being "normalized"–then stock prices could potentially be cut in half.

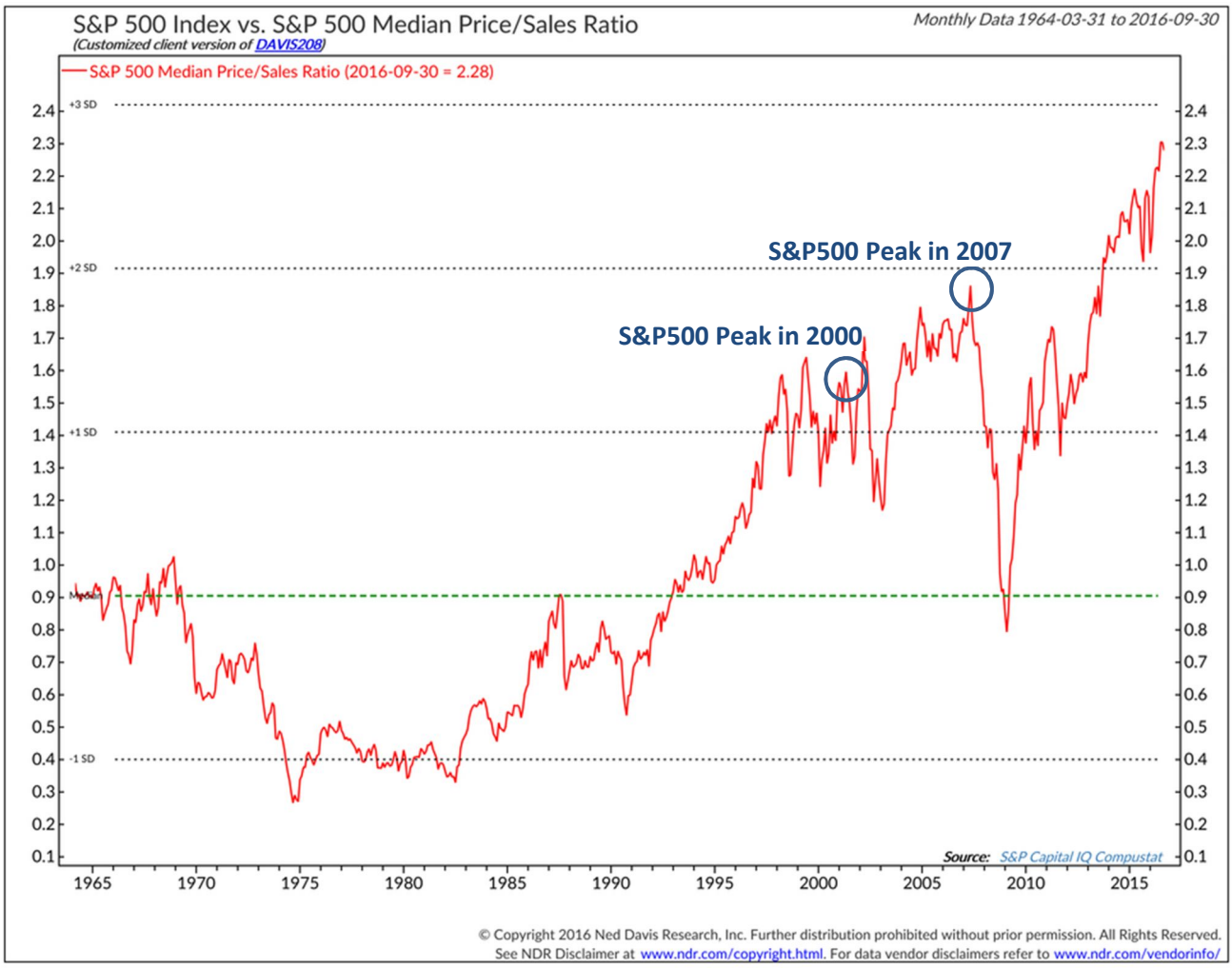
Chart 2 – S&P 500 Price/Sales



The fact is, while the price-sales ratio is not where it was in 2000, it is higher than it has been at any other time since 1955. It is also far above the levels that prevailed at the 2007 peak. Certainly, market dynamics during the dot-com era were different than they are today. Back then, the overvaluation was driven largely by three sectors: technology, media and telecommunications, or TMT. These groups became wildly expensive because investors believed that new era industries would radically change the world as we knew it, an act of faith that was, in some respects, true, but much too early. Meanwhile, other, less racy sectors remained unloved and moderately priced. In the end, valuations returned to more normal levels, as they have been wont to do since the days of Tulip mania.

Still, because the TMT mania seems especially crazy in retrospect, it might be easy to think that current conditions bear little resemblance to the giddy days of eyeballs and clicks. But a different perspective on current valuations suggests that the late-2000 crowd may actually have been more conservative than many might think. As the following chart shows, there are more overpriced companies in the current environment, on average, than there were during the halcyon days of a decade-and-a-half ago. Based on the median valuation of the S&P 500's constituent members, stocks are more expensive than they have been at any time since 1965.

Chart 3 – S&P 500 Median Price/Sales



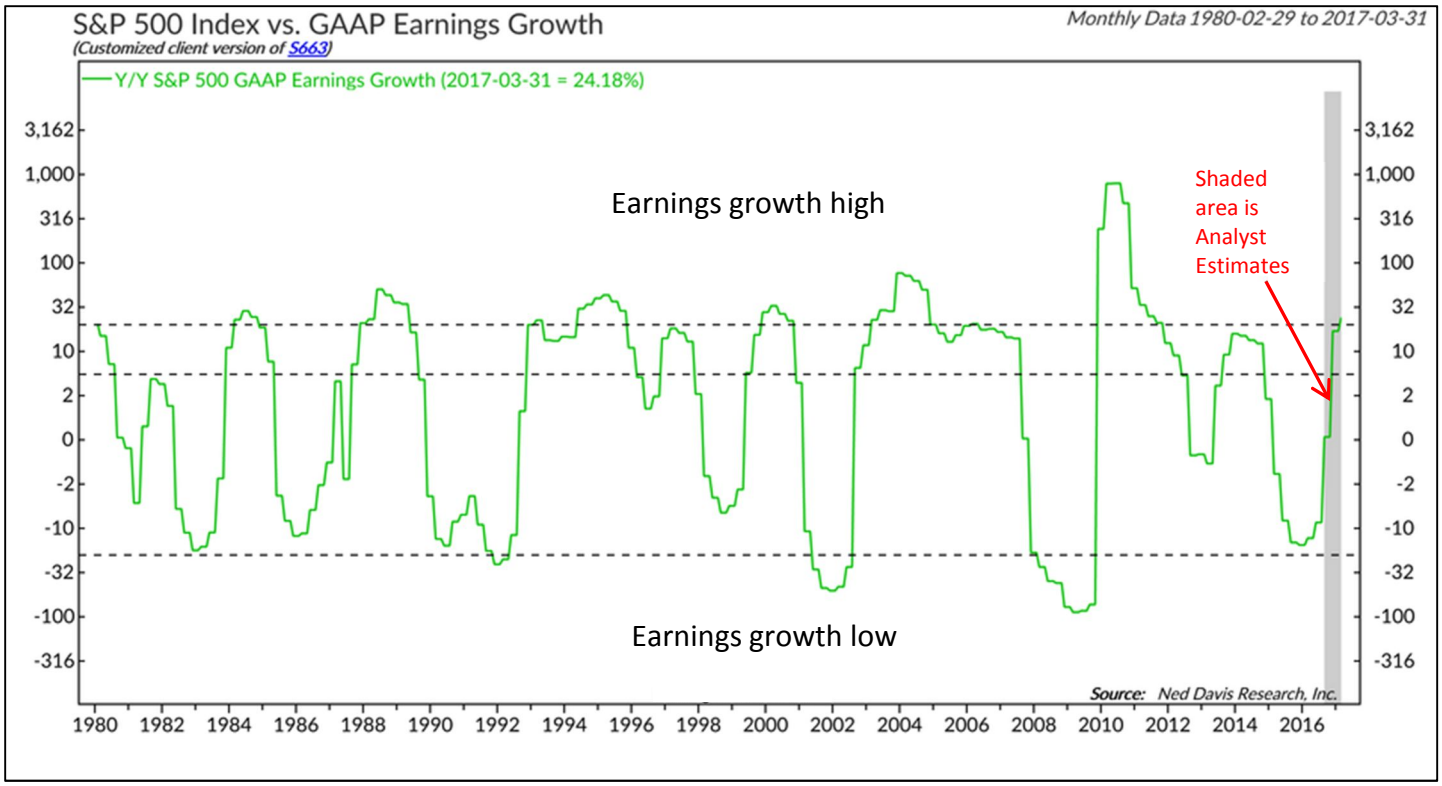
That said, the chart doesn't quite do justice with respect to the extent that prices have gotten ahead of themselves. A comparison of where today's valuations are relative to the past reveals a more succinct picture of speculative excess. As suggested by the table below, even if valuations were to retrace back to their prior peak, share prices could come under significant pressure, all else being equal. Simply put, it is hard to make a case that the current market represents a long-term buying opportunity.

	Historical Value	**Today's Value**	**Current % Premium**
Today's Valuation vs. Historical **Highest** Value	1.8	2.3	+28%
Today's Valuation vs. 50+ Year **Average** Value	0.9	2.3	+156%
Today's Valuation vs. Historical **Lowest** Value	0.3	2.3	+667%

Earnings

While sales are undoubtedly important, it's long been said that earnings are the "mother's milk" that drives stock prices. But even there, trends have been less than reassuring. As suggested below, the pace of earnings growth has been slowing since early-2010; aggregate earnings, meanwhile, have declined over the last five quarters.

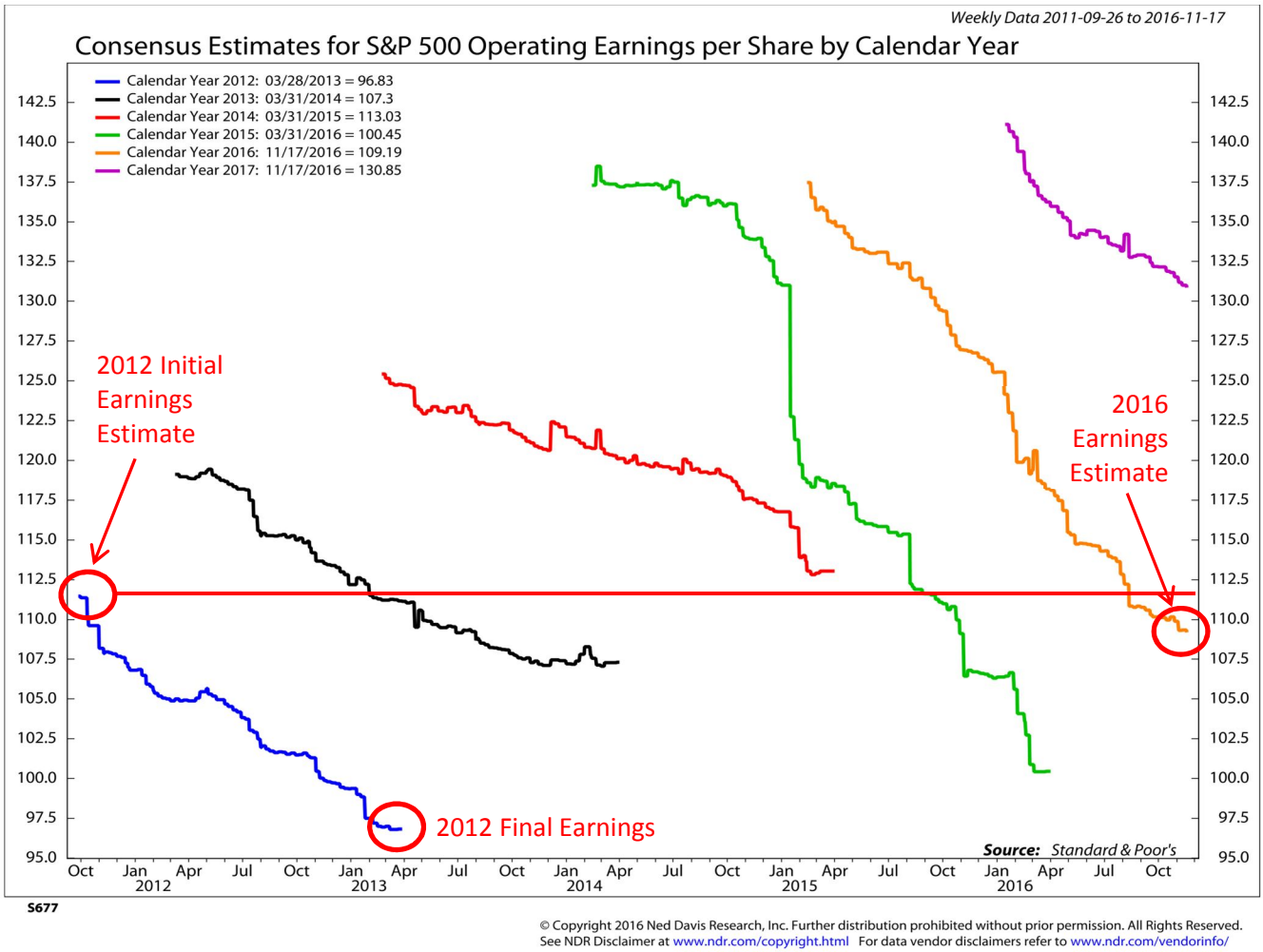
Chart 4 – S&P 500 Year/Year Earnings



Some might counter by noting that analysts are forecasting a meaningful pickup over the next three quarters, as illustrated by the shaded area at the tail end of the chart. But we should not read too much into this because the research crowd has been similarly optimistic every quarter during the last five years. But like clockwork, their exuberance has waned every time. As things progressed, they would revise their forecasts lower–sometimes dramatically so.

As the following chart illustrates, optimism seems to run rampant about six to nine months before each new calendar year begins–and then gradually, a sobering reality sets in. In some respects, this self-delusionary cycle is like a version of Bill Murray's classic film, *Groundhog Day*. Based on the latest estimates, analysts are forecasting 2016 earnings to be a tad lower than they were anticipating at the start of 2012. And yet, since that time, the S&P 500 has risen about 100%. A cynic might say their opinions don't matter that much, but one thing is clear: stocks are twice as expensive relative to expected earnings as they were five years ago.

Chart 5 – S&P 500 Operating Earnings Estimates

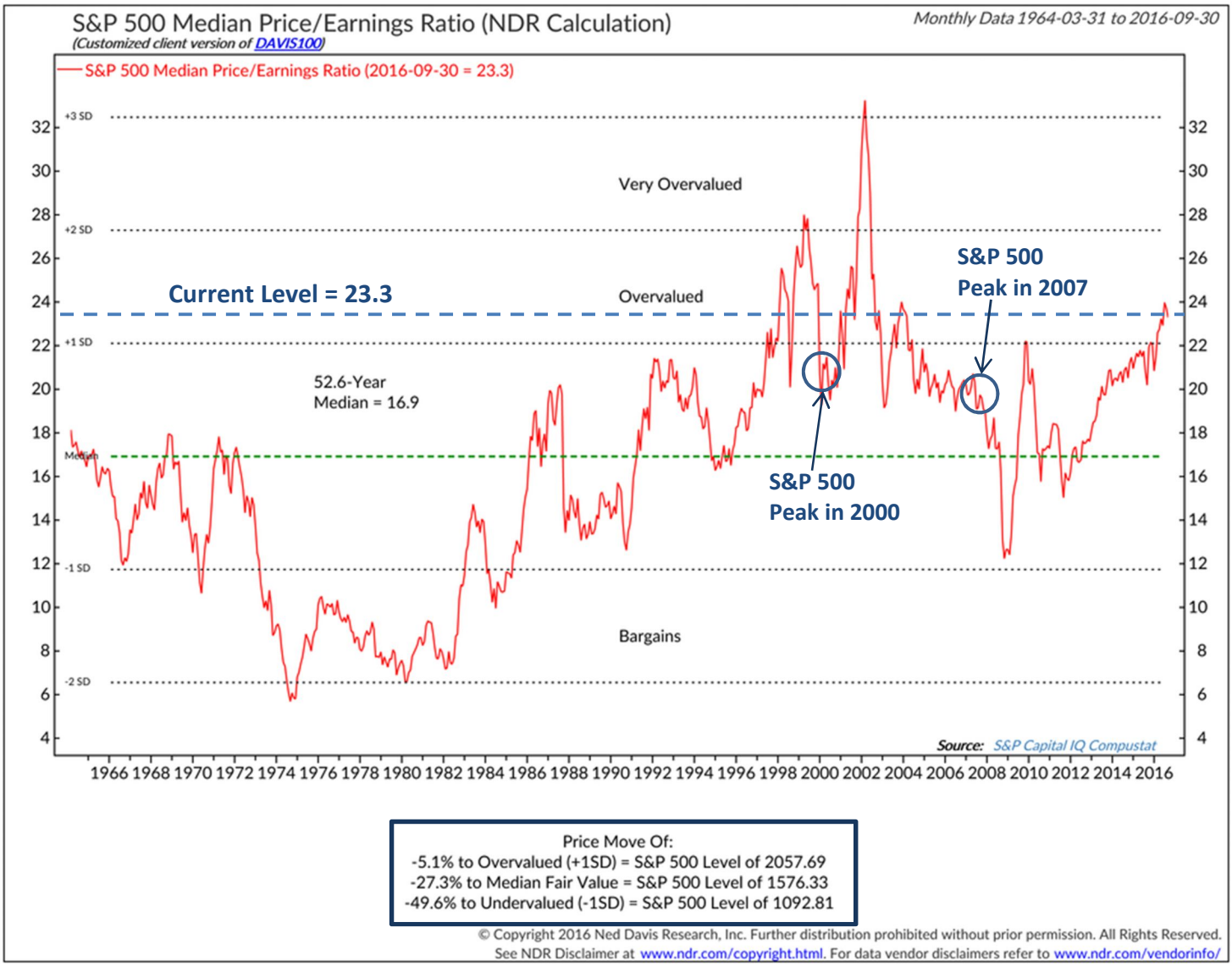


If earnings were on the upswing, a high multiple might be easier to justify. After all, as with some some select growth stocks, it occasionally–*very* occasionally–makes sense to pay up in anticipation of a major payoff somewhere down the road.

But that is not the case. Taking account of the second quarter's disappointing results, GAAP earnings have fallen by more than 8% over the past 12 months. If you factor in the subdued outlook, current valuations appear to rest on little more than hope. In fact, a chart of the S&P 500's median price-earnings ratio would seem to bear this out. As shown below, this measure is currently higher than at any point other than just before the collapse of the technology bubble. Given that valuations back then were elevated in part by sizable one-time writeoffs, that suggests the current situation is even worse than it looks.

But then again, things could be different this time–right?

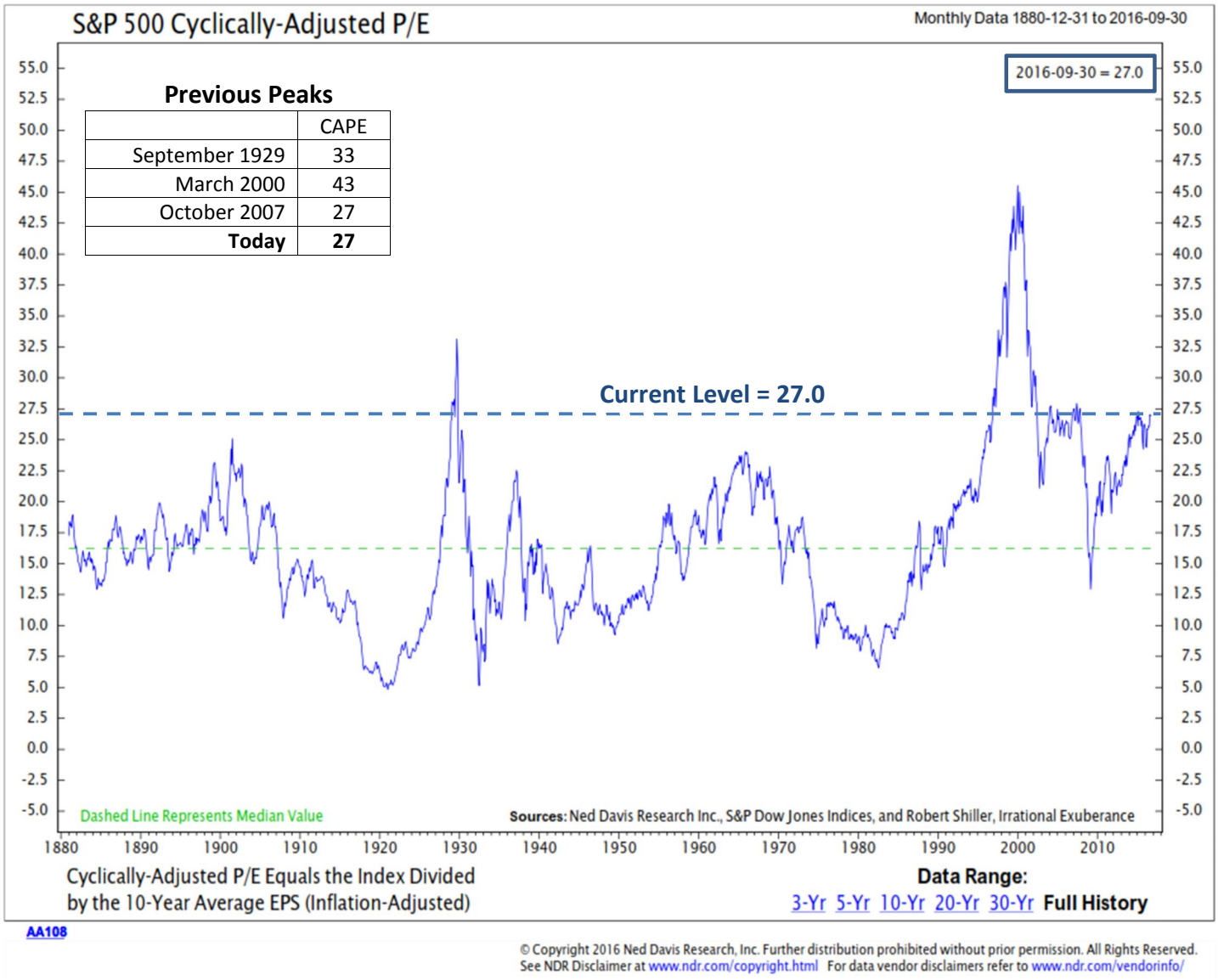
Chart 6 – S&P 500 Median Price/Earnings



Some observers maintain, perhaps rightfully so, that multiples based on current earnings can paint a misleading picture. As with prices, short-term swings in sales and profits may not tell us much about longer-term prospects. But even when this is taken into account, the results are not reassuring.

One approach that has become increasingly popular in recent times is to value the market based on a 10-year moving average of inflation-adjusted earnings. Originally developed by Yale professor Robert Shiller, the cyclically adjusted price-earnings ratio, or CAPE, is designed to filter out cyclical distortions and provide a better sense of the underlying trend. As illustrated below, CAPE is currently within a hair's breath of levels that prevailed in late-2007. As with the other valuation gauges, only in 2000–and, for that matter, 1929–was the market more expensive.

Chart 7 – Shiller S&P 500 Cyclically Adjusted Price/Earnings (CAPE)



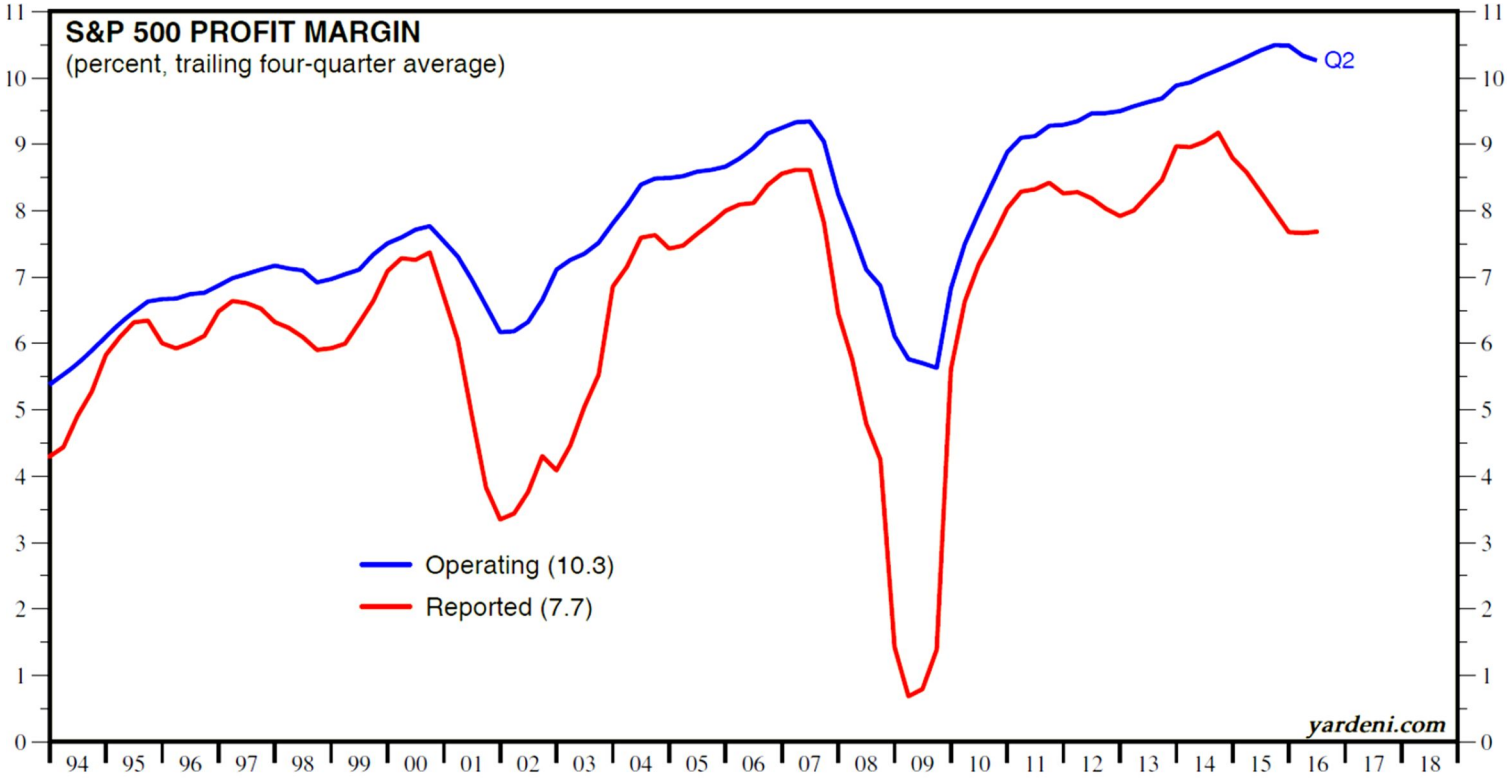
Certainly, there are those who believe that a relentlessly benign economic backdrop will more than compensate for any near-term disappointments on the earnings front. But the prospect that the U.S. and global economies will continue to serve as tailwinds that bolster bottom-lines and share prices seems far from certain, especially when monetary authorities around the globe are reconsidering their options and globalization is being called into question amid a growing populist backlash.

The World Trade Organization, for example, has recently slashed its 2016 trade growth forecast to 1.7%, down from 2.8% just seven months earlier. The International Monetary Fund, meanwhile, sees subpar global growth of 3.1% this year. They expect advanced economies to expand at a tepid 1.6% pace, and less-developed counterparts to grow by a historically modest 4.2%.

And even if the overall economy does not disappoint, there is some question about whether most companies will benefit. Amid growing signs that financing costs are set to rise and growing pressure from workers for a greater share of the pie, it seems a good bet that the supernormal profits of recent times are simply not

sustainable. In fact, as the following chart indicates, profit margins have been under pressure since peaking in 2014. Not coincidentally, a similar pattern also unfolded around the time of the 2000 and 2007 stock market peaks.

Chart 8 – S&P 500 Operating vs. Reported Profit Margin



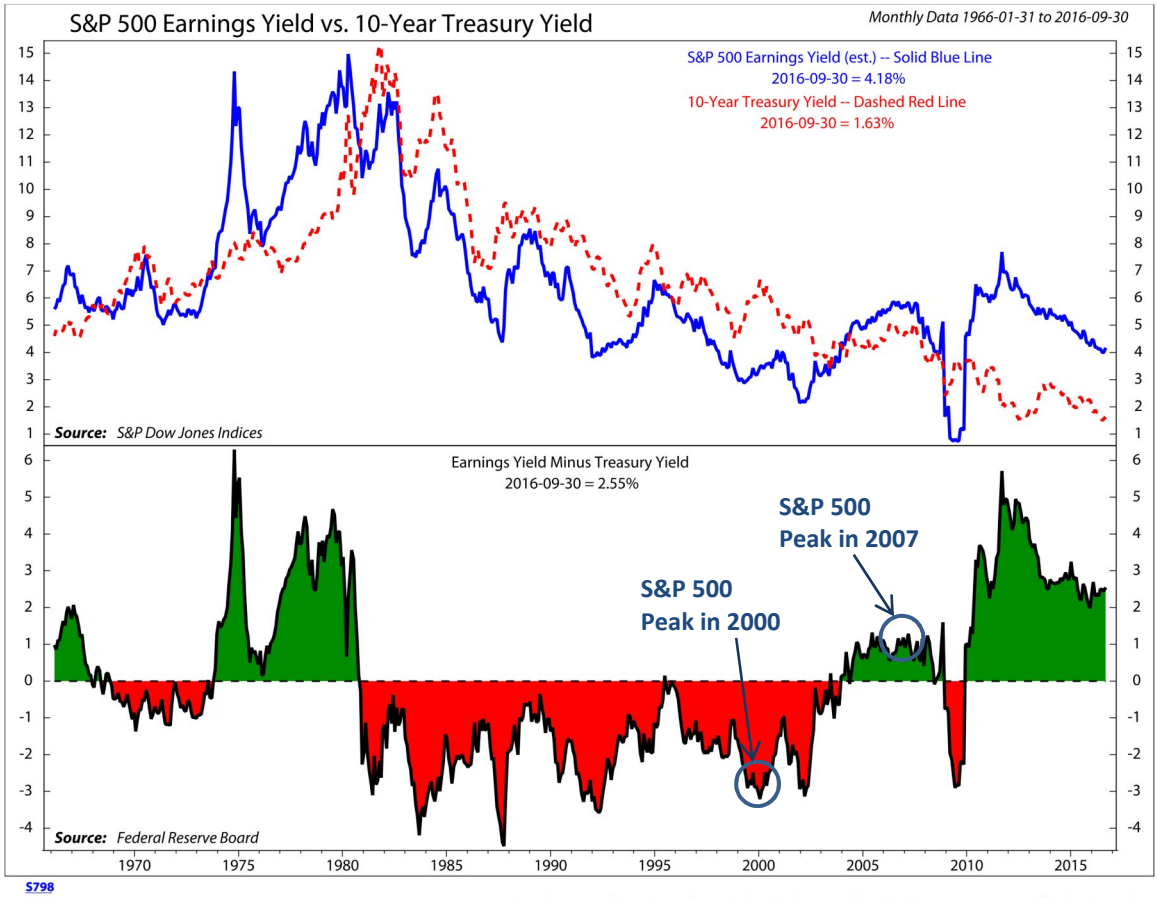
Source: Standard & Poor's Corporation (revenues and reported EPS) and Thomson Reuters I/B/E/S (operating EPS).

When all else fails, optimists are quick to point out that interest rates remain low in historical terms, and that equities may not be all that overvalued when viewed in this context. That is the argument that underpins the Fed Model, illustrated by the chart that follows, which holds that there is a relationship between the market's earnings yield–the inverse of its P/E ratio–and the 10-year Treasury yield.

But is such a comparison valid? At first glance, the theory makes sense. For one thing, it reflects the reality that valuation differentials naturally lead investors to favour investments perceived as cheap over more expensive counterparts, which is not such a bad assumption. But it also ignores a critical shortcoming of relativistic logic: just because one thing seems expensive doesn't mean another is cheap. While a $20 McDonald's Big Mac might look like a bargain in comparison to a $30 Burger King Whopper, both are outrageously expensive alongside a mouthwatering $15 prime-cut steak.

Under the circumstances, it is possible, nee likely, that both burgers–and asset classes–will eventually fall in price. In fact, given that yields are near their lowest levels in history, it's a good bet that path of least resistance for fixed-income prices is down rather than up. But even if circumstances don't turn out that way, maintaining that the Fed Model alone is a reason to own equities is questionable at best. Both a 2003 paper by Cliff Asness, *Fight the Fed Model*, and one published by Cantor, Butler and Rajani in 2014, *The Fallacy of the Fed Model*, have concluded that the theory has no merit.

Chart 9 – S&P 500 Earnings Yield vs. 10-Year Treasury Yield



Conclusion

If there is any lesson that can be learned from the history of finance, it's that fundamentals matter. This is not always true in the short run, of course. Fundamentals don't necessarily predict day-to-day price fluctuations or which investments will be in or out of favor at any given point in time. But over the longer term, valuations have been a reliable guidepost about the best way forward for long-term investors.

With that in mind, readers would be remiss to ignore current warning signs. While it is easy to believe that one can step off the train before things go awry, past experience makes it clear just how suddenly and unexpectedly the end can arrive. Naturally, there is always a fear of missing out, of leaving the party just as the real fun begins. But in times like this, it helps to recall the words of Berkshire Hattaway Chairman Warren Buffett, who knows a thing or two about investing.

Be fearful when others are greedy.

Perennial has invested adeptly in difficult times. If you are concerned about what the current environment means for your portfolio, let us tell you how we plan to grow our portfolios.

Sincerely,

Murray Belzberg
President