Caution Ahead

With the stock market's ascent in recent months, many investors are once again focused on the question of whether the market is overvalued. But that question has a number of nuances including:

1. How does the valuation today compare to the valuations during prior market cycles?

2. How can the extent of overvaluation be measured?

3. Is the market overvalued across the board or is it limited to certain sectors?

4. Are there suitable investment alternatives that are "less overvalued?"

In this post, I will focus on the first two questions. The classic case of stock market overvaluation occurred in the late 1990's and early 2000's with the advent of the dot.com boom and bust. As the bull market was charging toward the peak, there were two clear signs of speculation. First, stocks of many technology companies soared despite having very flimsy business plans as well as questionable growth prospects. As long as investors believed that a company would be a participant in the new economy, investors threw caution to the wind and bid the stock price higher and higher.

For the most part, we are not seeing this phenomenon during this cycle. Most of the companies in the technology sector are generating strong revenue and earnings growth as they pursue a variety of niche products for the digital economy. That said, when stock prices grow faster than revenue growth, investors need to pay attention. A number of large cap technology stocks would fall into that category.

One measure of overall market valuation that I carefully follow is the Cyclically Adjusted PE Ratio

(CAPE Ratio) that was developed by Nobel prize Yale professor, Robert Shiller. The Shiller CAPE Ratio measures the traditional price-to-earnings ratio on a cyclically adjusted basis, whereby earnings are smoothed out by averaging 10 years of earnings data. According to the data from Shiller's website (http://www.econ.yale.edu/~shiller/data.htm), the CAPE ratio is now back near the highs of this cycle at about 30X. While this is below the CAPE ratio at the end of 1999 (44X), it is near the high for this cycle and well above the long term mean of 16.7X.

Now the CAPE does not account for changes in interest rate levels. Moreover, interest rates are near historic lows. Nevertheless, the CAPE does suggest that the market valuation overall could be in a range where investors need to be more selective. Moreover, it would be prudent for investors to set stricter limits on how much they are willing to pay for a given stock, despite how attractive the business prospects appear.