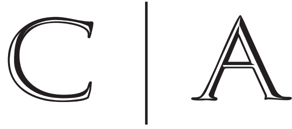

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

U.S. EQUITIES: MULTIPLE CONCERNS

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U.S. Equities: Multiple Concerns

Euphoria is back in the air. With equity prices soaring and economic indicators pointing up, investors seem to have regained much of the confidence lost over the last several years. Yet today's fierce rally comes with a major caveat: equity prices are still quite high relative to earnings, a scenario that historically has led to below-average long-term returns. In other words, price still matters, and equity buyers ignore today's high valuations at their peril.

Based on normalized ten-year real earnings, the S&P 500 currently sells at a price-to-earnings (P/E) ratio of 24.7, down sharply from its late 1999 high of 45.0, but still squarely in the top quintile of historical P/Es since 1935 for the index (see Table A).[1] Unfortunately, because so much of the top quintile consists of post-1990 examples, there is little data on long-term returns when valuations hit these levels. However, we do know that over the long term (ten years or longer) higher-than-average P/Es have traditionally resulted in lower-than-average returns (see Table B). Since the current P/E is roughly one standard deviation above its long-term average, it seems quite likely that U.S. equity investors will face below-average returns over the next decade or two.

It is, of course, possible that profits could continue their recent ramp and thereby alleviate some of the problem by pumping up the "E" in the equation. (As noted in last month's U.S. Market Comment, recent earnings growth has been solid but unspectacular.) Yet even if the economy continues its recovery, overall profit growth seems likely to slow. The reason for this is the growing influence of the financial sector, which now makes up an eye-popping 40% of S&P 500 earnings (and even more if quasi-financials such as GE and GM are included). Financials have benefited in recent years from the mortgage refinancing boom, as well as volatile bond and equity markets that have offered huge profit opportunities. But such one-off events will not continue forever, and no other sector appears poised to pick up the slack.[2] Therefore, unless investors are willing to assign equities a far higher P/E than normal, prices must either fall or at the very least stagnate until earnings eventually catch up.[3]

Nevertheless, excessive valuations have not historically been sufficient to bring down bull markets (or bear market rallies) on their own. In fact, the three- and five-year returns following the high valuations of the 1990s included some of the best performances on record (see Table C.) Given that the timing of a reversion to trend is impossible to predict, we continue to caution against underweighting equities and recommend that investors use rallies to assiduously rebalance and lock in gains.

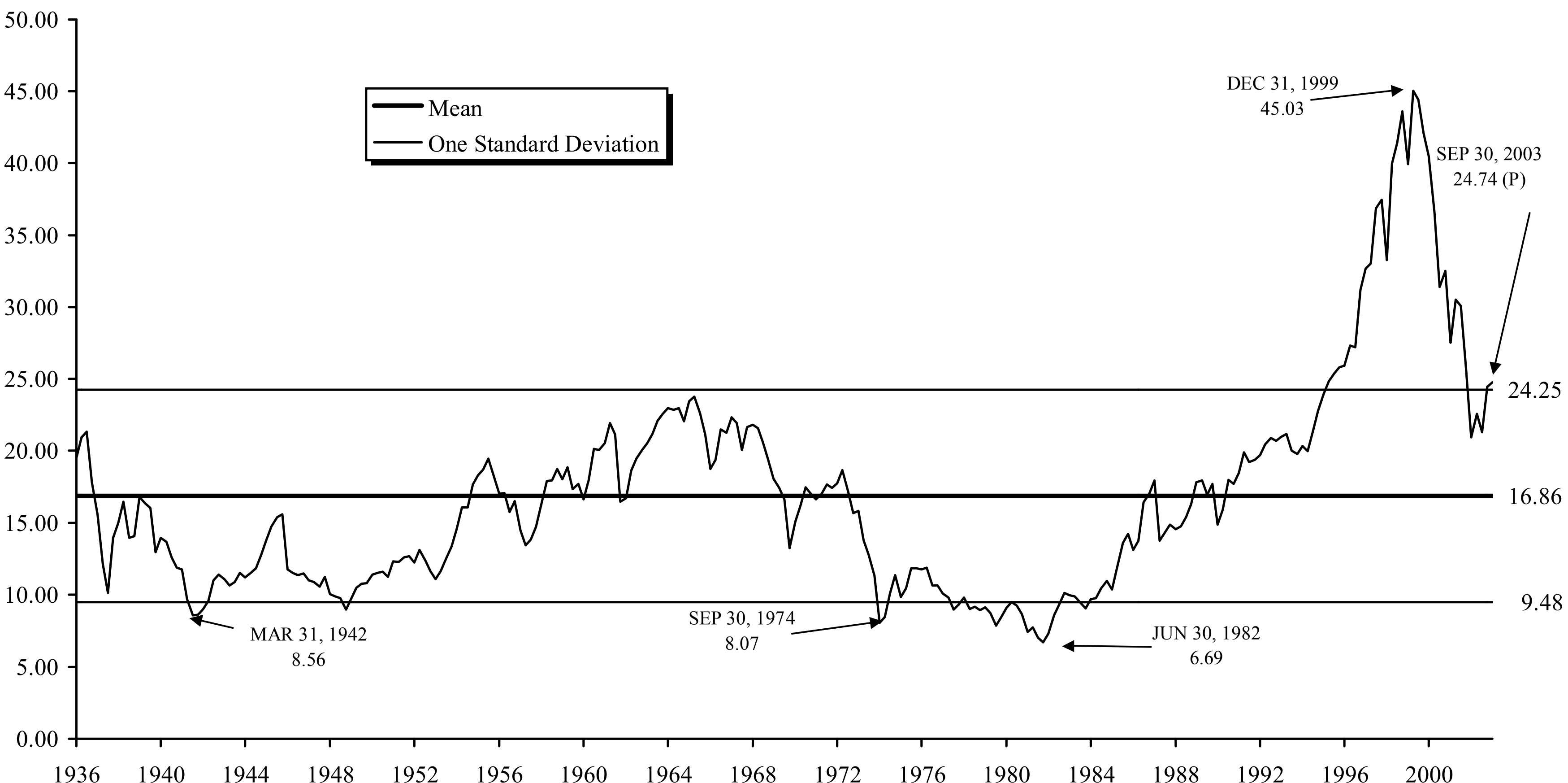
[1] We have found that normalized earnings based on the average real earnings for the trailing ten years provide the best basis for equity valuations, especially compared to reported and operating earnings. For more detail, see our January 2003 U.S. Market Comment: *U.S. Equity Valuations: Improving, but not Enough.*

[2] For more detail on the financial sector, see our June 2003 U.S. Market Comment: *The Financial Sector: A Giant Octopus and Its Tentacles.*

[3] Some have argued that today's low interest rate environment justifies higher equity valuations than usual. While such a discussion is beyond the scope of this comment, we would note that the dividend discount models often used to make this argument tend to break down when interest rates are very low.

Table A

S&P 500 NORMALIZED REAL PRICE-EARNINGS RATIOS SINCE 1936



Sources: Calculated from data provided by Bureau of Labor Statistics, Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal*.

Notes: (P) Preliminary. Normalized real price-earnings ratios for the S&P 500 are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. Graph represents quarterly data through 2003. Data for 2003 are through September 30.

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Table B

RELATIONSHIP BETWEEN S&P 500 NORMALIZED PRICE-EARNINGS RATIOS AND SUBSEQUENT LONG-TERM AACRS

1935-2002

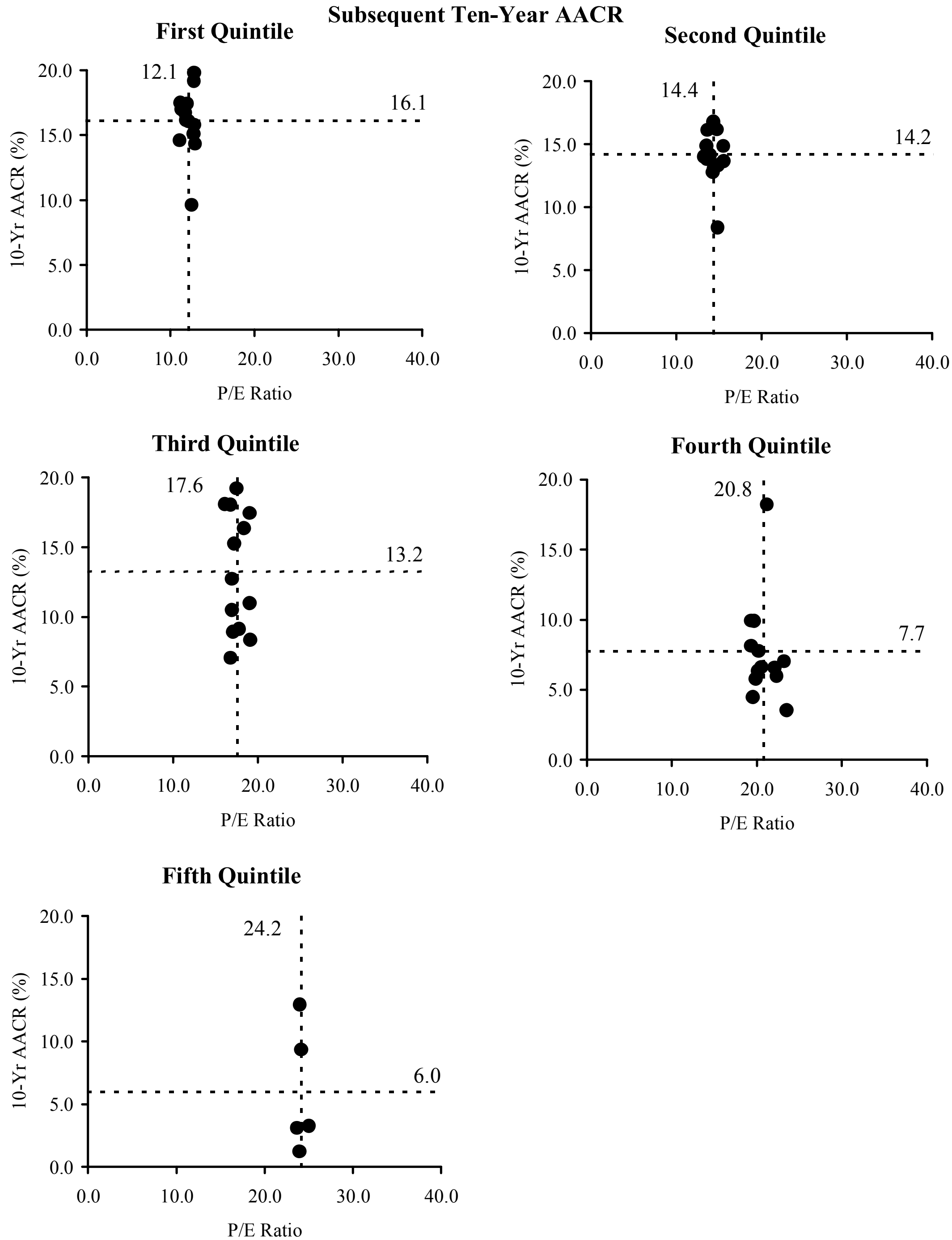
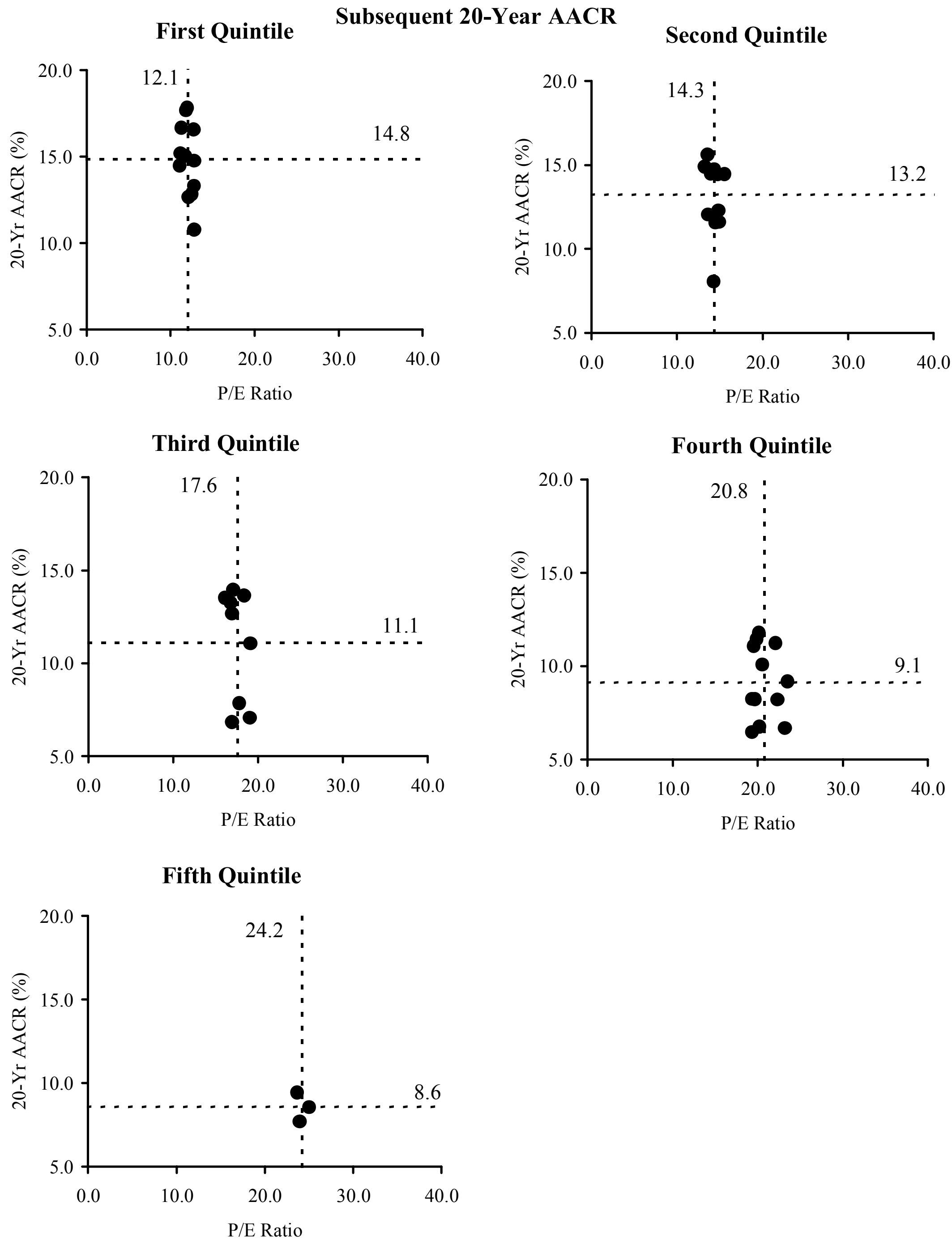


Table B (continued)

RELATIONSHIP BETWEEN S&P 500 NORMALIZED PRICE-EARNINGS RATIOS AND SUBSEQUENT LONG-TERM AACRS

1935-2002



Sources: Calculated from data provided by Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal*.

Note: Dashed lines represent the average price-earnings ratio and average subsequent period AACR for the quintile shown.

Table C

RELATIONSHIP BETWEEN S&P 500 NORMALIZED PRICE-EARNINGS RATIOS AND SUBSEQUENT AACRS

1935-2002

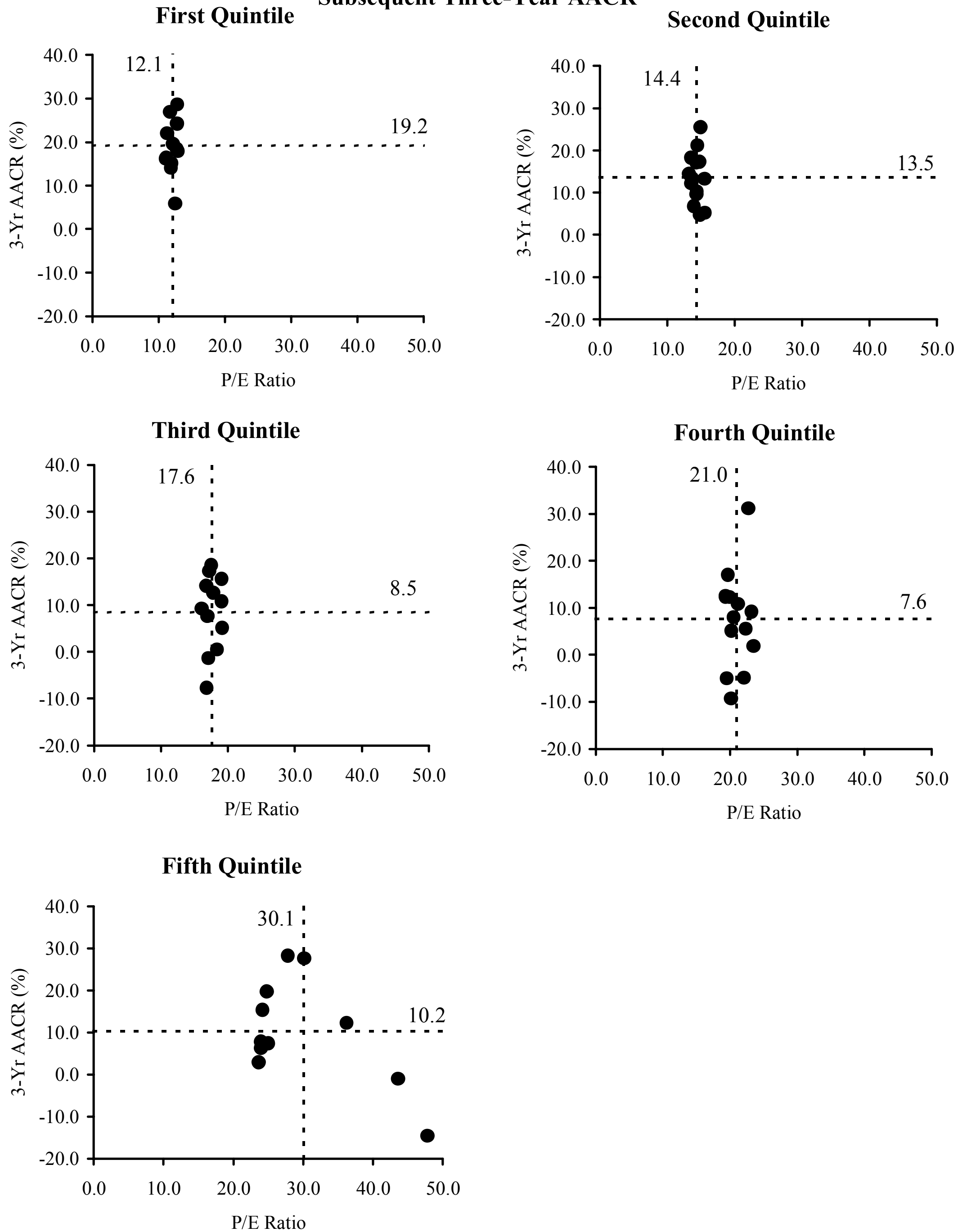
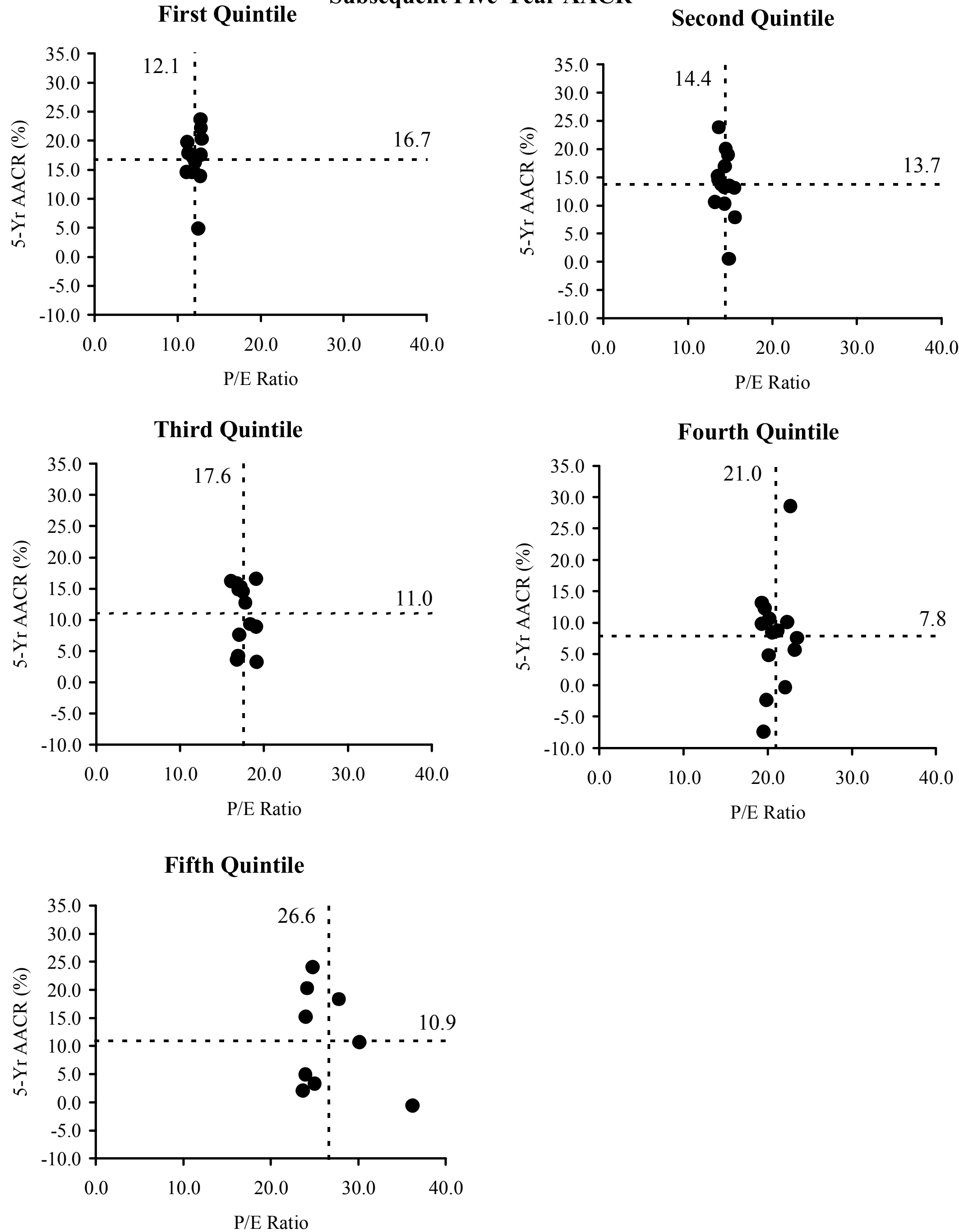


Table C (continued)

RELATIONSHIP BETWEEN S&P 500 NORMALIZED PRICE-EARNINGS RATIOS AND SUBSEQUENT AACRS

1935-2002

Subsequent Five-Year AACR



Sources: Calculated from data provided by Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal* .

Note: Dashed lines represent the average price-earnings ratio and average subsequent period AACR for the quintile shown.