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Signs of a bottom?

Stocks are cheap, but investors are fearful

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March 1, 2009, 6:01 AM EST

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By most measures, stocks are now cheap enough to justify a legitimate market rally that could easily develop into a multiyear bull run, according to some market watchers.

The main sticking point, however, seems to boil down to a lack of confidence tied largely to spreading uncertainty over government intervention and economic-stimulus efforts.

"I think the ultimate lows in the stock market will be this year, but from a practical standpoint, you need to see some stabilization in the economy," said Gary Flam, managing director and head of equities at Los Angeles-based Bel Air Investment Advisors LLC, which has \$6 billion in assets. "The big-picture issue right now is that just as a few years ago, people thought the good times would go on forever, right now, people think the bad times will go on forever."

Based on current conservative estimates that the aggregate earnings of the companies making up the Standard & Poor's 500 stock index will be \$50 for 2009, the benchmark's forward price-to-earnings ratio is 15.

This matches the historical average P/E going all the way back to 1926.

But even at such a low, it is difficult for some money managers to characterize stocks as being on sale.

"Right now the market really doesn't even care about valuation, because it is looking for fundamentals and stabilization from a policymaking point of view," said David Chalupnick, head of equities at Minneapolis-based FAF Advisors Inc., which has \$106 billion in assets.

MARKET TROUGH

Using the cyclically adjusted price-earnings ratio, a measure that smoothes out economic ups and downs by taking profits over the previous 10 years into account, the benchmark's P/E comes in at 13.5 — significantly below its historical average of 16.3, dating back to 1881. Over the past 60 years, a market trough has typically happened when the P/E has fallen to somewhere around 14 using that valuation model, according to Craig Columbus, president of Advanced Equities Asset Management in Scottsdale, Ariz.

"Right now we're getting into a range where the markets look near a bottom," he said. "But we know that the markets can stay overvalued or undervalued for a long time, so it depends if you want to look at the glass as half full or half empty, because you can get to either place."

The half-empty argument can be made by applying the stock market's 1932 bottom during The Great Depression when the S&P's trailing P/E dipped to 7.

If you apply that 7 P/E to the current market, it would suggest a market bottom of around 400, representing a 47% decline from where the S&P is currently trading.

"That's not the scenario I think is most likely," Mr. Columbus said. "I think the markets are starting to look more reasonable, and if you strip out financials there are some fairly healthy corporate balance sheets, but right now there's a lack of consistent policymaking and that's why sentiment is still ruling the market."

Part of the muted attitude toward stock market valuations might also be related to the fact that 2008 exposed the financial services industry's propensity for underestimating risks, according to Craig Callahan, president of Icon Advisers Inc. in Greenwood Village, Colo.

"To us, last year was a learning opportunity, and we've changed the way we quantify risk," he said. "We start now by considering the requirements to bondholders and then add a premium for equity risk."

Icon, which manages \$2.5 billion, calculates the value of about 2,000 domestic stocks, discounting earnings projections back to present value.

The valuation strategy, which is similar to a dividend discount model, calculates the current stock market at 31% below fair value.

This is the most undervalued Mr. Callahan has seen the market since March 2003, when the markets were concerned over fallout from the pending Iraq war.

Mr. Callahan said if gross domestic product data turns positive, as some analysts anticipate, in the third quarter of this year, then the stock market, which typically leads the economy by four to six months, is already at or near a bottom.

POSITIVE GDP

"Some people are acting as if there's no end to this thing," he said. "But by the second half of this year we'll return to positive GDP."

Based on that analysis, Mr. Callahan said he expects sectors such as technology and consumer discretionary, which have been punished in the downturn, to lead the market on the way up.

Stock valuations also get a boost when compared to less risky alternatives, namely a 2.7% yield on 10-year Treasury bills.

"That bodes well for the value of stocks, and it shows why you can't look at valuations in a vacuum," said John Buckingham, chief investment officer at AI Frank Asset Management Inc. in Laguna Beach, Calif.

Mr. Buckingham, whose firm manages \$350 million, translates the S&P's 15 P/E into a 6% yield.

He also factors in the high end of earnings estimates at \$63, which translates to a P/E of 12 and an 8% yield.

"There are so many undervalued stocks out there right now that we've had to implement an additional matrix to weed out companies," he said "But right now fear is still ruling the roost, and some of it is very valid."

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