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by Greg Gann

<u>Explaining Price/Earnings in Plain English to Judge Current Valuations</u>

We have all heard the adage to buy low and sell high. That sounds great, but what exactly does that mean within the world of stock and bond investing? One of the most fundamental measurements in making this assessment is the price to earnings ratio (P/E). Essentially when you are buying a stock or a bond, you are buying a future income stream generated by earnings. If you pay a high price for those earnings, you are limiting the likely possibility for appreciation. The reverse, of course, is similarly the case.

Allow me to expound upon this concept in plain English. Let's say we own a lemonade business that earned $10,000 and has issued 10,000 shares of outstanding stock. In that case we would have earned $1 per share. Now, let's say our company earns $1 per share, but is trading at a price of $15 per share, then our price relative to earnings or P/E ratio is 15. If earnings remain flat but the price of our stock goes to 25, then our P/E ratio would escalate to 25.

The S&P500 is a composite of 500 stocks listed in the U.S. from vast and diverse sectors of the economy. The historical median score for the P/E of the S&P 500 is around 15. When the P/E falls within single digits, the market is considered cheap and undervalued. Buying into the S&P 500 when its P/E is within the single digit range is the classic definition of "buying low". Buying into the S&P 500 when its P/E is around 15 means that based on this measure, one should anticipate an average prospective return.

Today, the P/E for the S&P 500 is a bit over 25. Going back to our lemonade example, if our lemonade company were trading at the current level of the S&P 500, it would mean that investors would be buying into a company trading at 25x its current earnings. Evaluating long-term P/E ratios of the S&P 500 averaged over a ten year rolling term, and comparing where the number is today indicates that we sit today at the second highest level ever, and only exceeded in the year 2000 at the peak of the dot com era.

So far in 2017, nearly half of the gains in the S&P 500 index have come from just 10 companies. And, to even further elucidate how narrow the range has been, the vast majority of these gains have come from just five companies. To provide a greater sense of the degree to which the major indexes such as the

S&P 500 and Nasdaq have been pushed higher by a slim margin of companies with extended P/E ratios, I would like to provide some examples. The trailing twelve month P/E ratios for Amazon, Netflix, Facebook, Microsoft, and Google are 178.5, 205, 38.21, 30.2, and 32.30 respectively. That means investors in Amazon are paying 178.5x earnings generated over the last twelve months. Netflix investors are paying 205x earnings, and investors in Facebook are paying 38.21x earnings.

Passive index funds have experienced the greatest inflows of capital over the last nine years. In fact, over this time frame, inflows into such funds have grown at an annual rate of somewhere estimated around 20%-25%. Indexes, and therefore the index funds which are designed to mimic the index, are disproportionately weighted to companies with the largest market capitalizations, and therefore commonly those with the most elevated P/E ratios. For example, within the S&P 500, Apple constitutes about 3.5% of the index. Facebook comprises 1.6% of the index. Amazon counts for 1.7%, and Microsoft and Google each comprise roughly 2.5%. With respect to the Nasdaq, Apple, Amazon, Google, Microsoft, and Facebook comprise 12%,7%,9%,8%, and 5.5% respectively. So, as all of this money has flowed into passive index funds post the financial crisis, most of it has concentrated amongst a relatively minute number of companies.

By investing into index funds, investors have ignored market valuations and concentrations. It is tantamount to investors buying shares in my lemonade business at wildly high multiples and expecting that my earnings will somehow skyrocket and/or that the price other buyers will pay for my lemonade will continue to increase pushing multiples to even greater extremes. If we are to buy low and sell high, now is a critical time to evaluate your holdings.

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All indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.