PORTFOLIO MANAGER INSIGHTS

WEEKLY INVESTOR COMMENTARY | JANUARY 20, 2021

Investment Committee

As the stock market continues its steep climb after last year's bear market crash, some investors worry about the possibility of a bubble. Over this period, the S&P 500 has risen 70% with dividends reinvested even as the pandemic rages on, many businesses continue to feel the pinch, and there are concerns over inflation. This is especially the case in technology-led sectors that have significantly outperformed. Should investors be concerned?

The question of whether there is a "bubble," at least the way most investors understand the term, should be distinguished from "will stocks fall?" This is because short-term stock market pullbacks are normal and can occur without notice. The stock market experiences a few large pullbacks almost every year including declines of over 10%. Last year, there were twelve declines of 5% or worse, with the largest being 34%, the deepest since the global financial crisis. In 2018, there were eight such pullbacks and the largest decline was almost 20%. And yet, the stock market made significant gains over this period despite these setbacks.

Thus, it's natural that the stock market will fall at some point. But whatever the reason for investors to lose their nerves - global headlines, economic concerns, political uncertainty, etc. - the market also eventually recovers. Trying to predict the exact timing and nature of these declines often backfires, doing more harm than good. Staying invested and diversified through these events, no matter how uncertain they may feel, has more often been rewarded.

To distinguish between these short-term pullbacks and bubbles, it's important to consider value. As with everything in life, what matters in investing isn't just what price you pay but what you get for your money. After all, the reason investors buy stocks is to own a part of a business and its cash flows. Thus, valuation metrics such as price-to-sales, price-to-earnings and more tell us not just the price of a share - but what we're getting for that price.

On this basis, major stock markets are certainly expensive by historical standards. The S&P 500's price-to-earnings ratio, at above 22 times next-twelve-month earnings, is approaching its dot-com era peak. Most other measures are also at their highest levels in the last 15 years.

THE STOCK MARKET IS NOT CHEAP COMPARED TO HISTORY

KEY TAKEAWAYS:

1. **The S&P 500 forward P/E ratio is elevated compared to its historical level. At the moment, this and other valuations are approaching dot-com bubble peaks.**
2. **Unlike during that era, today's high valuations are due to economic stress from the ongoing pandemic. Current investor and analyst expectations are for earnings and other fundamental measures to recover over the next year or two. If this happens, many of these valuation measures could come back down to earth.**

However, there are three important points to consider. First, it's well understood why valuations are elevated. The on-going pandemic and economic restrictions have hurt earnings and other fundamental measures. Thus, they have pushed up valuations over the past year. The fact that investors continue to buy and stay invested at these levels suggest they believe sales and earnings can recover, thus bringing valuations back down to earth. While there is still great uncertainty, this optimism has been rewarded since last March.

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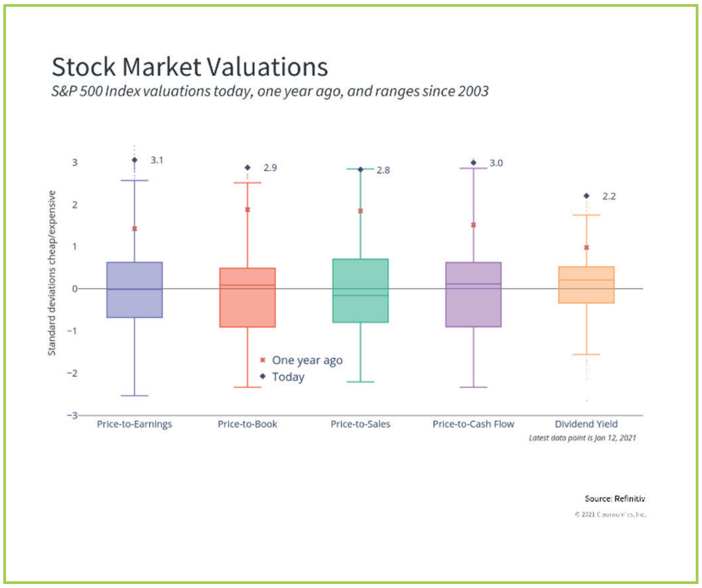
Second, even with higher valuation levels, the term "bubble" often implies a significant imbalance in the economy that will eventually "pop." More importantly, this bursting must then spread across the economy and result in a broader crisis. With the benefit of hindsight, this was true of the dot-com and housing bubbles to different extents.

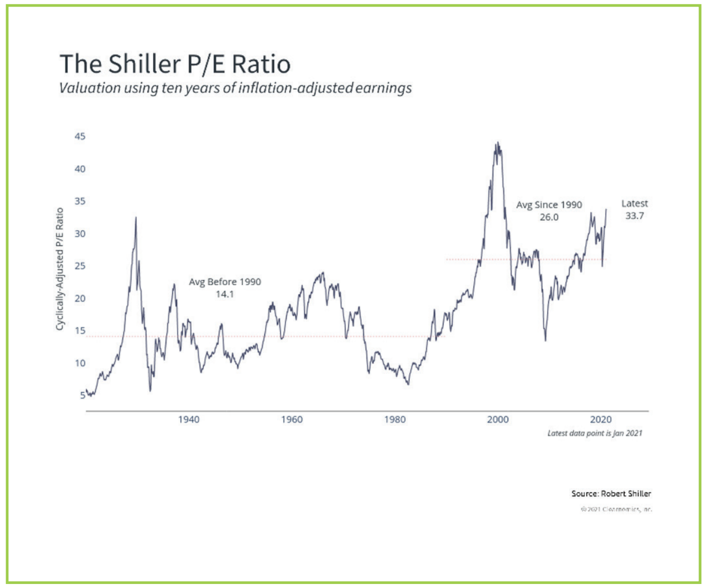
OTHER VALUATIONS ARE ALSO HIGHER BUT COULD NORMALIZE IN THE FUTURE



KEY TAKEAWAYS:

1. **Other commonly-used measures such as price-to-sales, price-to-book, dividend yield and more are also elevated.**
2. **This should be distinguished from a "bubble" as businesses continue to recover and interest rates remain low.**

THIS IS CONSISTENT WITH OTHER VALUATION MEASURES THAT LOOK AT LONGER TIMEFRAMES



KEY TAKEAWAYS:

1. **Other measures, such as the Shiller P/E ratio which looks at ten years of inflation-adjusted earnings, are consistent with the view that valuation levels could come down.**
2. **On this basis, valuation measures aren't quite where they were during the dot-com bubble, even if they are elevated.**

However, not only is it difficult to identify bubbles ahead of time, but not all highly-valued assets become bubbles - especially if they ultimately live up to expectations. There were many who called for a stock market bubble throughout the entire previous bull market cycle which became the longest on record. The fact that tech stocks and other pandemic-resistant sectors have risen does not necessarily mean they are in a bubble either. Instead, many companies have become more valuable over the past year, both in terms of their services and in their contributions to portfolios.

Third, interest rates are still extremely low. In general, this can boost stock market valuation levels since there are fewer attractive asset classes that can generate sufficient income and also reduces the cost of capital for companies, among other effects. While this does not guarantee that stock market valuations or prices can stay high indefinitely, it is a factor that has been at play since this low-rate environment began over a decade ago.

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What does this mean for everyday investors? Overall stock market valuations are certainly above average. However, rather than constantly fear bubbles, investors are better off staying diversified across sectors, styles and geographies in order to benefit from upside while protecting from possible downside risks.

The bottom line? While valuation levels are high, this does not necessarily imply that there is a stock market bubble. At the same time, short-term pullbacks are always possible. Investors should remain disciplined and stick to their long-term investment plans.