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What Is A Fair Price To Pay For Stocks?

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What Is A Fair Price To Pay For Stocks?

By Jim Pearce (bio at end)
April 12, 2018

By now, it is apparent that wary cynicism has replaced the tidal wave of unbridled optimism that propelled the stock market to record highs over the past two years. After peaking on January 26, the S&P 500 Index had more negative days than positive ones through the end of March while racking up a 9.3% loss in the process.

That has some investors wondering if the stock market has become oversold and is ripe for a rebound. That is always a possibility anytime a steep drop occurs over such a short period, but does not necessarily mean that there is less risk in the market. Instead of comparing the stock market's value today to what it was a few months ago, I believe it is better to measure it according to a trio of metrics that have proven over time to be a reasonably accurate barometer of its present value.

Earnings Yield versus Treasury Yield

The inverse of a stock's price to earnings ratio ("PER") is its earnings yield. For example, a stock with a PER of 20 has an earnings yield of 5%. Since profits are what stockholders own a proportionate share of, comparing the earnings yield to the yield on AAA-rated bonds gives us an idea of how much of a "risk premium" is priced into stocks.

The theory is simple; why take the additional risk of owning stocks when you can get the same yield (or higher) from safer bonds? Six years ago, when the Fed was pursuing its "ZIRP" (zero interest rate policy), the yield on the 10-year Treasury note bottomed out below 1.5%. Even if investors demand a 250 basis point (2.5 percentage points) risk premium for stocks, that results in an earnings yield of 4%, which equates to a PER of 25 times trailing earnings.

Now that the 10-year Treasury note is yielding closer to 3%, the equivalent earnings yield for stocks would be 5.5% for a PER of 18 times earnings. However, the multiple for the S&P 500 Index stubbornly remains near 25, suggesting that the yield spread between stocks and bonds is being ignored. If so, then the possibility of higher bond yields later this year as the Fed raises interest rates may not be as much of a threat to the stock market as originally feared. If not, then we could see a sudden drop when investors realize they are paying too much for earnings.

Forward P/E Ratio

If comparing the earnings yield for stocks to bonds is no longer relevant, then comparing the FPER (forward P/E ratio) for stocks is another way to determine a fair price to pay for them. After all, earnings over the past year may be considerably less than what they will be over the next twelve months, rendering an earnings yield comparison invalid.

However, we can compare the present FPER of the stock market to its historical metrics to get a feel for how likely it is to expand or contract. That is a less precise number since forward earnings are estimates while trailing earnings are fact, but on average it usually comes in pretty close to the mark. Over the past 20 years, the average FPER for the S&P 500 Index has been roughly 17 times earnings compared to a multiple near 18 at the end of 2017.

In that regard, the stock market does not appear to be excessively overvalued, especially when compared to its FPER of 27 achieved during the dotcom bubble in 1999. However, it is still more than 10% above its long-term average PER so, even after its recent 10% decline, it has a way to go before it can be considered fairly valued.

Price to Book Value

The term 'price to book value' ("PBV") is seldom invoked these days, but there was a time when a stock was priced based on the net value of its assets. Since stockholders own the company, then by extension they also own a proportionate share of the company's assets. After deducting depreciation and liabilities, what is left over is what the shareholders theoretically own.

Old school investors such as Warren Buffett still refer to book value occasionally, but you won't find any self-respecting "Master of the Universe" on Wall Street talking about it these days. That is partly due to the increasingly nebulous definition of exactly what an asset is. The notion of "intangible assets" such as branding has muddied the waters, as has claims on "intellectual property" due to the rise of information technology.

That being the case, we should compare the PBV for the S&P 500 Index over the past decade for a sense of where it is today versus at the onset of the Great Recession. At the end of 2007, the PBV for the index was 2.8 compared to 3.2 last month. At that level, the PBV for the stock market today is 14% higher than just before its most recent crash.

Looking at these three metrics, the conclusion is inescapable: Although the stock market is less overvalued than it was a few months ago, by historical standards it is still expensive and investors should make decisions accordingly.

However, there is one way you can make money while stocks are stuck in a sideways pattern, as my colleague Jim Fink explains HERE.

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Bio | **Archive**

Jim Pearce is the Chief Investment Strategist of *Personal Finance*, our flagship publication. He is also the Director of Research at Investing Daily, overseeing the work of our entire analyst team. He began his career as a stockbroker in 1983 and over the years has managed client investment portfolios for major banks, brokerage firms and investment advisors. Jim has a BA in Business Management from The College of William & Mary, and a CFP from the College for Financial Planning.