Richard Bernstein Advisors

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RBA Quick Insights

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Perception vs. Reality: Valuations

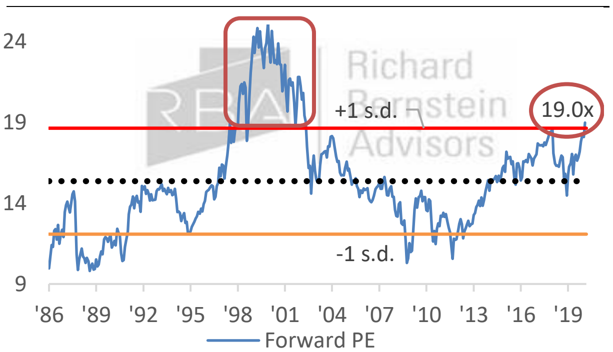
Having begun my career in the aftermath of the Tech Bubble collapse, I distinctly remember how obvious the bubble seemed to everybody…with the benefit of hindsight. The emergence of new technologies, particularly the internet, was going to change all our lives and create limitless opportunities for new business lines and profits. That part actually turned out to be true.

The problem lay more in the lack of discipline around determining how much to pay for these technology stocks and which stocks would ultimately outperform. How could investors have missed the warning signs? Neighbors, uncles, colleagues, gym buddies and taxi drivers all had tips on which stocks could double within a year, while people were leaving their jobs in droves to day trade or to join tech start-ups. Most glaringly, though, stock valuations skyrocketed to never-before seen levels, with the Tech sector commanding a third of the value of the entire stock market. Yet few market experts were ringing the warning alarms (most skeptics were eventually forced to capitulate as Tech returns exceeded 100% in the final year of the cycle).

As we approach the 20th anniversary of the Tech Bubble peak, valuations have returned to levels not seen since (see first chart). Is irrational euphoria coming back? A broad-based look at sentiment and valuation suggests that capital is becoming more abundant (i.e. optimism is building), which is generally a headwind to future returns (returns are greatest when capital is scarce). Many investors justify today's higher valuations based on interest rates being low, but the questions investors need to ask are: (1) Why are rates low? (2) Will they stay low? and (3) What does the empirical data suggest? If rates are low because they are discounting lower long-term growth prospects, it probably doesn't warrant paying a higher multiple. Also, if current rates do not stay low for at least the next decade (a very underappreciated risk in our view), then the low rate argument loses credibility. But most important is the empirical data. History suggests that adjusting valuations for interest rates adds no value in predicting future stock returns; in fact, it makes predictions much worse (see second chart).

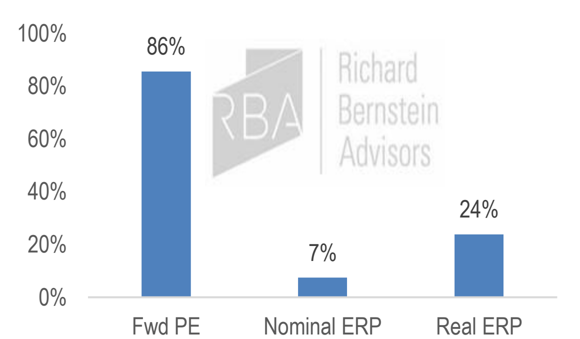
The bottom line: Valuation is a terrible timing indicator. The S&P 500® returned nearly 50% after it initially reached these valuation levels in 1998 (before going down nearly 50% in the subsequent bear market). But high valuations do suggest a worsening balance of risk and reward. Ultimately, returns are determined by valuations and cash flows, not narratives and stories.

S&P 500® forward PE ratio since 1986



Source: Richard Bernstein Advisors LLC, S&P, Refinitiv

Predictive power (r^2) of 10-year S&P 500® returns (since 1986)



Source: Richard Bernstein Advisors LLC, S&P 500, FRB, BLS

What is the equity risk premium (ERP)?
The equity risk premium (ERP) is the equivalent of a credit spread, but for the stock market. It's the extra return that investors require to take on the added risk of holding stocks rather than locking in a risk-free return. It can also be thought of as a way to adjust equity valuations for the level of interest rates. One simple approximation of the nominal ERP is to calculate the difference between the earnings yield (the inverse of the P/E ratio) and the risk-free rate (using the 10-year Treasury yield as a proxy). But some argue that, because earnings tend to grow with inflation, the earnings yield should be compared to the real risk-free rate (which we approximate here by subtracting CPI y/y%). While this is a useful concept, as we show in the chart above, these measures actually reduce the P/E ratio's effectiveness in forecasting future returns.
Nominal equity risk premium (ERP) = EPS/price - 10-yr Treasury Yield; Real ERP = EPS/price - (10-yr Treasury Yield - CPI y/y%)

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