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Impending stock market adjustment ahead...

Investors in Kurrekurredutt Isle

A guest contribution from Uwe Günther

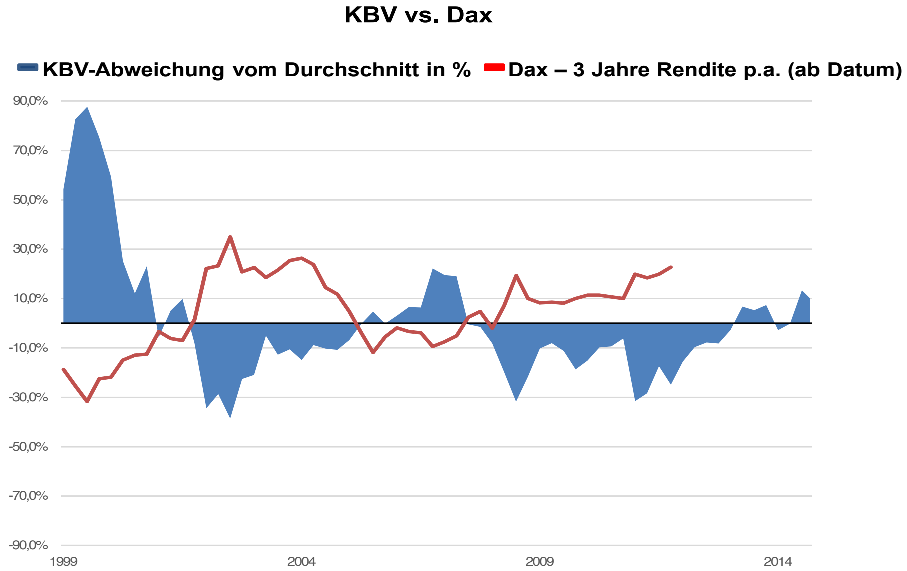
Stock markets are clearly overvalued. In the past, this has frequently led to crashes. But investors simply cannot prevent themselves from making the four big mistakes.

Pippi Long-Stocking was published for the first time exactly 70 years ago. The story of the little girl refusing to accept the rationality of the adult world has been a bestseller ever since. Looking at the actors on the capital markets in recent weeks, we cannot fail to get the impression that childhood dreams and a refusal to accept the realities and economic laws are also increasingly taking hold. Do the investors of today live on Kurrekurredutt Isle? Too far-fetched? Not in the least!

Like Pippi Long-Stocking, stock marketers are shaping the world into what they would like it to be. But they are making four serious mistakes:

Mistake No. 1: Shares are basically not expensive

If we look at the Dax price development in relation to the price-to-book-value ratio (PBV) across the entire stock market cycle, this shows that: Shares with relatively high PBVs do not offer good returns in the subsequent period. The substance-focused key ratio sets the price of a share in relation to its book value, i.e. to equity. It is less the absolute value of this key ratio which matters - it is its trend.



Quelle: BPM - Berlin Portfolio Management

In the past, whenever the price-to-book-value ratio of Dax companies (blue area) was above its long-term average, investors in the three subsequent years suffered negative earnings (red line) - they lost money. And the reverse of this relation also applies. For instance, after the dotcom bubble burst (2002-2003), the Dax PBV was around 40 percent below "normal", and in the period that followed, the Dax increased by 35 percent – per year no less. Currently, the Dax PBV is around ten percent above its long-term trend - which does not bode well. The German stock market is not the only one to be valued as (too) high at the moment - and at a minimum, it is ready for an adjustment.

Mistake No. 2: Shares are attractive compared to bonds

We must also qualify this assumption. The attractiveness of an investment greatly depends on expected earnings. The more an investor must pay for an investment, the lower will be the probable return. To give an example: If the cash flows from dividends are currently three percent above nearly no-interest bonds, and this lasts for five years, this would justify an increase in the valuation of 15 percent compared to the historic average valuations. At the moment, however, the risk premium of shares exceeds the widened cash flow range many times over. Let's take the example of Nestlé (WKN A0Q4DC): The favourite among value investors currently reaches a price-to-book-value ratio of 3.3. This means that only around 20 Euros of the 70 Euros which the share currently costs are substantiated by equity to which the shareholders are entitled. The remaining 50 Euros are future incoming cash flow, expected increases in profits and dividend increases. But experience tells us that if the development of profits and/or dividends falters, future expectations are dwarfed very quickly.

With bonds, investors at least receive back their nominal capital investment at the end of their term. This provides a high level of security. There might be hardly any interest, but at least the money isn't depreciated. In the current environment, fail-safe investments can be used to at least protect the value of the amount invested. This guarantee is lacking with shares. It makes them highly susceptible to price losses. Between 2000 and 2003, they fell by around 75 percent, and in 2008 and 2009 by about half.

Mistake No. 3: Companies are making fat profits

In a capitalist economic system, there is hardly a more reliable force than so-called mean reversion. This theory states that company profits fluctuate around a median value. Following the principle of "What goes up, must come down and vice versa", profits in the long term always return to their historic averages. Investments in shares at a time of high profit margins are frequently a guarantee for lower investment earnings in the future. Shares especially in the USA are currently at record highs. The extensive share repurchases are also contributing to this. In addition, companies are puffing up their supposed substance by delaying goodwill write-offs and pension provisions. A return to lower earnings would only be a return to normality.

Mistake No. 4: If you buy good value shares today, you can't go wrong
This statement can actually be true - or at least if investors think in periods of more than ten years. Today, this triggers the question what proportion of a share investment is actually substantiated with value and how much is no more than a fantasy inflated by borrowing? The extended valuations frequently used as an argument for a future increase in prices are nothing more than an inflation of company substance by adding virtually borrowed funds. According to experience, a significant proportion of the share price disappears in the usual debt crashes. Approximately the real substance remains. Incidentally, this also creates the contagious effect between bonds and shares: Dividends shares are increasingly financed by debts, which are nothing other than bonds. In turn, debts are in part secured using shares. Well then:

At the moment, all of these aspects make share purchases less attractive than they have been for a long time. The potential for adjustments is currently at least at the level of the years between 2000 and 2003 or of 2008 and 2009. Does it make us spoilsports to point out that the particularly the flows of cash after the crises in 2003 and 2009 drove the markets into massive incorrect valuations again? Nowadays, existing positions must be hedged.

A normalisation need not occur immediately. Expensive markets can get more expensive still! The basic mistake made by a lot of prophets of doom is that they do not (want to) recognise that overvaluation alone is not sufficient trigger for corrections - instead, a changed investor perception of risk is also required. While this remains, the party in Kurrekurredutt can continue. But as soon as stock marketers start addressing existing risks again, the party's over.

The principle used to be: Profits were made in the purchase, which was according to traditional teaching. But neither shares nor bonds can by now be purchased cheaply. Today, the principle is: Profits are made in the sale, which reminds us of a deja-vu of the New Market. And tomorrow, the principle might be: Profits are made by participating, which would mean the illusion of endless stock market booms. We'll stay true to the first.

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