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and

Euphoria on Wall Street

Warren Buffet's valuation of evaluate the equities market

A guest article by Uwe Günther

Warren Buffet is often regarded as an equity-fan. However, his favorite key indicators demonstrate that the S&P 500 is massively overvalued.

One of the world's most quoted, most revered and probably also the most successful investor of the present age is Warren Edward Buffett. Every year thousands of asset managers and investment professionals make the pilgrimage to Omaha, home of the shareholders' meeting of Berkshire Hathaway, the legendary investor's investment company. There they prostrate themselves at the feet of the master and discuss with fellow spirits the advantages of value investing à la Graham, Lynch and of course Buffett.

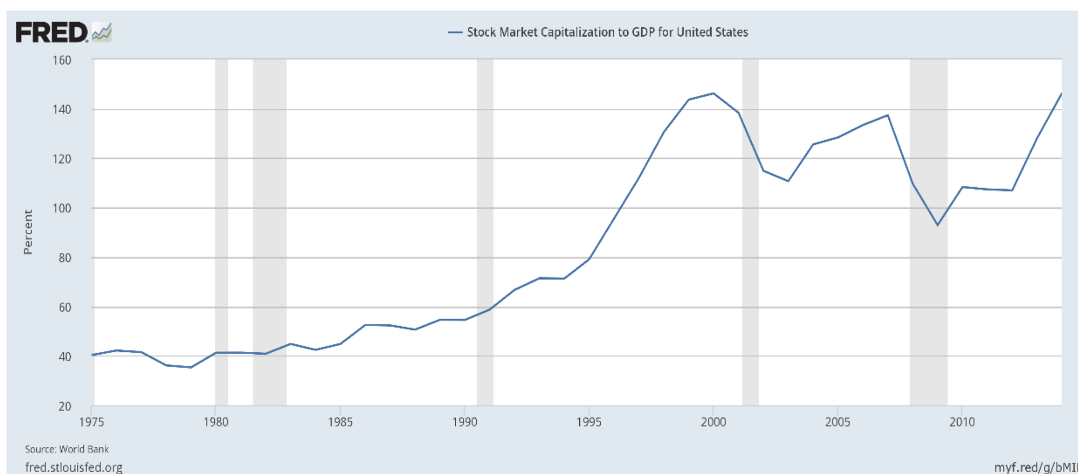
With his investment strategy the 'Oracle of Omaha', as Buffett is often referred to, has laid the foundation for the asset creation of countless investors. At the same time he has provided the professional backbone of many business models applied in the contemporary asset management industry. We ourselves successfully make use of solutions which are based on his principles.

So far, so good. In spite of this, with some fans the cult status of the master seems increasingly to be leading to generalizations and exaggerations in their pro-equity argumentation, which make a critical and objective analysis more and more difficult.

Record valuations - as in 2000 and 2008

Buffett's favorite indicator is the market capitalization of shares in relation to a country's gross domestic product (GDP). The aim of this figure is to determine whether an equity market is overvalued or undervalued in relation to the real economy.

The S&P 500 in relation to US economic performance

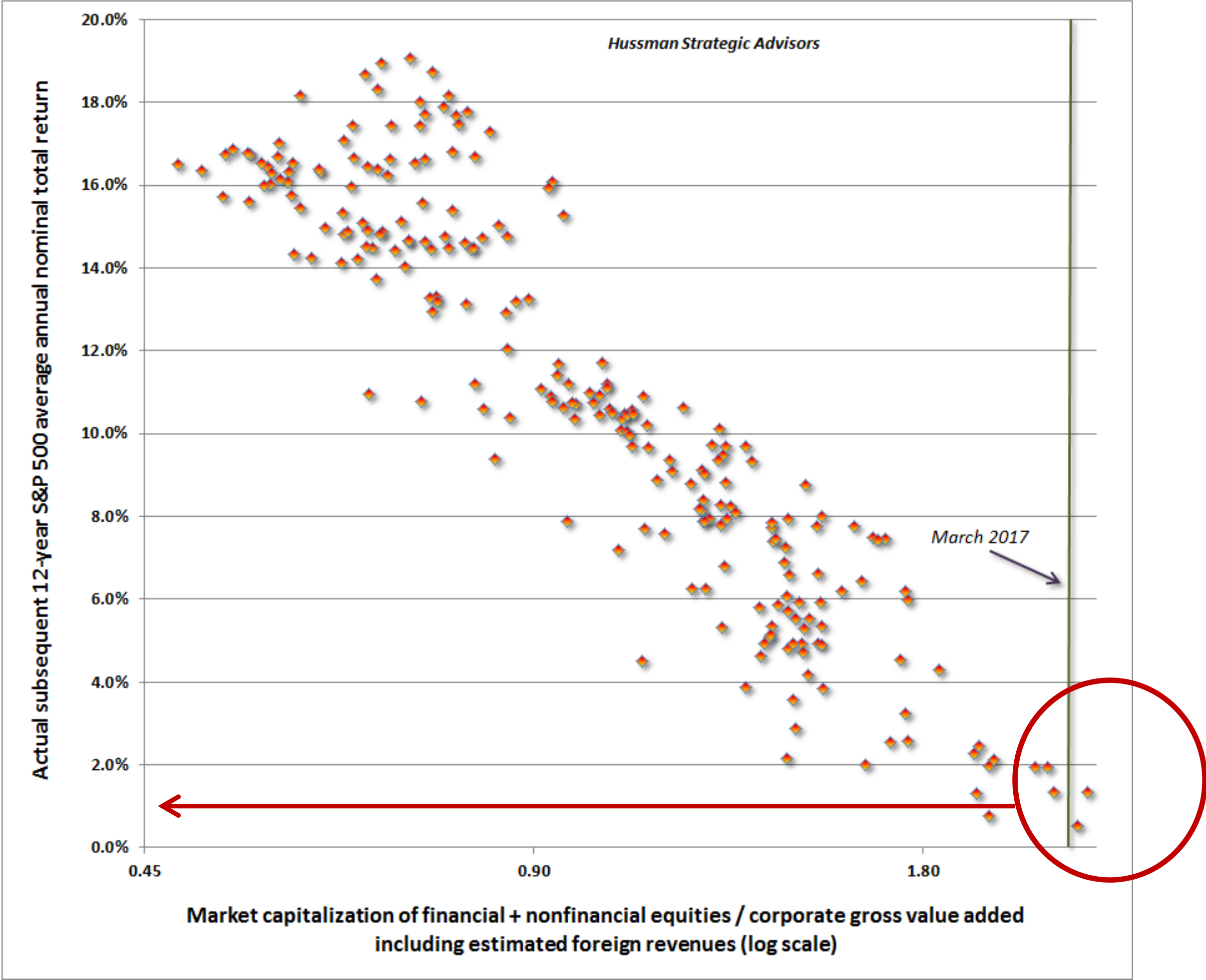


Source: Federal Reserve of St. Louis, USA

Measured by the S&P 500 index, which consists of America's 500 biggest listed companies, the American equities market in relation to US GDP is currently at its second-highest level since 1950. The only time when the indicator was higher was at the end of the 90s, just before the TMT bubble burst. In the years 2000 to 2003 the optimism of investors at that time was punished by a drop in share prices of up to 70%.

At the present day, these high indicators carry the risk of painful share-price losses. And it is only consistent to assume that a healthy market correction of 20 to 40 percent in equities would also exert massive pressure on Buffett's value stocks including a significant markdown on the inner company value.

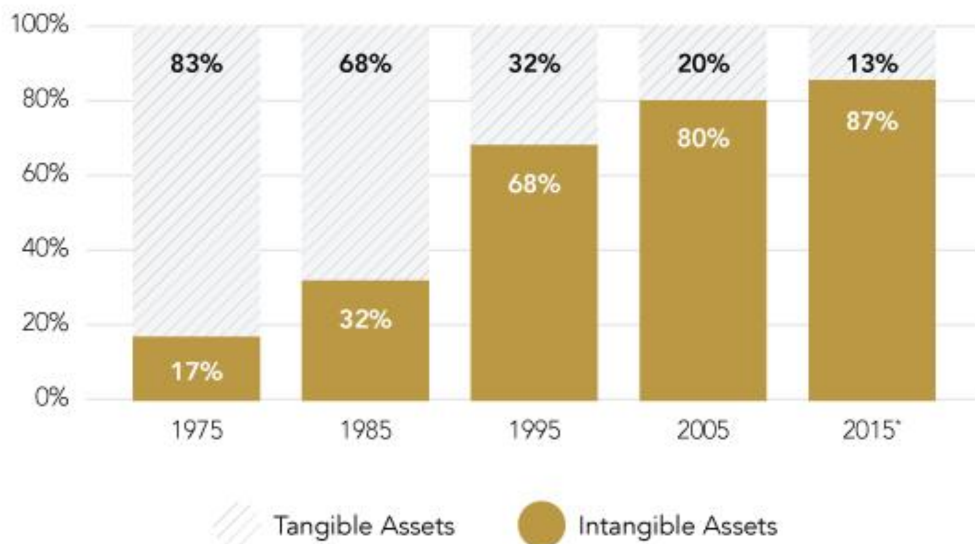
Things don't look much better in the case of the slightly modified version of this indicator, namely market capitalization in relation to the gross value added to an economy. Gross value added is the total value of the goods and services produced, less the value of the production costs. This, too, also leads to a dramatic revelation: apart from the year 2000, this indicator has not been worse at any time in the last 70 years. On the basis of this situation 'spoilsports' will come to the conclusion that in the next 12 years the overall annual yield of the S&P 500, in other words share-price gains plus dividends, will hardly amount to more than one per cent per year. Check out the following diagram, for example:



Source: Hussman, Strategic Advisors, USA

As a third example, a look at the real substance behind the shares in the S&P 500 will also be enough to demolish the current optimism. In 2015 the proportion of real tangible assets in the books of the S&P stocks reached a temporary low at 13% - this results from 'creative' valuation of intangible balance sheet assets and excessive new debts. Many companies have borrowed money at low interest rates to finance share

repurchases. In future the rising cost of servicing the relevant loans could – even in the event of a moderate rise in productivity – put the final nail in the coffin of many companies.



Conclusion: Buffett's strategy lives. However, it isn't fair to use him as the justification for every generalized promotion of equities as an investment option. Especially as many of the stocks that investors have in their portfolios would not meet his criteria. And if there is an abrupt market correction, Buffett has prepared for this eventuality with a highly appropriate bon mot: "Never buy a stock if you aren't prepared to see its price halved."

Uwe Günther is a founding member and Managing Director of BPM - Berlin Portfolio Management GmbH, Berlin.