

How Pricey Is This Market, Really?

A valuation check-up, and why a little insurance can be worth a small yearly cost

A fair question I get is why anyone would run a strategy that, over the long haul, has earned about one percent a year less than a plain, cheap balanced fund like Vanguard's Balanced Index (VBIAX). The honest answer is that the two are not really trying to do the same job. The balanced fund is built to capture the full ride, up and down. The strategy is built to step out of the way when the trend turns, trading a bit of average return for a smaller stomach-drop in a bad market. So the sensible thing to ask is a simple one. How stretched are stock prices today, and is this the kind of moment when that small yearly cost buys something worth having?

The yardsticks, one by one

The best-known yardstick is the Shiller price-to-earnings ratio, sometimes called CAPE. It compares stock prices to the last ten years of earnings, adjusted for inflation, so a single good or bad year does not throw it off. Today it sits around 40. To put that in plain terms, the long-run typical reading is about 16 or 17, and the only times it has been higher than now were the peak of the dot-com boom in 1999 and 2000 and the run-up in 2021. High readings like this have never told you the market would fall next week, but historically they have gone hand in hand with weaker returns over the following decade.

A second gauge is the one named for Warren Buffett, which stacks the total value of the stock market against the size of the whole economy. Buffett once called anything over 120 percent expensive. Today it is near 235 percent, about as high as it has ever been. Jeremy Grantham's firm GMO, which forecasts returns seven years out, tells a similar story. Their latest work pegs U.S. large-company stocks at roughly a negative five percent real return per year over the next seven years, meaning after inflation, and rates U.S. stocks the most overpriced major asset in the world.

Grantham also has a useful way of describing just how far prices stray from normal. He measures the distance in what statisticians call standard deviations, which is simply a way of saying how rare a stretch is. An ordinary bubble reaches a level of extreme he calls two standard deviations, a reading that in a calm world would show up only once in a great while. A true superbubble, like 1929, 2000, and 2021, is even rarer. His point, backed by every prior case in developed markets, is that these extremes have always eventually drifted back to normal.

No single number is gospel, so it is worth glancing at a few more. Forward price-to-earnings, which compares prices to the coming year's expected profits, is about 20 today against a ten-year norm nearer 19. The excess CAPE yield, which measures how much extra stock investors are being paid over safe bonds, is thin, a sign there is not much cushion. Others worth

watching are the dividend yield, the price-to-sales ratio, and Tobin's Q, which compares stock prices to what it would cost to rebuild the companies from scratch. Nearly all of them are flashing the same color.

The honest takeaway

Valuation is a poor stopwatch. Pricey markets can grow pricier for years, and none of these gauges can tell you the day, the month, or even the year a decline arrives. What they can tell you is that the ground is tilted, that both the odds of a meaningful fall and the likely size of one are higher than usual. That is exactly the setting in which giving up a sliver of return each year, in exchange for a rule that quietly steps aside when the trend breaks, starts to look less like a cost and more like cheap insurance. Whether that trade suits you depends on your own nerves and your own timeline, and only you can answer that.

— John