

# Has the Market Gone Crazy?

First Quarter 1998

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The first quarter of 1998 was another very good year for investors. The market shrugged off a steady stream of reductions in corporate earnings estimates along with slightly higher interest rates to post a remarkably strong 14% gain for the quarter. As a result, based on our analysis of expected returns for stocks versus bonds, the market is now approximately 10-15% overvalued. While this is still within the range that we consider to be “normal,” we are approaching the boundary.

Given the market’s strength there are three questions which undoubtedly are on the minds of investors:

- Has the market gone crazy?
- Are there any investment opportunities available at reasonable prices?
- Will we ever be able to achieve our target of outperforming the S&P 500 over a full market cycle?

Since our inception at the beginning of 1996, the market has appreciated at an annual rate of 32.1%. While we have only matched the performance of the market during this period, we have done so with considerably less risk. Undoubtedly, owning an index has been a smart thing to do during the past few years. Is there a place for a lower risk strategy? We think so. To own the S&P 500 today entails risks far greater than implied by the recent lack of volatility, namely the risk inherent in high valuation and above trend earnings.

While our portfolios don’t include many of the high-flyers that have driven the market in the recent past, they have managed to keep pace with the market without incurring some of these high valuation risks. At 4.4 times book value, and historically unsustainable returns on equity, the S&P 500 will be a risky place to be when earnings return to normal. Our portfolios are already selling at a low price, and have earnings in line with long term trends. Consequently, the risk is far lower.

Given the likelihood that the next five years should witness stock market returns significantly below the last five years, a research driven process can uncover opportunities without paying a high price. ♦