PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

July 2019

This Paradigm focuses on the contribution that changing valuation levels can have to returns, both in the short term and the long term. The main takeaway from this Paradigm is that sometimes changing valuation levels are more important to returns than earnings and economic growth.

We are not going to address the many factors that contributed to the composition of returns. Our interest this month lies in reminding investors about the importance of changing valuation levels to returns, both in the short and long term.

For stocks, we will use the change in P/E ratio as our valuation metric. For bonds, we will use the change in price as our valuation metric.

2019's First Half

For this exercise, we will only look at returns for the S&P 500 Index and the Bloomberg Barclays U.S. Aggregate Bond Index.

Asset Class	First Half Returns
S&P 500 Index	18.5%
Barclays U.S. Aggregate Bond Index	6.1%

The S&P 500 performed exceedingly well in the first half. Earnings estimates for the S&P 500 have remained near $165 for the entire year. This is important for two reasons. First, it means that the S&P 500 ended the second quarter slightly less than 18 times the estimated earnings for 2019. This is above the long-term average but does not appear to be at "market bubble" levels.

The second reason this constant earnings estimate is important speaks to the contribution that changing valuation levels (changing P/E ratio) had in the first-half returns. The year started with valuation levels slightly more than 15 times the $165 figure. This means that the vast majority of the 18.5% return is from rising valuation levels as opposed to earnings growth and dividends.

An analogous story existed for bonds. The bond index's yield is slightly less than 3% per year or 1.5% for half a year. This implies that of the 6.1% return, 1.5% is from interest and 4.6% is from rising bond prices (rising valuation levels) due to falling interest rates. This means that, like stocks, the vast majority of the 6.1% return is from rising valuation levels as opposed to interest income.

10-and 20-Year Periods Ending June 30, 2019

Given how much changing valuation levels contributed to first half returns, we thought it would be useful to review the impact over longer periods. For this exercise, we are going to look only at the S&P 500.

Let's look back at the past annual S&P 500 returns for the 10- and 20-year periods ending June 30, 2019, as shown in the table below.

Index	10 years	20 years
S&P 500	14.7%	5.9%

To be clear, the table says that for the 10-year period ending June 30, 2019, the S&P 500 returns were **14.7%** per year, and that for the 20-year period ending June 30, 2019 the S&P 500 returns were **5.9%** per year.

The previous section showed that stock valuations were above average on June 30, 2019, but not in bubble territory. This means that for the two time periods above, the ***beginning*** valuation levels had more to do with returns than the ending valuation level.

Think back 10 years: The S&P 500 bottomed out in March 2009 at a price over 50% below its 2007 peak. Although the market had recovered some by June 2009, the beginning valuation level materially contributed to the nearly 15% returns per year for the past decade.

The beginning valuation also helps to explain the 20-year returns of roughly 6% per year. Think back 20 years: The S&P 500 was near the end of its huge dot.com era run. In fact, the S&P 500 peaked in early 2000 at a P/E ratio of nearly 30. Returns, therefore, were impacted over the past 20 years as the P/E ratio (the valuation level) declined from 30 to 18.

Changing valuation levels affect returns. Sometimes the affect can be major. We simply ask investors to remain aware of this, in both good times and not so good times.

Tel. 425-213-1600 3740 Carillon Point Kirkland, WA 98033 www.privateasset.com