WALL STREET JOURNAL

August 7, 2017

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Are Stock Prices Dangerously High? It Depends How You Look at It

Jeff Brown

U.S. stocks have set record after record this year, pleasing investors who might have expected a postelection slump. But have prices soared to levels that are too risky?

Just as a 50-degree day is cool in August and warm in January, share prices can look high or low depending on the frame of reference. Still, by almost any standard, share prices are indeed high today—sobering for anyone with a serious stake in the market. Consider the three most popular measures: trailing price-to-earnings ratio, forward P/E ratio and cyclically adjusted P/E ratio.

"Each of the measures is currently higher than its long-term average, prompting many market analysts to predict an impending market decline," says Brandon Thomas, co-founder and chief investment officer at Envestnet , a Chicago-based research and advice provider for financial advisers.—

Yet some experts make a case that stocks are *not* overpriced by important measures and will continue to rise. What's an investor to do?

Here's a look at what the top barometers are showing—and why stocks continue to defy them—along with the pros' arguments about what comes next.

Trailing P/E Ratio: The classic price-to-earnings ratio, or P/E, looks at the current price divided by the company's total earnings for the past 12 months.

Today, the P/E for the stocks in the S&P 500 index is about 24, meaning investors pay $24 for every $1 in corporate earnings. That's quite high compared with the historical average of about 15 or 16, but not so high compared with some periods of crisis in the past—more than 40 around the dot-com bubble and above 100 after the financial crisis broke. To return to average, prices would have to tumble or earnings skyrocket.

Some experts note, however, that it isn't unusual, or particularly risky, for the P/E to be somewhat higher than average when interest rates and inflation are unusually low. If you'll earn only a tad over 2% on a 10-year Treasury note, paying $50 for every $1 in interest income, why not pay 24 times earnings on a stock? That would be a 4% earnings yield (earnings divided by price). Also, a low earnings yield is easier to stomach if little will be lost to inflation.

Andrew Kleis, co-founder of Insight Wealth Group, a wealth-management firm in West Des Moines, Iowa, says that "in times of incredibly low interest rates, like today and the last several years, investors put their money into the equities markets because they believe that is their best opportunity for risk-adjusted returns. That drives up P/E ratios. It's happened before, and it's happening again."

This view assumes investors own stocks to share in current or future earnings, even though not all earnings are paid out as dividends. Undistributed earnings used for plant expansion, research and development or stock buybacks should boost the share price.

Forward P/E: For another look, many experts use a P/E based on projected or forecast earnings, usually from company estimates and a consensus among analysts. Because many analysts are predicting earnings will grow in the near and medium term, this view produces a P/E a little less frightening—currently about 19 for the S&P 500, close to its long-term average.

Jim Tierney, chief investment officer for concentrated U.S. growth equities at AllianceBernstein asset management in New York, says "forward earnings are what we care about the most," and notes that Wall Street analysts expect healthy earnings gains, producing a forward P/E just shy of 19 this year and close to 17 in 2018. "A bit elevated, but not excessive in a world where the 10-year Treasury as at 2.37%," Mr. Tierney says.

Of course, a forward-looking P/E can be off if earnings later come in higher or lower than expected. Earnings estimates sometimes have a bit of wishful thinking, and experts say many analysts currently assume earnings will be boosted by a big Republican corporate-tax cut.

Craig Birk, executive vice president of portfolio management at Personal Capital, an investment-management firm in San Carlos, Calif., says he prefers trailing P/E because it relies on established facts. "Forward-looking P/E is also useful, but it must be taken in the context that earnings projections tend to change meaningfully," Mr. Birk says.

CAPE: Robert Shiller, the Yale economist known for his book "Irrational Exuberance," which warned of price bubbles in stocks and housing, devised a different approach to reduce distortions from short-term factors. His "cyclically adjusted price-to-earnings ratio," or CAPE, divides the S&P 500's current level by the average of 10 years of earnings adjusted for inflation.

That produces a frightening figure—a P/E today around 30, matching the level on Black Tuesday in 1929, and nearly double the long-term average of about 17 (but still below the peak of nearly 45 in 2000).

While CAPE is less volatile than the other two P/E gauges, some experts caution that it can be misleading at times. Right now, the 10-year earnings average is dragged down by the poor results during the financial crisis, pushing the CAPE ratio up.

Steve Violin, senior vice president and portfolio manager, F.L. Putnam Investment Management in Wellesley, Mass., prefers a CAPE using a five-year earnings average instead of 10, feeling it captures the current business climate and avoids distortions from events too far back to matter.

"A five-year CAPE ratio tends to be reasonably stable by avoiding estimates and smoothing out annual fluctuation," he says. It's currently at 23.6, compared with about 18 over the long term.

A look at the S&P's components shows that P/Es vary, with some stocks riskier than others—and demonstrates that no gauge can provide a simple view by itself of what's going on.

Mr. Kleis notes, for example, that the average price of the S&P 500 is driven up by the 100 largest stocks in the index, with the remaining 400 trading closer to their historical P/E levels. "We know that investors have invested [their money] largely in the big, popular names they know and love," he says. Because the

index is based on market weight (stock price times number of shares), the top 100 make up 65% of the index's value and have a disproportionate effect, he says.

Debating what various gauges really mean at any given moment is an endless process that always has some experts screaming that the sky is about to fall and others saying, "What, me worry?"

The important point today is that all the most popular barometers say share prices are high.

Mr. Violin notes, though, that valuation measures like P/E ratios are only part of the picture and need to be seen alongside measures of profit growth and financial strength. For that, he recommends zeroing in on individual companies. "It's hard to use valuation ratios as a timing mechanism on their own," he says. "Elevated stock-market valuations can persist for extended periods as they are sometimes justified."

P/E ratios have been above average for years, and investors who dumped stocks as soon as they started to look high would have missed huge gains. "Stock valuations are elevated in aggregate, but economic and profit growth has justified these valuations so far," Mr. Violin says. "This trend looks like it could persist, especially if interest rates remain low."

Mr. Thomas says that despite high P/Es, the market is currently a "Goldilocks environment"—just right—due to low inflation and forecasts for higher corporate earnings. Though rising interest rates are traditionally damaging to stocks, Mr. Thomas believes rates are going up slowly enough for the markets to digest without much harm.

"Stock prices are at record highs for a reason," he says, "and that is an expectation of improving earnings growth going forward. Many analysts are forecasting an acceleration in earnings growth as a result of an expected tax cut."

Of course, things can go wrong. With the turmoil in Washington, for example, tax cuts are far from guaranteed.

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The New York Times

February 8, 2013, page B1

Einhorn Sues Apple Over Plan to Discard Preferred Stock

By MICHAEL J. DE LA MERCED

9:02 p.m. | Updated

Wall Street has had a long romance with Apple. Now one of the company's best-known investors is saying: I love you, but you need to change.

The surprising declaration by the billionaire hedge fund manager David Einhorn adds to the growing dissatisfaction with Apple and its once soaring stock.

On Thursday, Mr. Einhorn urged his fellow shareholders to block a plan by Apple to scrap a certain class of stock. He says that the move limits the company's ability to use its enormous war chest - some $137 billion in cash - to reward investors.

The campaign is an unusually aggressive one for Mr. Einhorn, who came to fame betting against Lehman Brothers. To thwart the proposal, Mr. Einhorn is suing Apple in Federal District Court in Manhattan, claiming that it violated securities rules by tying the plan with two other initiatives that he sees as good corporate governance.

The standoff sets up an unusual clash between two sides who can each claim a huge following on Wall Street. In one corner is Apple, whose stock's almost unearthly growth has bewitched investors across the globe - at least until recently. In the other is Mr. Einhorn, widely regarded as an intelligent investor whose moves inspire legions of copycats. His merely asking a few questions on an earnings call for Herbalife, a nutritional supplement company, last May prompted a plunge in its shares.

So far, each side has remained cordial. Mr. Einhorn called Apple "phenomenal" and contended that his campaign had nothing to do with its recent stock decline. His firm, Greenlight Capital, currently holds 1.3 million shares, now worth nearly $609 million.

"We own more Apple today than we ever have before," he said in a telephone interview. "We're optimistic about the company's prospects, and think too much bad news has been priced in."

In a response, Apple said that it "welcomes" Mr. Einhorn's views and added that its management and its board were actively discussing how to return more cash to shareholders.

But the spat underlines recent hand-wringing over Apple, whose stock has proved vulnerable in recent weeks. Over the decade that ended in late September, its share price soared an astounding 18,749 percent, to more than $700. Scores of hedge funds bought into the stock, riding its coat tails to bolster their own returns.

Since about Sept. 21, however, Apple's stock price has tumbled almost 33 percent, closing on Thursday at $468.22. (Even so, its market capitalization stands at $439.7 billion, making Apple the most valuable public company in the world.)

As the shares have fallen, the volume of criticism has risen.

"Because the stock has sold off from its high, and because Apple's earnings have declined for the first time in a decade, you'll hear people become more vocal," said Walter Piecyk Jr., an analyst at BTIG Research.

Since at least 2005, no shareholder has conducted a formal campaign against an Apple management proposal, according to the data provider FactSet.

Mr. Einhorn's main concern is Apple's cash hoard, which is bigger than Intel's entire market value. Shareholders have long complained that the cash, invested in the likes of Treasury bonds, is increasingly a drag on the stock price and should either be invested in new opportunities for growth or returned to them.

Last spring, the company announced a plan to return $45 billion to shareholders over three years, in the form of share buybacks and a dividend for its common stock. But that will hardly make a dent in a cash pile that swelled by $117 million a day during its most recent quarter.

Mr. Einhorn on Thursday compared Apple to his grandmother, whose experience surviving the Great Depression molded her into an extreme saver who did not leave voice mail messages for fear of using extra cellphone minutes. The company's own near-death experience in 1997, he said, left a similarly profound scar on its corporate psyche.

As an alternative, he has been proposing since last May what he calls a "win-win" for Apple and its investors. The company, he says, could issue $50 billion in preferred shares to existing shareholders, which would carry a roughly 4 percent annual dividend. Over time, Apple could issue more preferred stock and increase its overall payouts.

The idea, which Mr. Einhorn said had been discussed within his firm for some time, would reward shareholders while ensuring that Apple would spend that additional cash over time. He raised the idea with company executives, including Apple's chief financial officer, Peter Oppenheimer, over several months, but was rebuffed.

Mr. Einhorn became more aggressive after seeing Apple's proposal to eliminate so-called blank check preferred stock from its corporate charter. The move would prohibit it from issuing preferred stock without shareholder approval. To Mr. Einhorn, that would sharply limit options for "unlocking value."

He was further irked by Apple's tying the plan with two others that he said he would ordinarily support.

In its statement, Apple said that its proposal was actually aimed at making itself more responsive to investors. It added that the plan would not prevent the introduction of precisely the kind of initiative that Mr. Einhorn had discussed.

At least one major investor has sided with Apple. Calpers, the giant California public employee pension fund that is the company's 43rd-biggest shareholder, said in a statement that the proposal "significantly strengthens share owner rights and deserves full support."

For his part, Mr. Einhorn said he planned on trying to persuade other shareholders. And he has reconciled himself to Apple's days of meteoric growth now lying in the past.

"It's not going to grow 80 percent a year," he said of the company, "but that doesn't mean it's going to go bankrupt."

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