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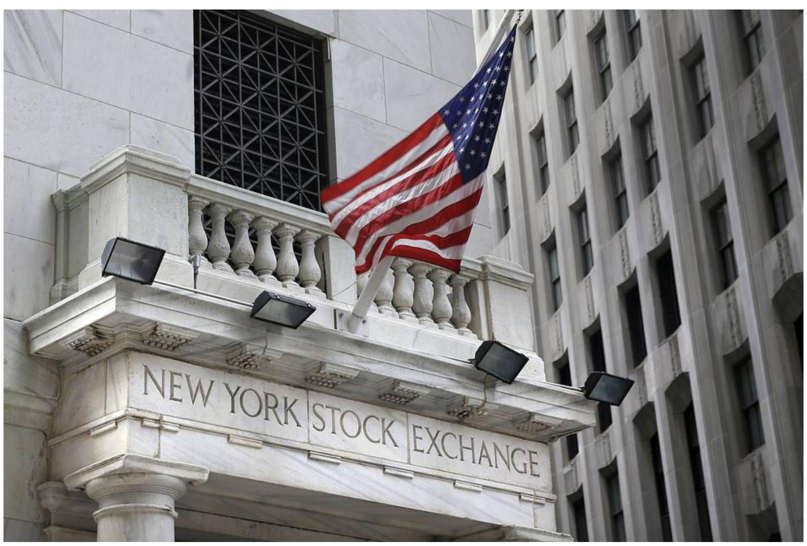
Stock Valuations Flash a Warning Sign

Stocks at record highs come with rich valuations, a warning sign that matters not only for individual investors but also public pension funds that base their health on investment targets



The New York Stock Exchange. The three main U.S. stock indexes hit records on the same day last week.
PHOTO: ASSOCIATED PRESS

By **STEVEN RUSSOLILLO**
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Lower your sights.

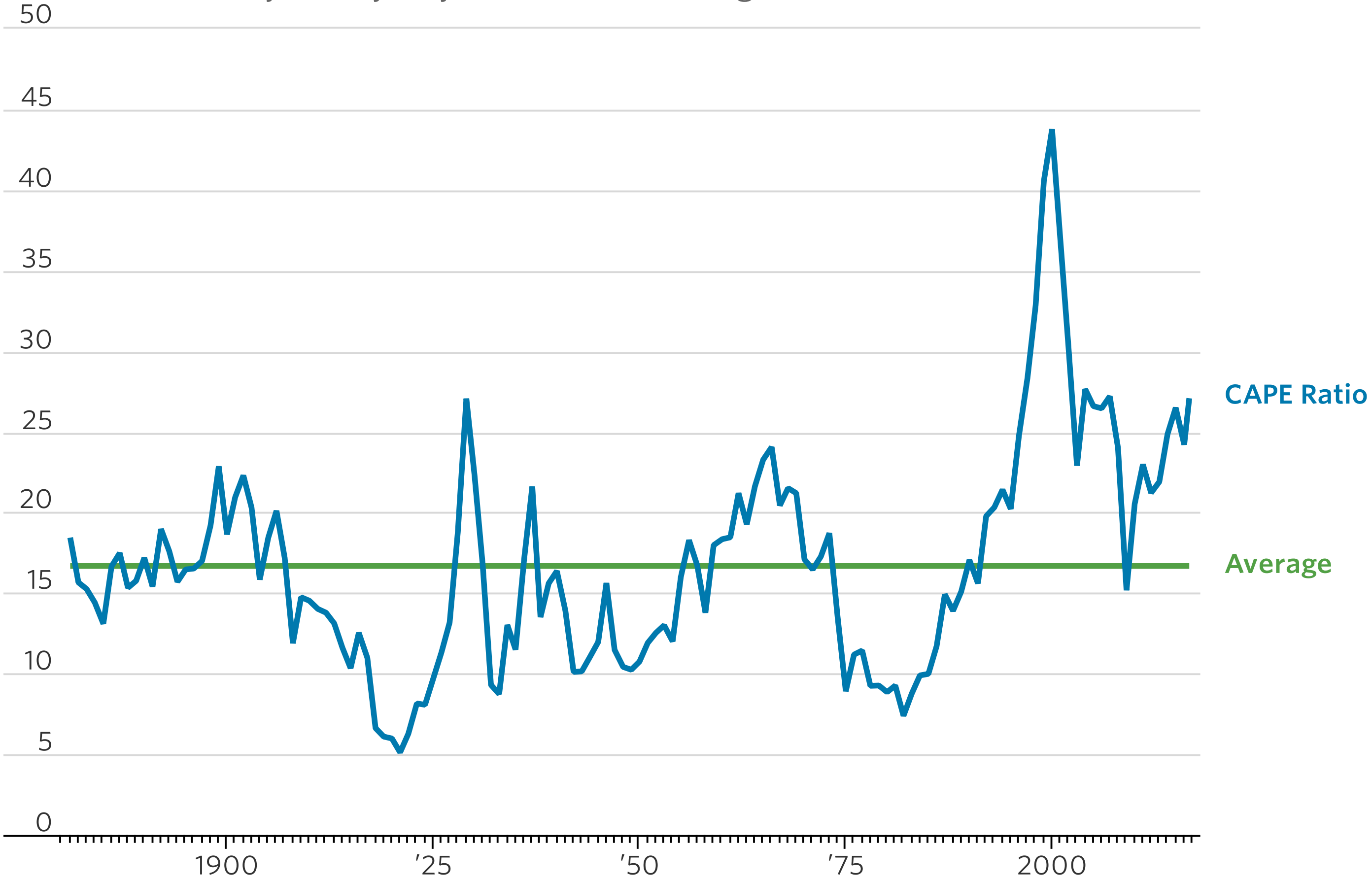
The U.S. stock market's trifecta of record index values last week, its first since 1999, comes with a glaring warning that isn't getting as much attention as it deserves: rising valuations. This has important implications not only for individual investors but also public pension funds that base their health on investment targets. They look absurdly optimistic.

While pricey valuations don't necessarily mean the market is poised to drop, they do suggest that the already yawning gap in public accounts is understated to the tune of perhaps hundreds of billions of dollars. Taxpayers and owners of municipal bonds that could be left on the hook should take heed.

Price/earnings ratios are volatile, but consider the more stable long-term valuation indicator popularized by Nobel Prize winning economist Robert Shiller. His metric, the cyclically adjusted price/earnings ratio, is based on the S&P 500's current price divided by its average earnings over the past 10 years adjusted for inflation. It currently stands at 27.1, well above its long-term average of about 16.

That's Rich

Robert Shiller's Cyclically Adjusted Price/Earnings Ratio



Source: Robert Shiller

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Today's valuation falls into the top tenth of historical observations, based on data since the 1880s. When the CAPE is in the top decile as it is now, the S&P 500 subsequently averages about 4% annually for the next 10 years. The upshot: While not a short-term market-timing tool, rich stock-market valuations often have led to the worst returns a decade later.

This is the conundrum facing pension funds, many of which already aren't fully funded on existing assumptions. A typical 7.5% investment target is used to discount liabilities, so a lower number would mean a bigger gap. In a traditional portfolio of 60% stocks and 40% bonds, though, that looks nearly impossible to achieve, at least over the next decade.

For instance, a basket of 10-year Treasurys and corporate bonds yields roughly 1.75%. That means equities would have to return about 11.4% annually for pensions to meet their targets in the next 10 years. That far exceeds the average at times like these, when valuations are least favorable.

The power of positive thinking can only take investors and taxpayers only so far.

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