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SHARING THE LOVE

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If you're of a certain age, you might recall the 1964 satirical movie Dr. Strangelove, directed by Stanley Kubrick and starring Peter Sellers and George C. Scott. But do you recall the full title? Yes, it was indeed Dr. Strangelove or: How I Learned to Stop Worrying and Love the Bomb.

That brings me to today's topic: How I learned to stop worrying about valuations and love the stock market.

I've been writing about investing for 35 years. And for the entire 35 years, grumpy old men (yes, it's almost always been men) have been warning about the dangers of lofty price-earnings ratios and modest dividend yields. Meanwhile, global share prices have soared, turning a $1,000 investment into almost $24,000.

No doubt about it, U.S. stocks are expensive by historical standards. Today, the S&P 500 companies are trading at 25 times trailing 12-month reported earnings, versus a 50-year average of 19.4. Similarly, the S&P 500 stocks have a dividend yield of 1.7%, well below the 50-year average of 2.9%. But should we be worried about these lofty valuations? Here are seven reasons to ignore the grumpy old men:

IF YOU'RE SITTING IN CASH WAITING FOR STOCK MARKET VALUATIONS TO RETURN TO "NORMAL,"...IT COULD BE A LONG WAIT.

– #1 –

Bonds are the main alternative to stocks—and these days they're offering scant competition, thanks to rock-bottom interest rates. That doesn't mean you shouldn't own bonds. They're a great diversifier for stocks and a source of spending money when stocks are struggling. But with interest rates so low, it's no great surprise that many investors have moved money out of bonds and into stocks, driving up valuations.

#2

U.S. shares may be pricey, but valuations in foreign markets look quite reasonable. According to StarCapital.de, stocks in developed European nations are at less than 19 times earnings, developed Asia-Pacific countries are just above 16 times corporate profits and emerging markets are at 14 times.

#3

Thanks in large part to low-cost index funds and shrinking trading costs, it's become far cheaper to buy, own and sell stocks. Result: To earn the same after-cost return as 30 years ago, you now need lower pre-cost performance, thus justifying today's higher price-earnings ratios and lower dividend yields. In other words, the lower long-run returns implied by today's higher valuations may still put the same amount of money in your pocket.

#4

As the world has grown richer, we have more and more capital pursuing limited opportunities, and that's driven up stock market valuations. When discussing the huge quantities of capital sloshing around the global financial markets, commentators often point to the loose monetary policy engineered by central banks over the past dozen years.

But in truth, this growth in available capital is part of a long-term trend. A century ago, only a minuscule portion of the world's population had money earmarked for anything other than immediate consumption. Today, more than half the U.S. population owns stocks and stock funds, and the rest of the world is headed in the same direction.

#5

As the economy has grown more stable, that reduced risk has been reflected in falling interest rates and rising stock market valuations. To be sure, there have been occasional economic bumps along the way, like the rampant inflation of the 1970s or the Great Recession of 2008-09.

But think about the long sweep of history: Isn't the world a safer place to invest today than, say, 400 or 500 years ago, when making and lending money was constantly disrupted by war, natural disasters, weak rule of law, and constant cycles of over- and undersupply? Back then, lending out money for even a single growing season would have been a huge risk. Today, by contrast, 20-year-olds have few qualms about buying stock mutual funds to pay for their retirement 50 years from now.

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#6

Compared to three decades ago, the companies that dominate today's stock market are a completely different beast. Think about Alphabet (a.k.a. Google), Apple and Facebook. These companies aren't building factories. Instead, they're building intellectual capital and valuable brand names. Problem is, accounting standards haven't caught up.

If a company spends $50 million on a factory, it can depreciate that capital spending over many years, so the immediate hit to reported profits is relatively modest. But if the company spends that $50 million on research and development, the entire cost is expensed in the first year, putting a big dent in corporate profits—and arguably resulting in a price-earnings ratio that's misleadingly high.

#7

Companies are increasingly downplaying dividends and instead buying back their own shares. The latter is seen as a more tax-efficient way to return money to shareholders. When a company pays a dividend, all investors who own the stock in a taxable account end up with a tax bill. But when a company buys back its own stock, only those who want to sell their shares end up owing money to Uncle Sam. Indeed, U.S. companies now spend more money buying back stock than paying out dividends, so it's no great surprise that the S&P 500's dividend yield is below 2%.

None of this means the stock market couldn't nosedive next week or next month. But if you're sitting in cash waiting for stock market valuations to return to "normal," it feels like it could be an awfully long wait.

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