Are Stocks Expensive Now?

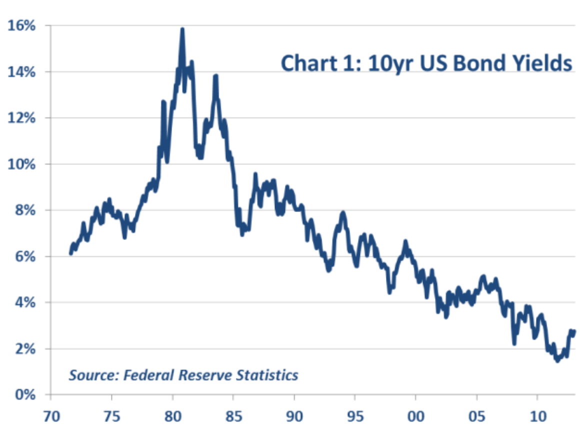
Amwal

Since our last report titled "Time to Embrace Qatari Equities" published at the end of September 2013, Qatari Equities are up around 12% and a natural inclination might be to question if stocks are now expensive. We delve into this question in detail in this report, but in a nutshell our view is: **Stocks are still not expensive, and although potential future returns may be lower in absolute terms, their attractiveness relative to bonds continues to stand out**.

When investors ask if stocks are expensive or not, they are often comparing current prices and valuations with historical prices and valuations. Simplistic valuation metrics on their own can be very misleading for two reasons (1) a structural change in underlying factors ranging from interest rates and inflation to GDP growth, and (2) using reported earnings rather than "trend earnings".

The importance of interest rates

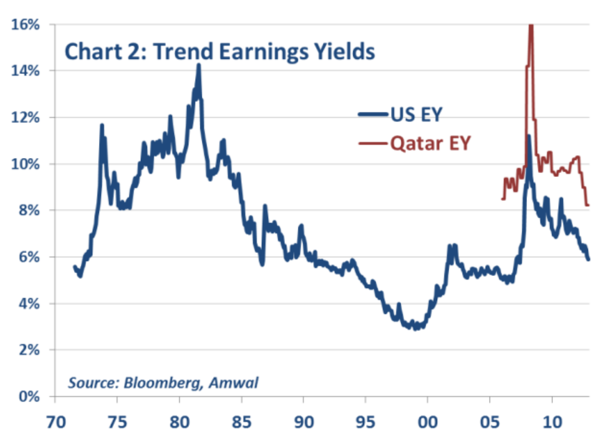
US interest rates have never been this low historically except for a short period during World War II (see Chart 1).



With bond yields at historic lows, it should come as no surprise that earnings yields have tumbled as well (see Chart 2). PE ratios (mathematically the inverse of earnings yield) have consequently risen, with investors asking if this is the "new normal". **The question equity investors should really be asking is whether the low interest rate environment is here to stay.**

Focus on trend earnings

One mistake often made when looking at stock valuations is to compare stock prices to current year earnings, referred to as the "PE ratio". **The limitation of this approach is that current earnings frequently fails to reflect "trend earnings", due to a variety of cyclical and secular reasons**. For example, during the 2008 crisis, stock prices declined but so did reported earnings (particularly bank earnings), so PE ratios did not reveal how attractive stocks had become. Only after earnings recovered from crisis low did stocks start to look cheap, but by that time stocks were already up significantly.



To overcome this common mistake, we instead look at earnings yield using trend earnings, rather than the current year earnings. This helps us eliminate temporary volatilities in earnings so it acts as a better guide for measuring a stock's attractiveness. However even this is not enough either as this still does not factor in either future profit outlook or future interest rates.

So how should one value stocks?

Computing the present value of future earnings (also referred to as Discounted Cash Flow) is the only fundamentally complete approach for valuing stocks. However making the right assumptions is as important as the valuation method. For example using past bond yields as the risk free rate may be good for explaining current valuations, but they will not help in predicting future valuations. Equally using past or current earnings does not help in predicting future stock returns.

In our approach to selecting stocks, we first thoroughly analyze companies as if we are the owners of the businesses not just stocks. Then once we are convinced we understand the future prospects of the company, we look at long-term macro variables to predict future growth rates, inflation and interest rates. Understanding company earnings is important but sometimes not enough in stock selection.

Future market returns likely to be lower; But stock selection can make it up

Investors' key aim is to always maximize future returns given a set of assets to choose from. Presently as interest rates are at an all-time low and stock valuations are not as cheap, it should come as no surprise that future returns from all asset classes are expected to be lower as well. However we find equities attractive relative to fixed income for those investors that can invest with a longer horizon. While equity investors should expect to experience volatility, we feel fixed income investors are also likely to see more of it than in the past as secular trends in interest rates are no longer apparent.

Stock selection in our view will become even more important in the current low return environment where investors will be looking for true alpha to get a boost over low market returns. For example in the past when equity market returns were on average 10-15%, a fund delivering an additional 2-3% may not have been that visible; however when market returns are around 5-7%, than these additional returns will become more visible and valuable. The case for stock selection is particularly strengthened by the chart below which shows a significant decline in correlation of returns among stocks. **In simple terms, stocks have not all gone up or gone down at the same time, so knowing which stocks to choose is becoming ever more important**.

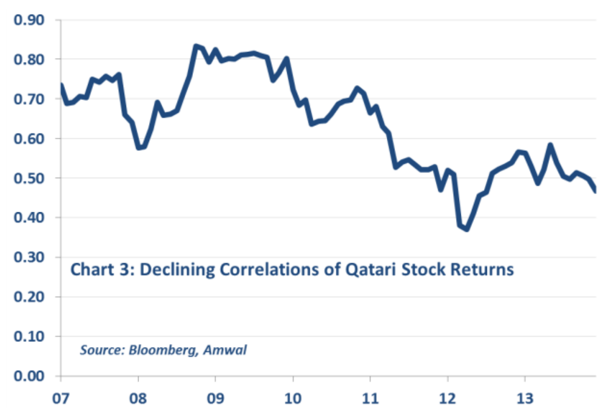


Chart 3: Declining Correlations of Qatari Stock Returns

How can our analysis help investors' in asset allocation?

In managing our clients' equity portfolios, we analyze and forecast macro variables as well as other asset class returns. These can be used as key inputs in their asset allocation decisions. When making asset allocation decisions, it is very important to assess risks, returns and correlations of all available asset classes.

A vital distinction that many investors miss is between market volatility and the risk of permanent loss of value. Investors who have the ability to invest longer term without short term liquidity requirements can structure their portfolios with a sharp focus on the latter, and treat the former as an opportunity.

We are all very conscious of short term (annual) returns, but the ability and fortitude to hold onto high conviction positions during market corrections can boost long term returns significantly.

In closing we are reminded of a quote from the world's most successful long-term investor Warren Buffet "The biggest risk in investing is not knowing what you are investing in".

About Amwal

Amwal LLC is wholly owned by Sheikha Hanadi Nasser bin Khaled Al Thani, founder of the first regulated investment company in Qatar in 1998. Amwal LLC is authorized by the QFCRA and is a leading independent asset management firm serving institutional clients, family offices and high net worth individuals. The Amwal group has pioneered the Qatar financial services industry for over a decade, with a number of firsts to its credit, including the first to offer financial planning and wealth management, first mutual fund, first Islamic mezzanine private equity fund and first money market fund.

Amwal has received awards for Best Asset Manager in Qatar from EMEA Finance for three consecutive years (2011, 2012 and 2013), Best Investment Bank in Qatar from World Finance (2012), and Qatar Deal of the Year from Islamic Finance News (2008). Qatar Gate Fund, managed by Amwal, was ranked the #1 equity fund in the MENA region ranked by 3-year returns in a report prepared by MENA FM (April 2013).

Amwal Tower, 22nd Floor, West Bay
PO Box 494, Doha, Qatar
+974 4452 7777
am@amwalqa.com