By Russell Wild, MBA

IS THE MARKET OVERHEATED?

There are some cautionary signs, but be careful how you read them

Flip a coin, get five heads in a row, and you can't help thinking you're due for tails. Likewise, after five strong years for the stock market, your "Spidey sense" may warn you to turn tail and run. But just as the sixth coin flip is unrelated to the previous five – its chance of coming up tails is exactly 50-50 – a stock market rising for five years is not, in itself, a predictor of future stock performance, notes Wade Pfau, Ph.D., CFA, a professor of retirement income at The American College in Bryn Mawr, Pennsylvania. "But a rising stock market without a corresponding rise in company earnings – such as we've been seeing – could be a sign of an overheated market."

Pfau has studied the matter, crunched numbers upon numbers, and concluded that the ratio of market prices to corporate earnings – sometimes referred to as the P/E ratio or the market's valuation – has historically been a predictor of stock market performance, albeit far from a perfect one. Much of Pfau's work corroborates the findings of Robert Shiller of Yale who was awarded a Nobel Prize in economics last year for his analysis of asset prices. It was Shiller who used, in his book title, the phrase "irrational exuberance" to describe the market bubble of the late 1990s, and he used the market's valuation at the time as his barometer.

Is there irrational exuberance today? Shiller has gone on record that he is a bit concerned, while emphasizing that current valuations are far shy of what they were in, say, 1999. Pfau expresses concern as well, but he's not losing sleep over it: "The valuation of the stock market has explained about 30 percent of stock market returns over the following 10 years," says Pfau. "There are many other factors that come into play."

Note that the "E" in P/E ratio represents earnings over the last 12 months (or the next 12 months in the case of projected "forward" earnings). Shiller popularized a valuation measure that long-term investors should find more meaningful: The CAPE ratio, or cyclically adjusted price/earnings ratio, smooths out the effects of inflation and year-to-year earnings' swings by comparing today's price to average earnings over the past 10 years. Applying that measure, "we are now at a ratio of about 25, while the historical average CAPE ratio has been about 16," says Pfau. "A high valuation is an indication that stock market performance over the next 10 years may be tepid," he says, adding, "but nothing is certain." (You can find the current CAPE ratio and see how it has changed over the years at multpl.com/shiller-pe.)

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Pfau recommends that when the CAPE is as high as it is now, you might want to take a few steps back from stocks. That's not the same as turning tail and running: "Personally, if the CAPE were closer to its historical average, I'd have a portfolio of about 80 percent stocks; with the CAPE at 25, I'm going with 70 percent stocks," says Pfau.

Josh Peters, Morningstar's director of equity-income strategy, agrees that five years of "heads" should neither be ignored nor serve as a reason for panic. "It is possible that valuations are changing over time, and higher valuations will become the norm," he says. "The structure of our economy is changing, and today's top companies, such as Apple and Google, are very different from the industrial giants of yesteryear. Higher valuations may just be here to stay."

That being said, an up market of five years, regardless of valuations, still offers a good reason why you might want to shift your portfolio, if you shift it at all, a tad toward a more conservative position (with a lesser percentage of stocks). "High returns over these past years has probably meant that you are closer to your financial goals than you were before," says Pfau. "If that is the case, you might consider taking some risk off the table."

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