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Kevin Bales, CFA, Director, Research

A Stock's Price is Different than When to Buy

BY KEVIN BALES, CFA, DIRECTOR, RESEARCH

"I never have the faintest idea what the stock market is going to do in the next six months, or the next year, or the next two." - Warren Buffet

Despite how extremely difficult it is to time the stock market, it seems almost daily that some financial commentary declares the stock market overvalued with a bear market right around the corner. The reality is that market valuations alone have historically been a poor predictor of future returns. Investors should be somewhat cautious if attempting to time the stock market based on valuations.

While current U.S. stock market valuations are above average, valuations are not extreme by historical standards. When examining equity valuations one needs to understand the drivers of current valuation levels. Low interest rates and a skewed Price/ Earnings (P/E) ratio from the energy sector have elevated market valuations. The trailing 12-month P/E ratio is a popular metric used to gauge if the market is expensive. The ratio is calculated by taking the market price divided by the last 12 months of earnings per share. For example, the price of the S&P 500 Index at the end of April was $2,384.20 divided by its trailing 12-month earnings per share of $112.49 (Source: Bloomberg), which results in a trailing 12-month P/E ratio of 21.3, which is above it's long-term average but not at the extremes we have seen in the past.

Hartland Continues to Bolster Team with New Talent

We are pleased to announce that Terri Clouse will join Hartland as Director, Institutional Business Development. Terri will be responsible for developing a more systematic process for identifying and securing new business opportunities.

Prior to joining Hartland, Terri had a long and successful career, most recently at JP Morgan Asset Management in New York City. Prior to JP Morgan, Terri worked for a variety of prestigious firms including Donaldson, Lufkin & Jenrette and McDonald & Company.

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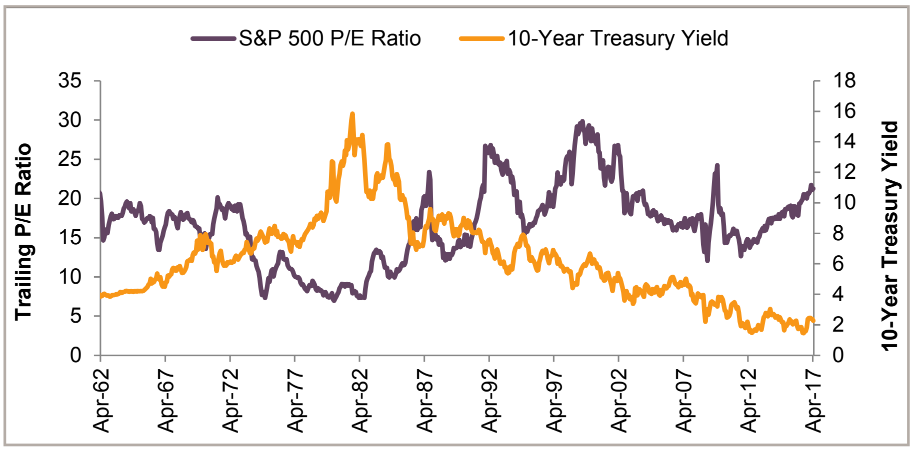
Interest Rates and Stock Market Valuations

Current market valuations have been influenced by low interest rates. The yield on the U.S. 10-Year Treasury Bond peaked in the early 1980's and has slowly declined to the historically low levels that have defined the post Financial Crisis environment as seen in Figure 1. Over the last 5 years the yield on the 10-Year Treasury has averaged 2.13% while the dividend yield on the S&P 500 has averaged 2.06% (Source: Bloomberg). With no material yield difference between the 10-Year and S&P 500, some investors have shunned bonds in favor of equities where they can also benefit from price appreciation. Investors have turned to stocks to increase income and returns, which have increased valuations as seen in the trailing P/E ratio of the S&P 500 in Figure 1. This effect may be most pronounced in the utilities sector. The utilities sector's current dividend yield is 3.3% (Source: Bloomberg), higher than both the S&P 500 and 10-Year Treasury. Over the last 5 years investors have put a premium on the higher yields offered by utilities stocks and their valuations have risen. Over the last 5 years the trailing P/E ratio for the utilities sector has increased from 13.45 to 21.46; much higher than its 10-year average of 17.11 (Source: Bloomberg).

Figure 1 (Source: Bloomberg)



Energy Sector Influence on Stock Market Valuations

Another factor that has elevated valuations is a skewed P/E ratio from the energy sector. The dramatic plunge in the price of oil has depressed earnings in the energy sector and skewed valuations. The price of oil began its decline in June of 2014 and lost 73% (Source: Bloomberg) before bottoming in January 2016. The trailing 12-month earnings for the energy sector declined during this period from $44.87 in June 2014 to $7.75 (Source: Bloomberg) in April 2017. However, even though the energy sector was obviously cheaper due to the decline in price, its trailing P/E ratio rose from 16.21 in June 2014 to 64.4 (Source: Bloomberg) in April 2017.

Hartland Showcases Urban Community School and Urban Squash Cleveland

On June 1 Hartland sponsored an event for clients and friends at Urban Community School. UCS is a forty-five year old ecumenical school in the Catholic tradtion that provides primarily low-income children from Cleveland's near West side with an indivualized, innovative, and challenging education. Hartland serves as an advisor to the UCS endowment. In addition, we learned about the squash and academic facilities being built on the UCS campus by Urban Squash Cleveland. Urban Squash Cleveland is a youth development program that tranforms the lives of inner city youth through academic support and the sport of squash. Hartland also supports Urban Squash and its programs.

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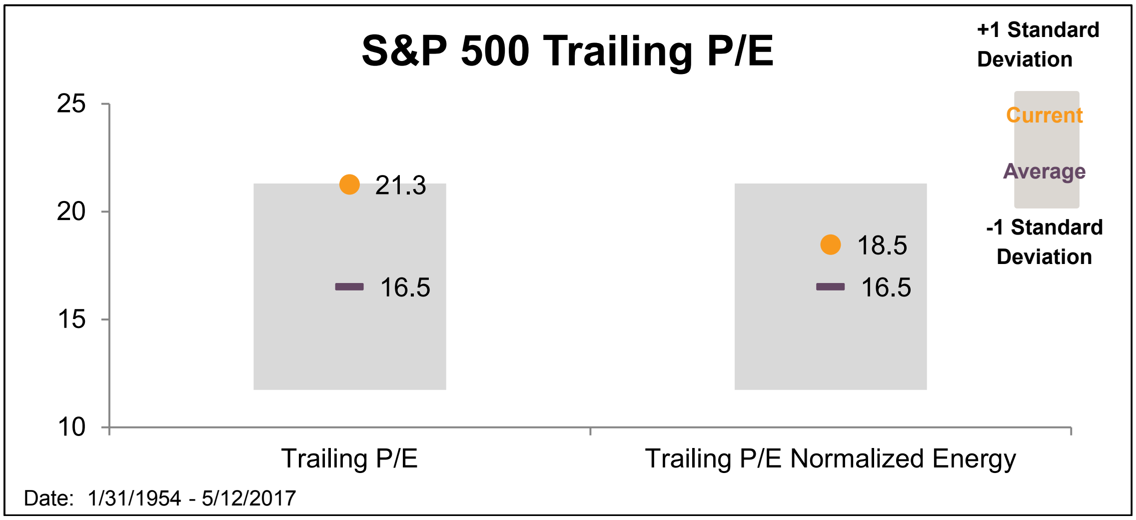
S&P 500 Energy Sector (Source: Bloomberg)	6/30/2014	6/30/2015	6/30/2016	4/30/2017
Price	$727.63	$551.11	$512.39	$498.95
Trailing 12-Month EPS	$44.87	$29.08	$7.41	$7.75
Trailing 12-Month P/E Ratio	16.21	18.95	69.14	64.39

If the energy sector was trading at a normalized trailing P/E ratio, overall stock market valuations would appear more reasonable as seen in Figure 2 below. The current trailing P/E ratio for the S&P 500 is 21.3, above its long-term average since 1954 of 16.5 (Source: Bloomberg). If we apply the long-term average trailing P/E for the energy sector of 20.3 since 1990, instead of the current trailing P/E of 64.4, the overall trailing P/E for the S&P 500 would drop by 2.80 to 18.5. This shows that the stock market as a whole may not be as overvalued as others suggest on the surface. However, are valuations useful in timing the market? Evidence has shown that the trailing P/E valuation may not be a useful predictor of future return.

Figure 2 (Source: Bloomberg)



**Standard Deviation Definition - Standard deviation is a measure of the dispersion of a set of data from its mean. If the data behaves in a normal curve, then 68% of the data points will fall within one standard deviation of the average, or mean data point. Source: Investopedia*

Valuations and Future Stock Market Returns

Investors should be cautious when financial commentators proclaim that the stock market is overvalued and is primed for a significant pull back. The reality is valuations alone have shown little predictive power of short-term returns. Figure 3 below shows the S&P 500's monthly trailing P/E ratio on the horizontal axis and the index next 1-year return from that point in time on the vertical axis. The P/E ratios have ranged from approximately 10 to 30 and there have been a wide range of performance outcomes regardless if the P/E ratio was low or high. At the end of April 2017 the S&P 500's Trailing P/E ratio was 21.3. From this P/E level the S&P 500 has had a wide range of outcomes, returning anywhere from +40% to -20% over the next 1-year period. The wide variety of returns explains why the R^2 for the data set is only 8%. An R^2* of 8% represents the amount of variation in the 1-year performance of the S&P 500 that can be explained by the trailing P/E ratio. That means that 92% of the variation in the 1-year performance of the S&P 500 is explained by other variables. Essentially, the trailing P/E ratio is not a good predictor of future returns for the S&P 500.

**R-Squared (R^2) Definition - A statistical method that explains how much of the variability of a factor can be caused or explained by its relationship to another factor. Source: http://www.businessdictionary.com*

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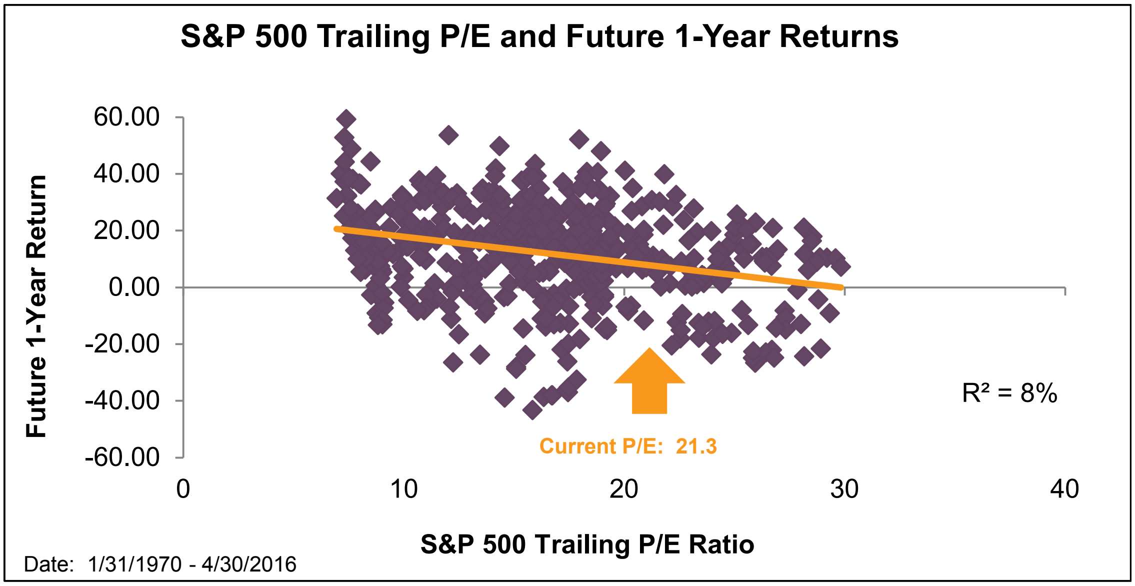
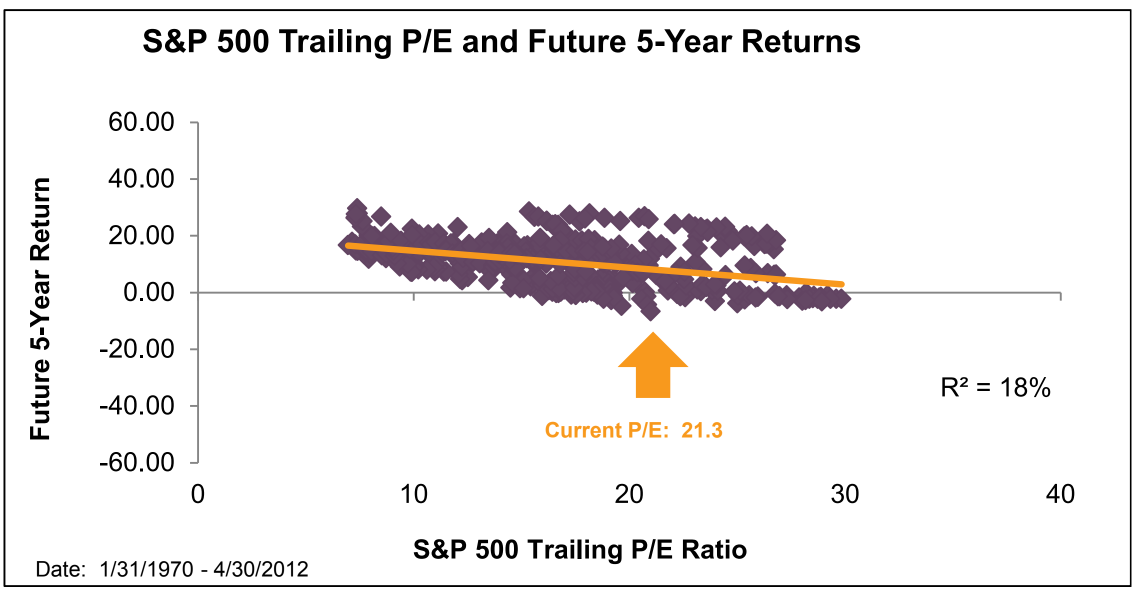
Figure 3 (Source: Bloomberg & Morningstar)



The results are similar using long-term returns for the S&P 500. Figure 4 shows the same general relationship as Figure 3, but uses 5-year returns. Again we see a wide range of outcomes from the current trailing P/E of 21.3. From this level the S&P 500 has returned between +26% and -2% over future 5-year periods. While the R2 of 18% is better than the previous chart, the trailing P/E ratios are still not a good predictor of future 5-year returns for the S&P 500. It is difficult to time the market and using P/E ratios alone may not yield successful outcomes.

Figure 4 (Source: Bloomberg & Morningstar)



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Legendary investor Peter Lynch once said "I can't recall ever once having seen the name of a market timer on the Forbes' annual list of richest people in the world." It is extremely difficult to time the stock market and timing it based on valuations alone is not a likely path toward success. At Hartland, we are not short-term market timers that encourage moving in or out of the stock market. Rather we take a long-term, holistic view of our client's goals and objectives to strategically construct risk appropriate, low cost and diversified portfolios that we expect to withstand the inevitable ups and downs of the market and position portfolios opportunistically on the margin to enhance returns.

MARKET BENCHMARK RETURNS

May 31, 2017		1M	3M	12M	YTD
US Large Cap	S&P 500	1.4%	2.6%	17.5%	8.7%
US Small Cap	Russell 2000	-2.0%	-0.8%	20.4%	1.5%
Developed Intl	MSCI EAFE	3.8%	9.6%	17.0%	14.4%
Emerging Intl	MSCI Em Mkt	3.0%	7.9%	27.9%	17.3%
Real Estate	NAREIT	-.01%	-1.0%	6.0%	3.3%
Core Fixed	BarCap Agg	0.8%	1.5%	1.6%	2.4%
Short Fixed	BarCap 1-3Yr	0.2%	0.4%	1.0%	0.8%
Long Fixed	BarCap LT G/C	2.0%	3.0%	3.0%	5.2%
Corp Debt	BarCap Corp	1.1%	1.9%	3.9%	3.4%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.