Wealth Management

Column: For better results to come, invest domestically and globally

By BILL VALENTINE For The Bulletin
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I began in the investment business 30 years ago at EF Hutton (a brokerage firm long since gobbled up by a firm that's been long since gobbled up and so on, and so on). I'll never forget pulling into the parking lot one day and seeing a cherry red Corvette whose license plate read, "SOLD HI."

Isn't that gross? The owner wanted us all to know that he bought his 'vette with the proceeds from a stock "sold high." This was my introduction to the stock market adage that the goal of investors was to "buy low, sell high."

I share this silly anecdote for two reasons.

One, I chuckle (and gag a little) every time I think about the "SOLD HI" car.

But also, I want to talk about buying low and selling high in the current investment environment. That's because my concern going forward is that it will be harder and harder to find investments that can be sold high given how long stocks have done well. In order expand your investment opportunity set, it will require you to think outside our stock market.

One way to measure the low vs. high of a stock is to look at its "expensiveness" or valuation. The most common metric is the price-to-earnings ratio. At present, the average P/E ratio of U.S. stocks is 22. In Europe, the average is 17. Asian stocks have a P/E of 16. Historically, the average valuation is about 14 — so stocks are not cheap. Not here, and not necessarily abroad.

Looking forward, it will be trickier to find opportunities that provide good returns. Another way to look at this dilemma is to consider the components of stock market returns.

Stock returns historically have averaged about 10%, derived from four components.

The first is the dividend yield — the amount of dividends you get per dollar of stock price invested. Historically the average yield in the U.S. has been about 4.5%. Today, dividend yields in the U.S. are closer to 1.2%. Yikes.

The second component that's contributed to the 10% historical return is inflation. In the long run, it's come in at about 3% annually. For the past few decades, inflation has been below that, but there are indications that it is picking up pace right now and how much (or how little) inflation the next decade reveals will have a big impact on stock returns.

The third component to stock returns is the real growth of earnings. Over the long haul, that rate has been about 1.5%. Companies have grown profits by that rate, net of inflation. How well companies do going forward is impossible to guess. Optimists will peg that growth number north of 1.5% due to advancements in productivity on the back of extraordinary benefits of technology. That's plausible.

Finally, about 1% of the 10% annual average stock return owes itself to the increase in the valuation of the market — the aforementioned P/E. Given how high valuations are already, it's hard to see the multiple continue to expand.

Looking forward in the U.S., your estimate for stock returns then is sum of your estimates of the four components.

If we think dividend yields aren't going to change much (1.2%) and we assume higher, but normal, inflation (3%) and we add that to solid earnings growth (2%) and no change in valuation, that assumes the go-forward return in the U.S. is about 6% per year.

So what's the takeaway?

To eke out results above that 6% will require the broadest opportunity set possible. Thus, we have to look overseas. However, this does not mean abandoning investments domestically.

In our view, the decade ahead should be decent for most markets, and the U.S. market will likely continue to be a leader. Diversifying globally will be the added key to extracting the best the markets have to offer investors.

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