

# *Asset Valuation & Allocation Models*

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# - Introduction -

## I. Fed's Stock Valuation Model

How can we judge whether stock prices are too high, too low, or just right? The purpose of this weekly report is to track a stock valuation model that attempts to answer this question. While the model is very simple, it has been quite accurate and can also be used as a stocks-versus-bonds asset allocation tool. I started to study the model in 1997, after reading that the folks at the Federal Reserve have been using it. If it is good enough for them, it's good enough for me. I dubbed it the Fed's Stock Valuation Model (FSVM), though no one at the Fed ever officially endorsed it.

On December 5, 1996, Alan Greenspan, Chairman of the Federal Reserve Board, famously worried out loud for the first time about “irrational exuberance” in the stock market. He didn't actually say that stock prices were too high. Rather he asked the question: “But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions....”<sup>1</sup> He did it again on February 26, 1997.<sup>2</sup> He probably instructed his staff to devise a stock market valuation model to help him evaluate the extent of the market's exuberance. Apparently, they did so and it was made public, though buried, in the Fed's Monetary Policy Report to the Congress, which accompanied Mr. Greenspan's Humphrey-Hawkins testimony on July 22, 1997.<sup>3</sup>

The Fed model was summed up in one paragraph and one chart on page 24 of the 25-page document (see following table). The chart shows a strong correlation between the S&P 500 forward earnings yield (FEY)—i.e., the ratio of expected operating earnings (E) to the price index for the S&P 500 companies (P), using 12-month-ahead consensus earnings estimates compiled by Thomson Financial First Call.—and the 10-year Treasury bond yield (TBY). The average spread between the forward earnings yield and the Treasury yield (i.e., FEY-TBY) is 29 basis points since 1979. This near-zero average implies that the market is fairly valued when the two are identical:

### 1) $FEY = TBY$

Of course, in the investment community, we tend to follow the price-to-earnings ratio more than the earnings yield. The ratio of the S&P 500 price index to expected earnings (P/E) is highly correlated with the reciprocal of the 10-year bond yield, and on average the two have been nearly identical. In other words, the “fair value” price for the S&P 500 (FVP) is equal to expected earnings divided by the bond yield in the Fed's valuation model:

### 2) $FVP = E/TBY$

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<sup>1</sup> <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>

<sup>2</sup> “We have not been able, as yet, to provide a satisfying answer to this question, but there are reasons in the current environment to keep this question on the table.”

<http://www.federalreserve.gov/boarddocs/hh/1997/february/testimony.htm>

<sup>3</sup> <http://www.federalreserve.gov/boarddocs/hh/1997/july/ReportSection2.htm>

**Excerpt from Fed's July 1997 Monetary Policy Report:**

The run-up in stock prices in the spring was bolstered by unexpectedly strong corporate profits for the first quarter. Still, the ratio of prices in the S&P 500 to consensus estimates of earnings over the coming twelve months has risen further from levels that were already unusually high. Changes in this ratio have often been inversely related to changes in long-term Treasury yields, but this year's stock price gains were not matched by a significant net decline in interest rates. As a result, the yield on ten-year Treasury notes now exceeds the ratio of twelve-month-ahead earnings to prices by the largest amount since 1991, when earnings were depressed by the economic slowdown. One important factor behind the increase in stock prices this year appears to be a further rise in analysts' reported expectations of earnings growth over the next three to five years. The average of these expectations has risen fairly steadily since early 1995 and currently stands at a level not seen since the steep recession of the early 1980s, when earnings were expected to bounce back from levels that were quite low.

The ratio of the actual S&P 500 price index to the fair value price shows the degree of overvaluation or undervaluation. History shows that markets can stay overvalued and become even more overvalued for a while. But eventually, overvaluation is corrected in three ways: 1) falling interest rates, 2) higher earnings expectations, and of course, 3) falling stock prices—the old fashioned way to decrease values. Undervaluation can be corrected by rising yields, lower earnings expectations, or higher stock prices. The Fed's Stock Valuation Model worked quite well in the past. It identified when stock prices were excessively overvalued or undervalued, and likely to fall or rise:

- 1) The market was extremely undervalued from 1979 through 1982, setting the stage for a powerful rally that lasted through the summer of 1987.
- 2) Stock prices crashed after the market rose to a record 34% overvaluation peak during September 1987.
- 3) Then the market was undervalued in the late 1980s, and stock prices rose.
- 4) In the early 1990s, it was moderately overvalued and stock values advanced at a lackluster pace.
- 5) Stock prices were mostly undervalued during the mid-1990s, and a great bull market started in late 1994.
- 6) Ironically, the market was actually fairly valued during December 1996 when the Fed Chairman worried out loud about irrational exuberance.

- 7) During both the summers of 1997 and 1998, overvaluation conditions were corrected by a sharp drop in prices.
- 8) Then a two-month undervaluation condition during September and October 1998 was quickly reversed as stock prices soared to a remarkable record 70% overvaluation reading during January 2000. This bubble was led by the Nasdaq and technology stocks, which crashed over the rest of the year, bringing the market closer to fair value

## II. New Improved Model

The FSVM is missing a variable reflecting that the forward earnings yield is riskier than the government bond yield. How should we measure risk in the model? An obvious choice is to use the spread between corporate bond yields and Treasury bond yields. This spread measures the market's assessment of the risk that some corporations might be forced to default on their bonds. Of course, such events are very unusual, especially for companies included in the S&P 500. However, the spread is only likely to widen during periods of economic distress, when bond investors tend to worry that profits won't be sufficient to meet the debt-servicing obligations of some companies. Most companies won't have this problem, but their earnings would most likely be depressed during such periods. The FSVM is also missing a variable for long-term earnings growth. My New Improved Model includes these variables as follows:

### 3) $FEY = CBY - b \cdot LTEG$

where CBY is Moody's A-rated corporate bond yield. LTEG is long-term expected earnings growth, which is measured using consensus five-year earnings growth projections. I/B/E/S International compiles these monthly. The "b" coefficient is the weight that the market gives to long-term earnings projections. It can be derived as  $-(FEY - CBY) / LTEG$ . Since the start of the data in 1985, this "earnings growth coefficient" averaged 0.1.

Equation 3 can be rearranged to produce the following:

### 4) $FVP = E \cdot [CBY - b \cdot LTEG]$

FVP is the fair value price of the S&P 500 index. Exhibit 10 shows three fair value price series using the actual data for E, CBY, and LTEG with  $b = 0.1$ ,  $b = 0.2$ , and  $b = 0.25$ . The market was fairly valued during 1999 and the first half of 2000 based on the consensus forecast that earnings could grow more than 16% per year over the next five years and that this variable should be weighted by 0.25, or two and a half times more than the average historical weight.

## III. Back To Basics

With the benefit of hindsight, it seems that these assumptions were too optimistic. But,

this is exactly the added value of the New Improved FSVM. It can be used to make explicit the implicit assumptions in the stock market about the weight given to long-term earnings growth. The simple version has worked so well historically because the long-term growth component has been offset on average by the risk variable in the corporate bond market.

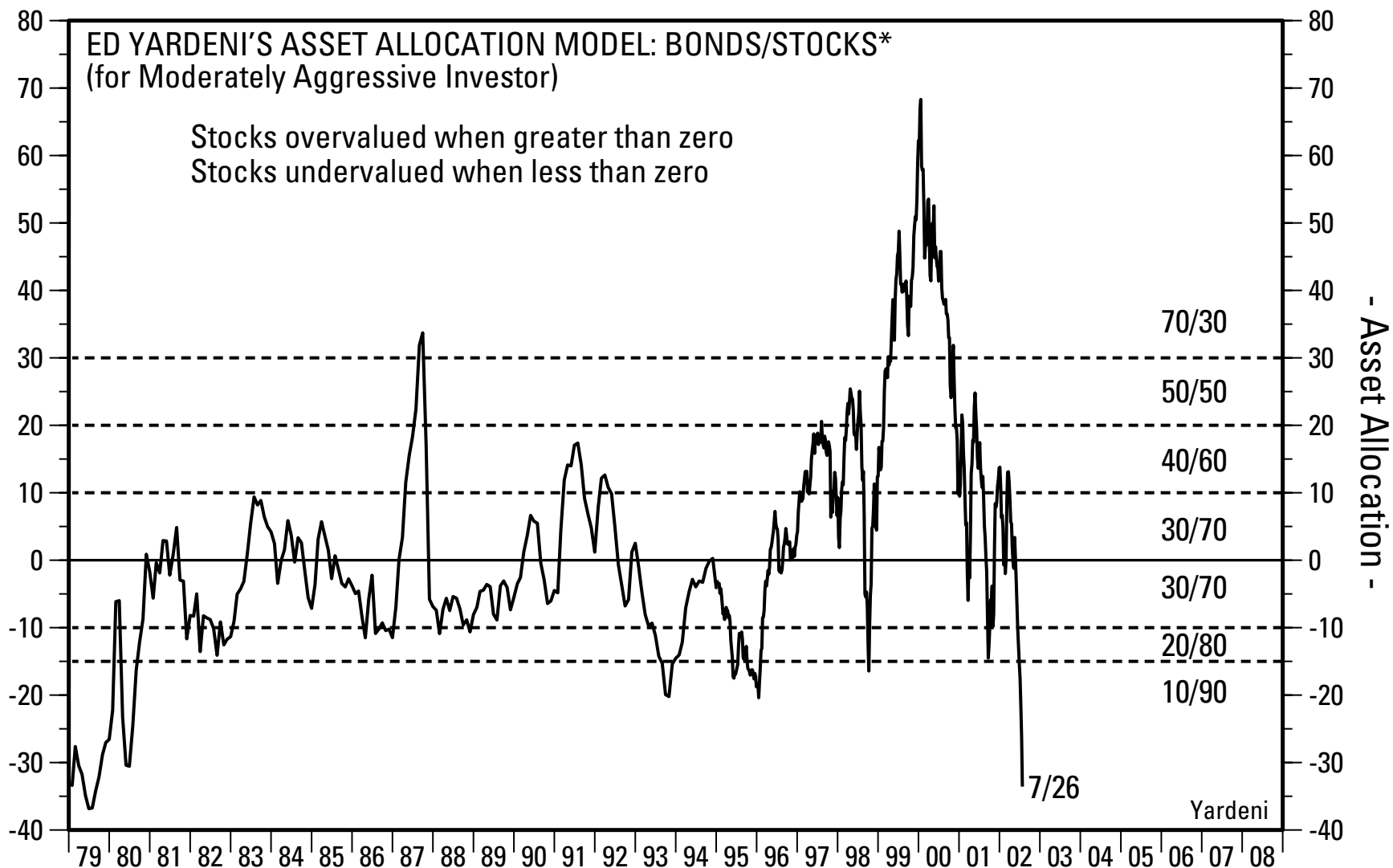
#### **IV. Stocks Versus Bonds**

The FSVM is a very simple stock valuation model. It should be used along with other stock valuation tools, including the New Improved version of the model. Of course, there are numerous other more sophisticated and complex models. The Fed model is not a market-timing tool. As noted above, an overvalued (undervalued) market can become even more overvalued (undervalued). However, the Fed model does have a good track record of showing whether stocks are cheap or expensive. Investors are likely to earn below (above) average returns over the next 12-24 months when the market is overvalued (undervalued).

The next logical step is to convert the FSVM into a simple asset allocation model (Exhibit 1). I've done so by subjectively associating the "right" stock/bond asset mixes with the degree of over/under valuation as shown in the table below. For example, whenever stocks are 10% to 20% overvalued, I would recommend that a moderately aggressive investor should have a mix of 60% in stocks and 40% in bonds in their portfolio.

##### **Bonds/Stocks Asset Allocation Model**

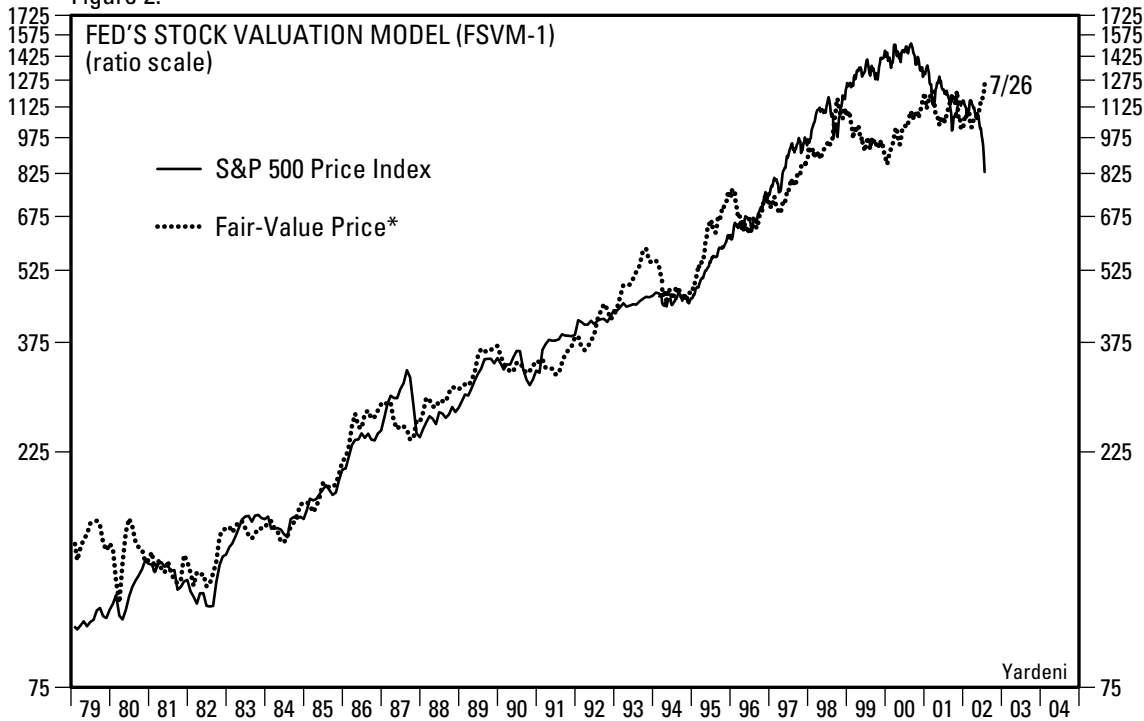
More than 30% overvalued	70% bonds, 30% stocks
20% to 30% overvalued	50% bonds, 50% stocks
10% to 20% overvalued	40% bonds, 60% stocks
10% undervalued to 10% overvalued	30% bonds, 70% stocks
10% to 15% undervalued	20% bonds, 80% stocks
More than 15% undervalued	10% bonds, 90% stocks



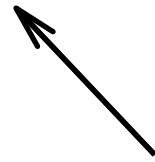
\* Ratio of S&P 500 index to its fair value (12-month forward consensus expected operating earnings per share divided by the ten-year U.S. Treasury bond yield) minus 100. Monthly through March 1994, weekly after.  
Source: Thomson Financial.

# - Valuation Model -

Figure 2.

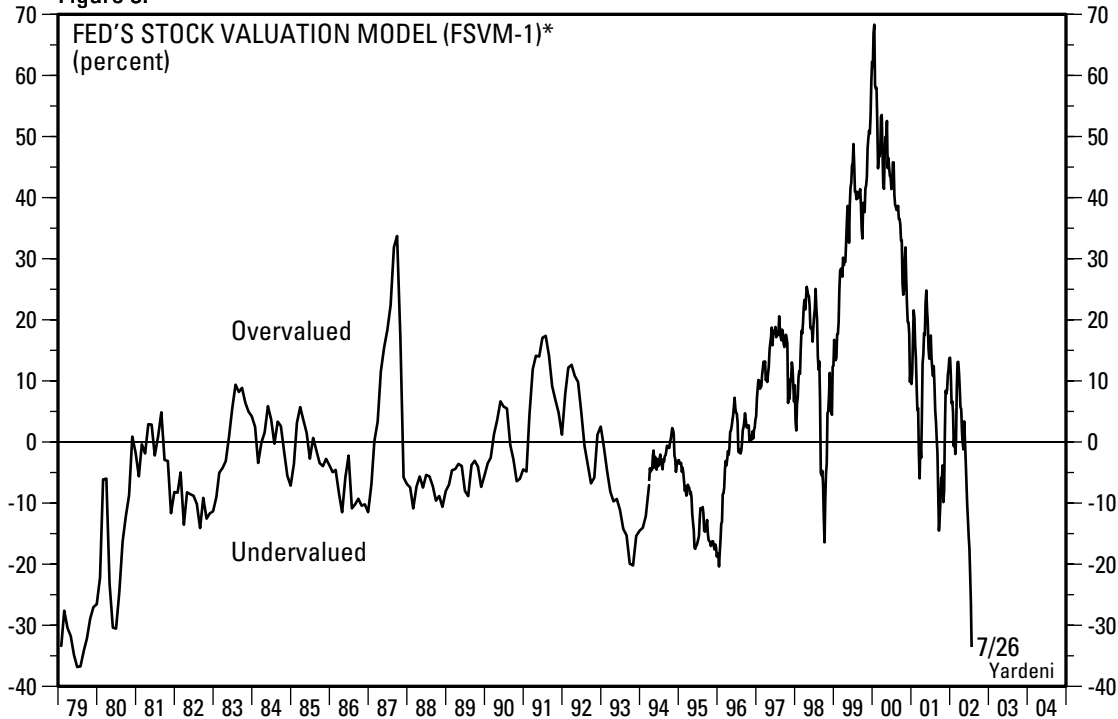


\* 52-week forward consensus expected S&P 500 operating earnings per share divided by 10-year US Treasury bond yield. Monthly through March 1994, weekly after.  
Source: Thomson Financial.

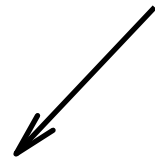


According to the Fed model, when stock prices are overpriced, returns from stocks are likely to be subpar over the next 12-24 months. Better-than-average returns tend to come from underpriced markets.

Figure 3.

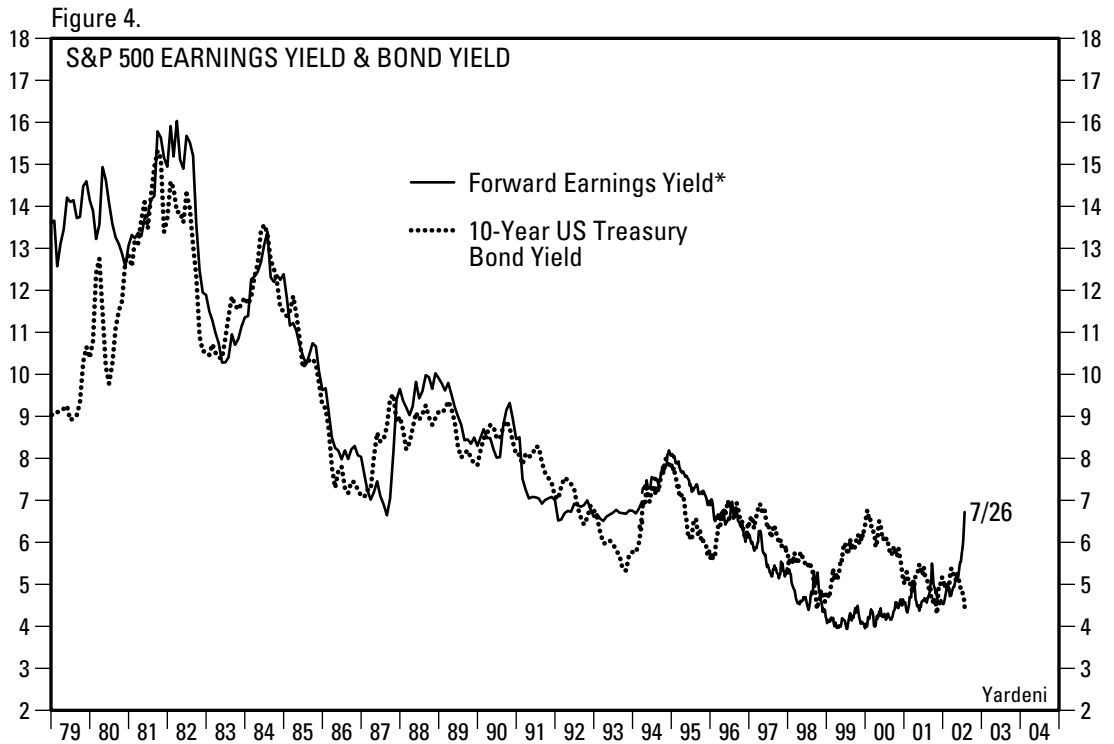


\* Ratio of S&P 500 Index to its Fair-Value (52-week forward consensus expected S&P 500 operating earnings per share divided by the 10-year US Treasury bond yield) minus 100. Monthly through April 1994, weekly thereafter.  
Source: Thomson Financial.



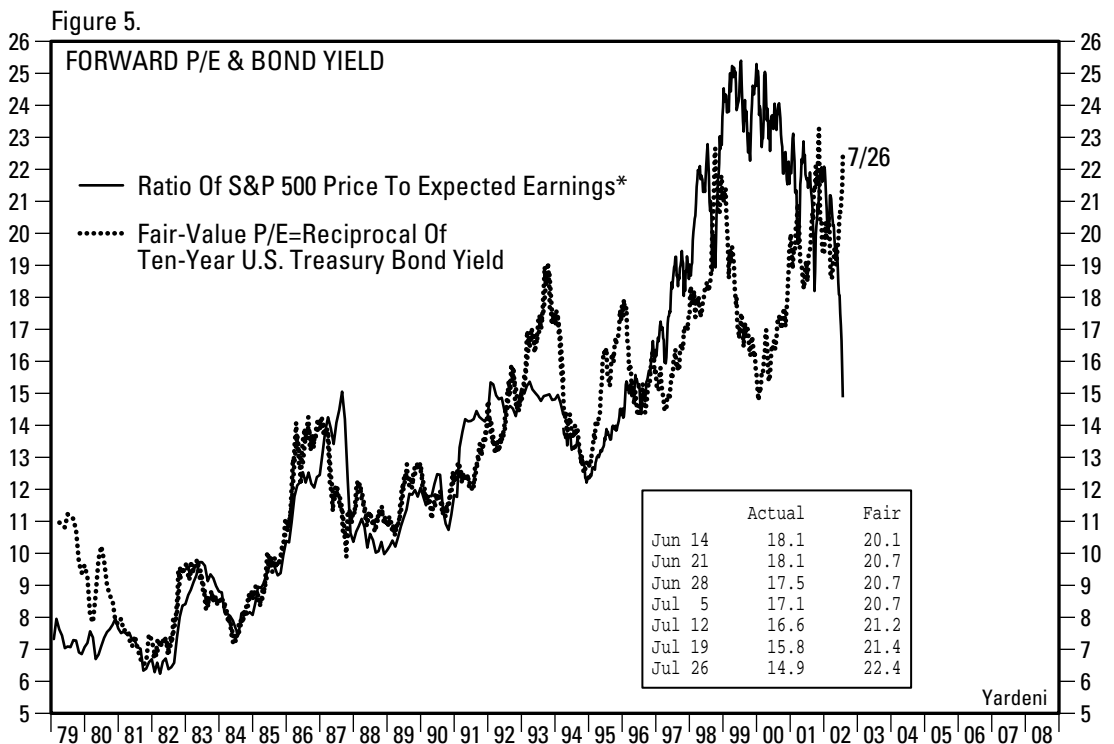
## - Valuation Model -

This chart appeared in the Fed's July 1997 Monetary Policy Report to the Congress. It shows a very close correlation between the earnings yield of the stock market and the bond yield. Another, more familiar way to look at it follows.



\* 52-week forward consensus expected S&P 500 operating earnings per share divided by S&P 500 Index. Monthly through March 1994, weekly after.  
Source: Thomson Financial.

The S&P 500 P/E (using expected earnings) is highly correlated with reciprocal of the bond yield.

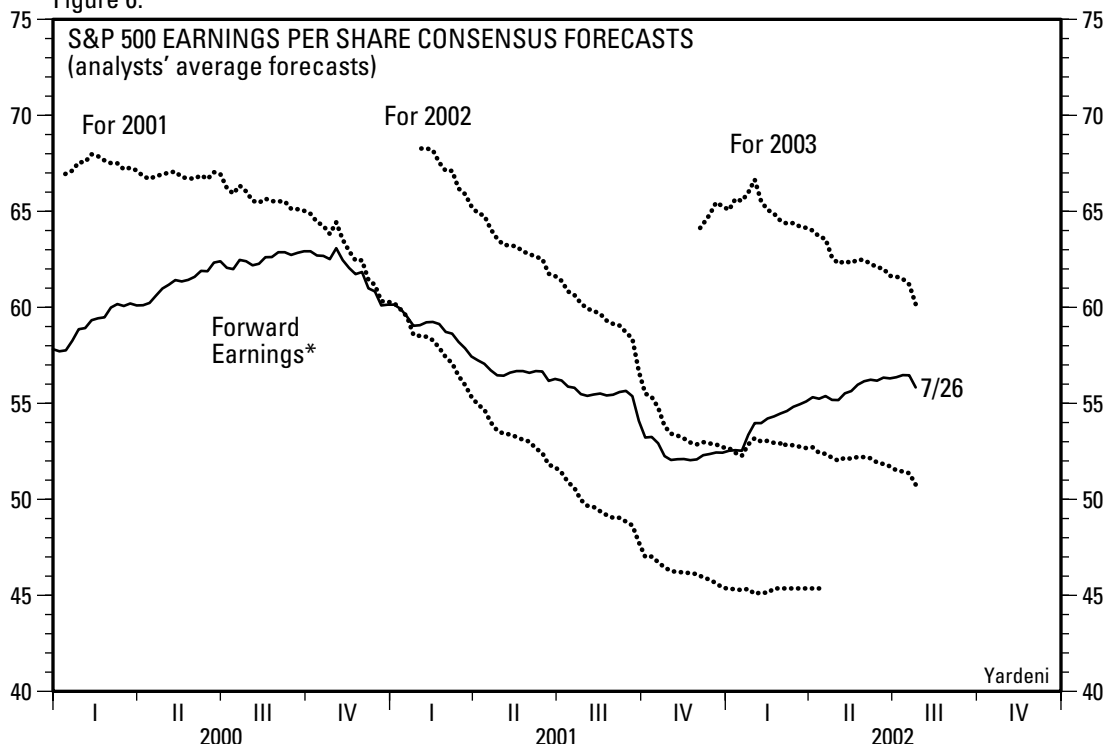


\* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly after.  
Source: Thomson Financial.



## - Earnings -

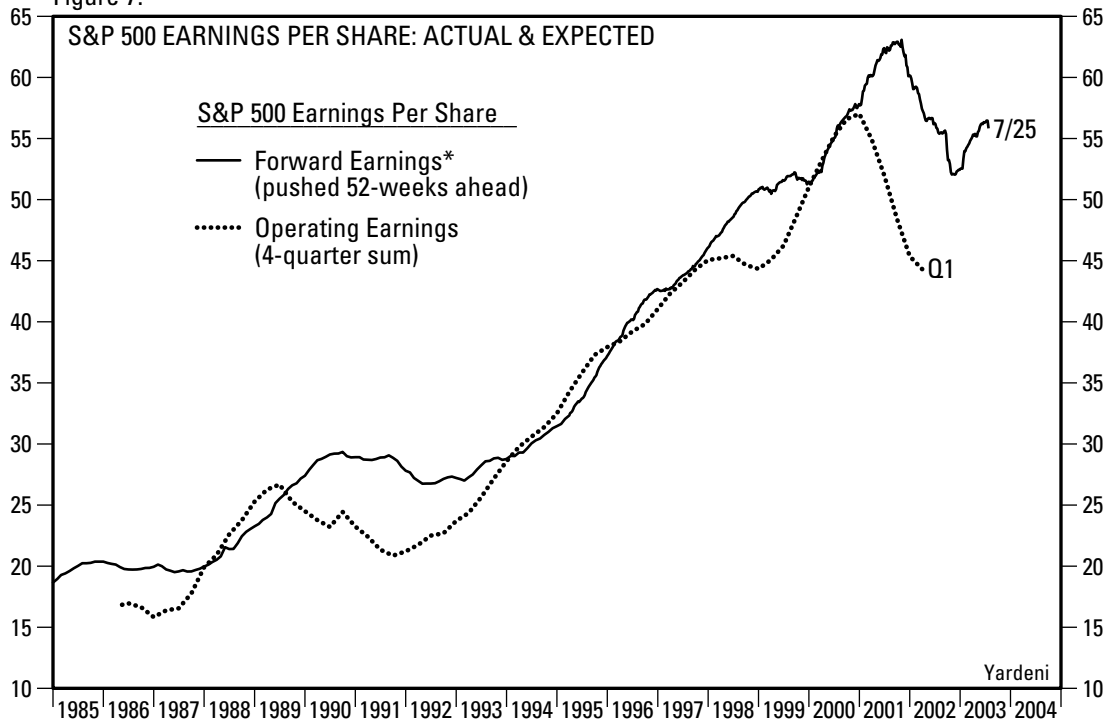
Figure 6.



Expected forward earnings is a time-weighted average of current and the coming years' consensus forecasts.

\* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current year and next year's consensus forecasts.  
Source: Thomson Financial.

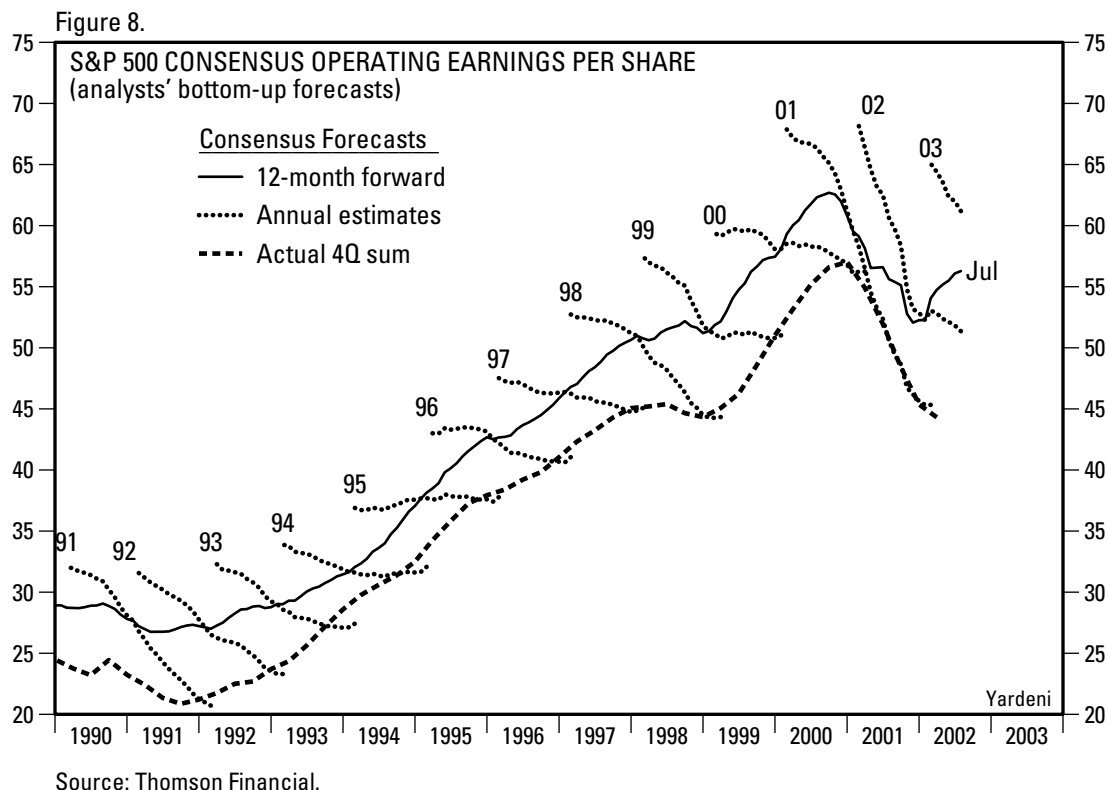
Figure 7.



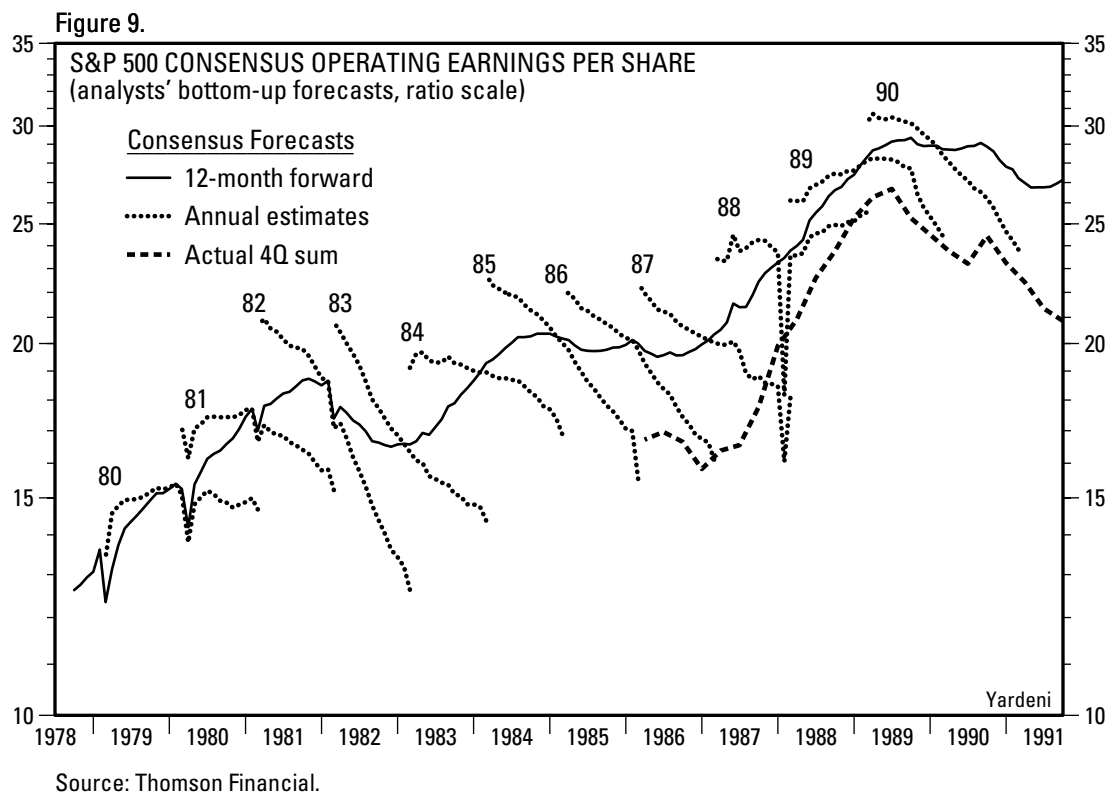
Bottom-up 52-week forward expected earnings tends to be a good predictor of actual earnings, with a few significant misses.

\* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly after.  
Source: Thomson Financial.

# - Earnings -

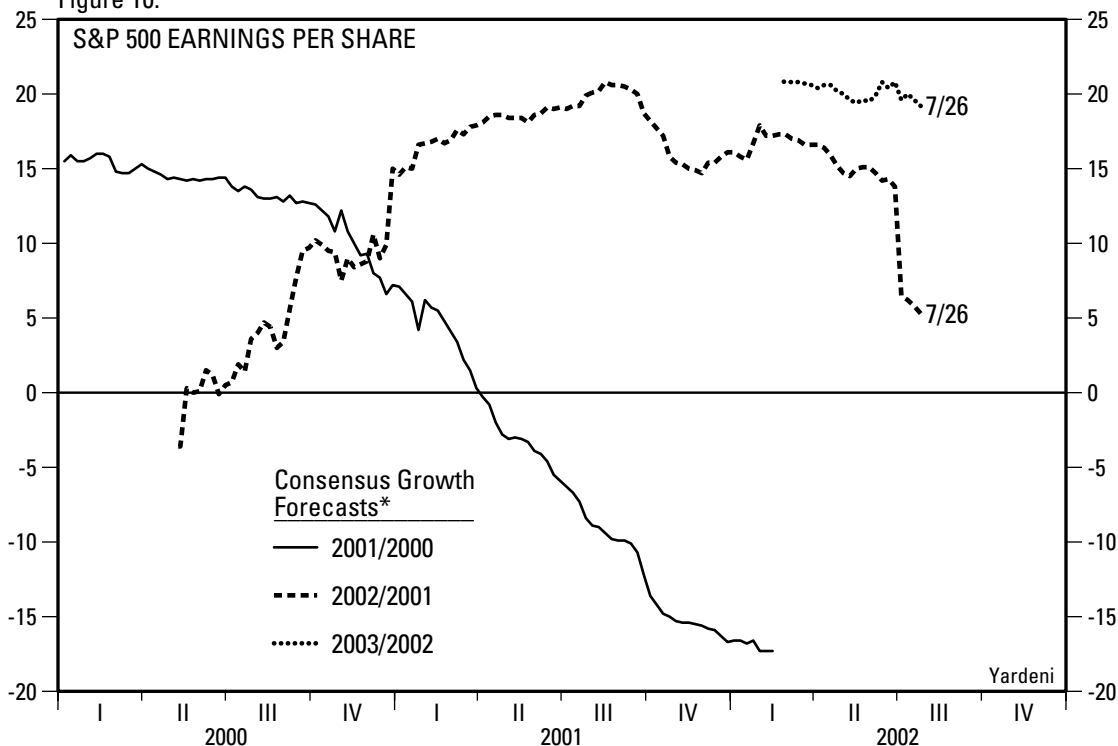


Analysts always start out too optimistic about the prospects for earnings.



## - Earnings -

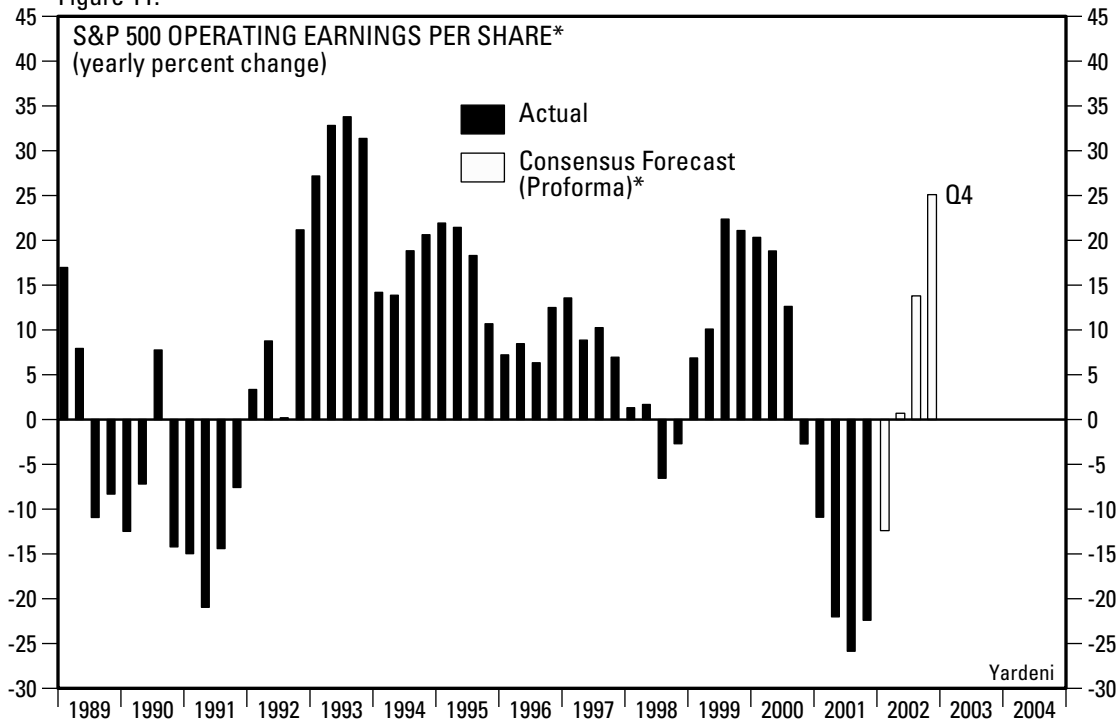
Figure 10.



\* Based on consensus expected S&P 500 operating earnings per share for years shown. Source: Thomson Financial.

The data on consensus expected earnings can be used to derive consensus earnings growth forecasts.

Figure 11.

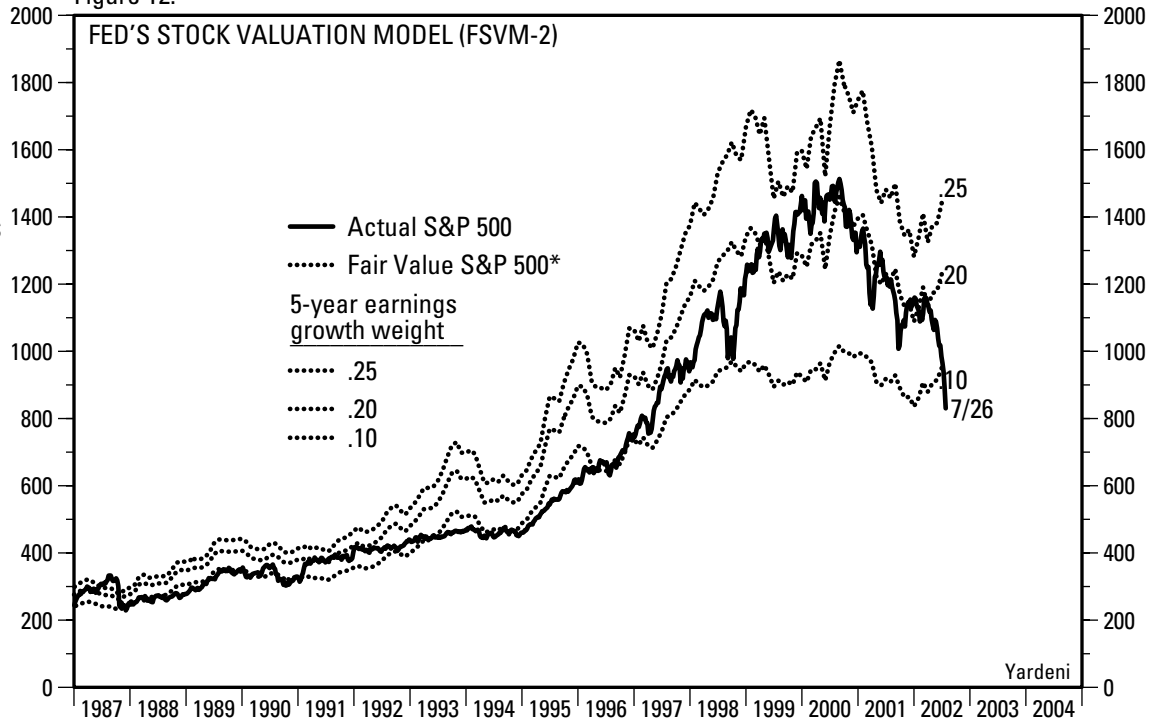


\* S&P 500 composition is constantly changing. Actual data are not adjusted for these changes. Proforma forecasts are same-company comparisons. Source: Thomson Financial.

Earnings growth is highly cyclical.

## - New Improved Model -

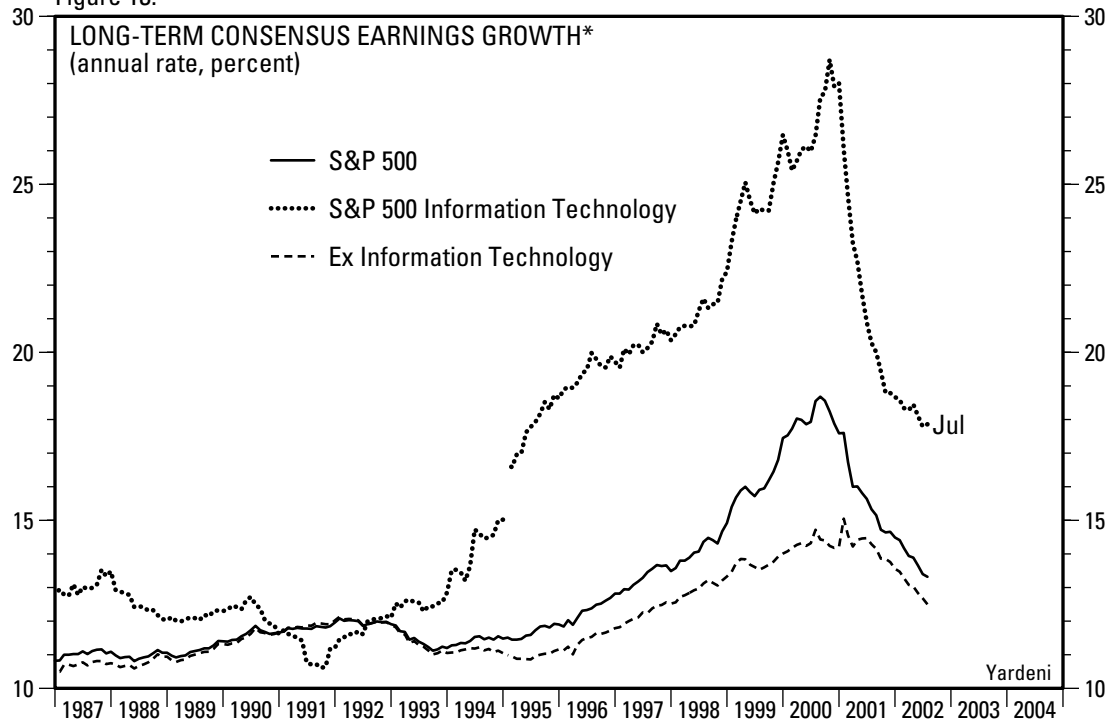
Figure 12.



This second version of the Fed's Stock Valuation Model builds on the simple one by adding variables for long-term expected earnings growth and risk.

\* Fair Value is 12-month forward consensus expected S&P 500 operating earnings per share divided by difference between Moody's A-rated corporate bond yield less fraction (as shown above) of 5-year consensus expected earnings growth.  
 Source: Thomson Financial

Figure 13.

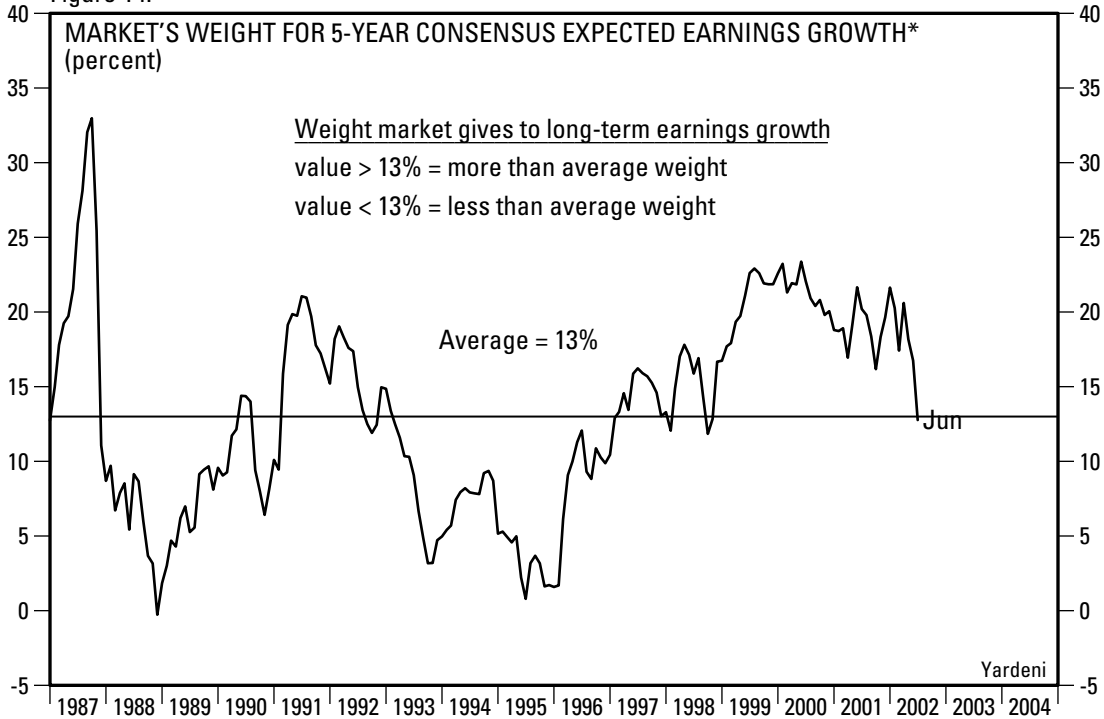


Long-term earnings growth expectations rose sharply during 1990s. They fell sharply from 2000-2002.

\* 5-year forward consensus expected S&P 500 earnings growth. Data from 1995 based on new Global Industry Classification Standard.  
 Source: Thomson Financial.

## - New Improved Model -

Figure 14.

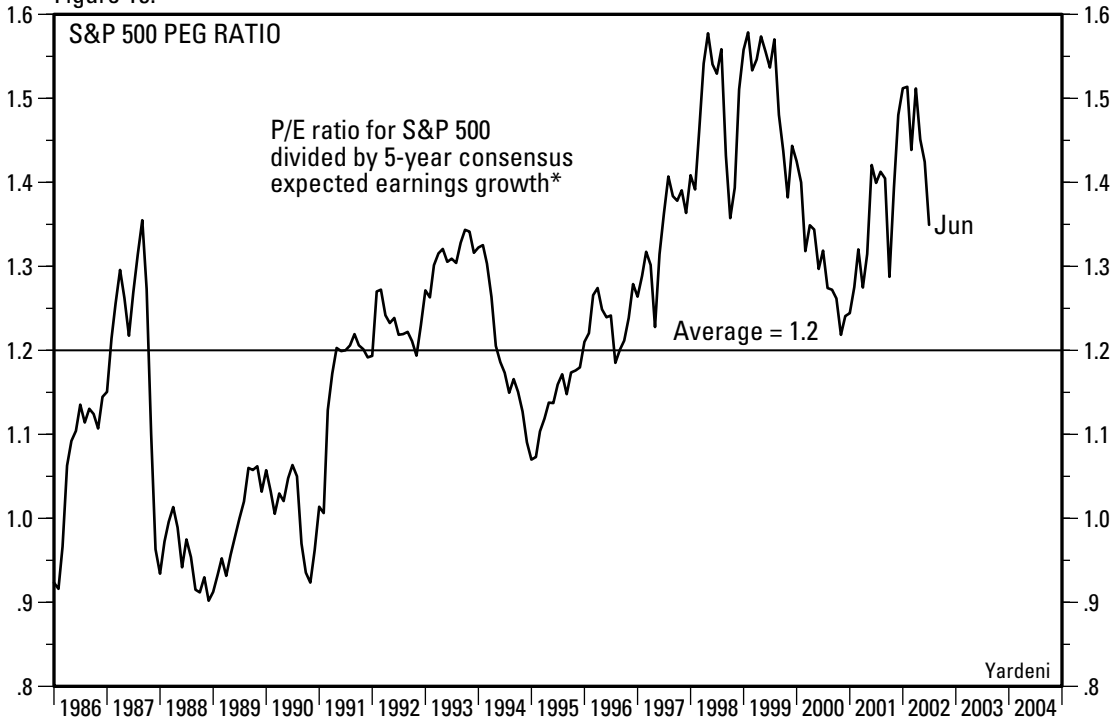


Investors have on average over time subtracted 13% of their long-term earnings growth expectations from the corporate bond yield to determine earnings yield.

\* Moody's A-rated corporate bond yield less earnings yield divided by 5-year consensus expected earnings growth.

\* Source: Standard and Poor's Corporation, Thomson Financial and Moody's Investors Service.

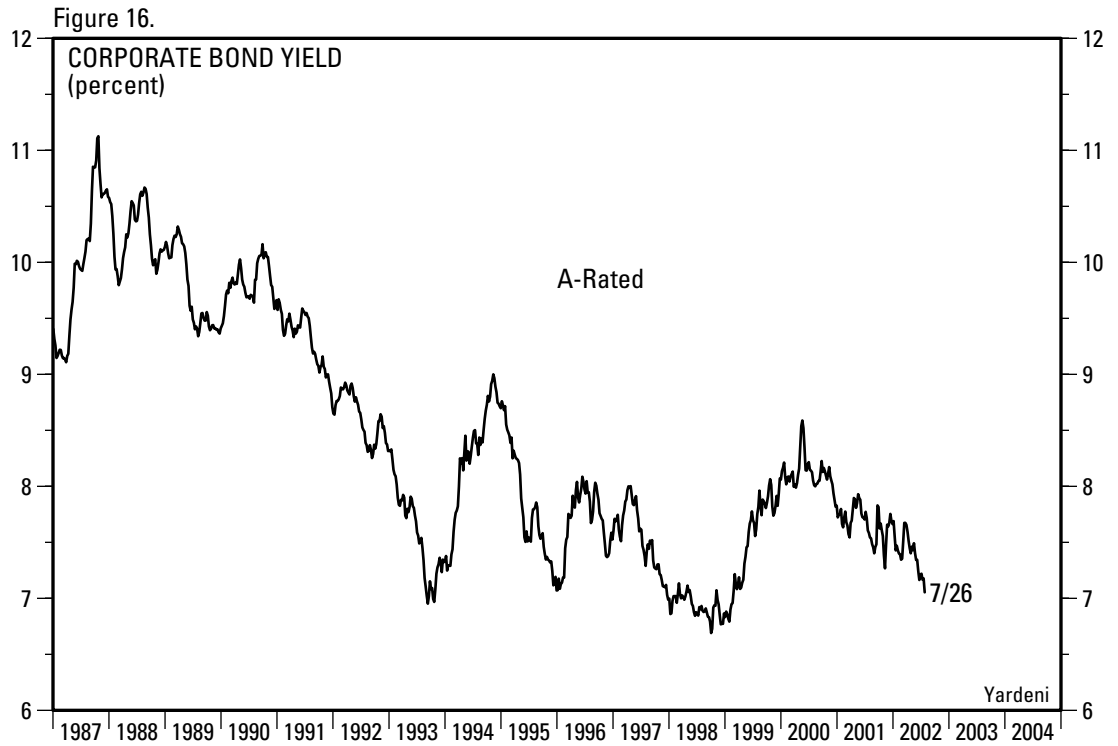
Figure 15.



Historically, S&P 500 sold at P/E of 1.2 times long-term expected earnings growth, on average, with quite a bit of volatility.

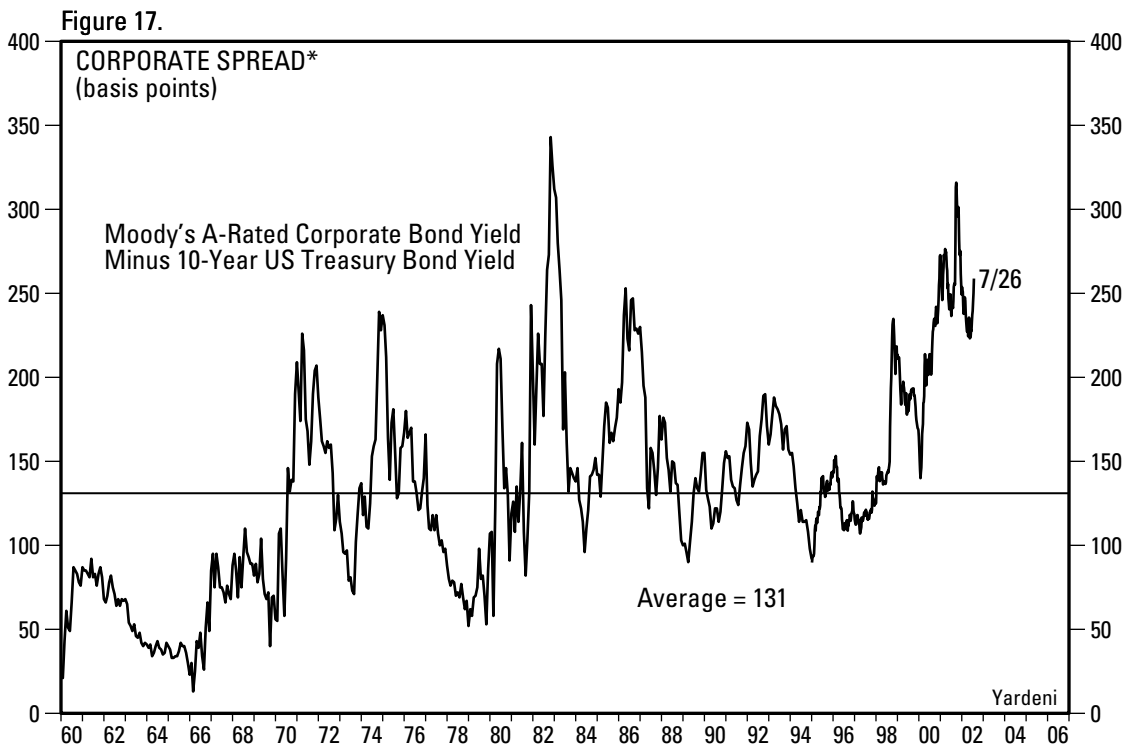
\* P/E using 12-month forward consensus S&P 500 expected earnings and prices at mid-month.  
Source: Thomson Financial.

# - New Improved Model -



Source: Moody's Investors Service.

Corporate bond yield variable in FSVM-2 captures risk that earnings will be weaker than expected.

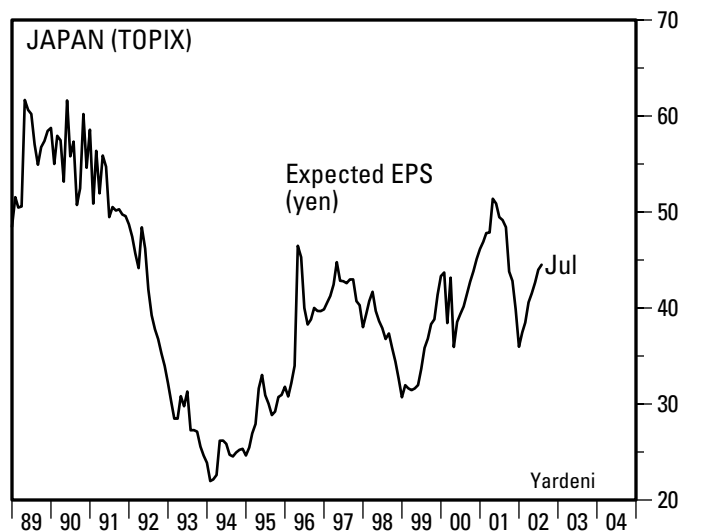
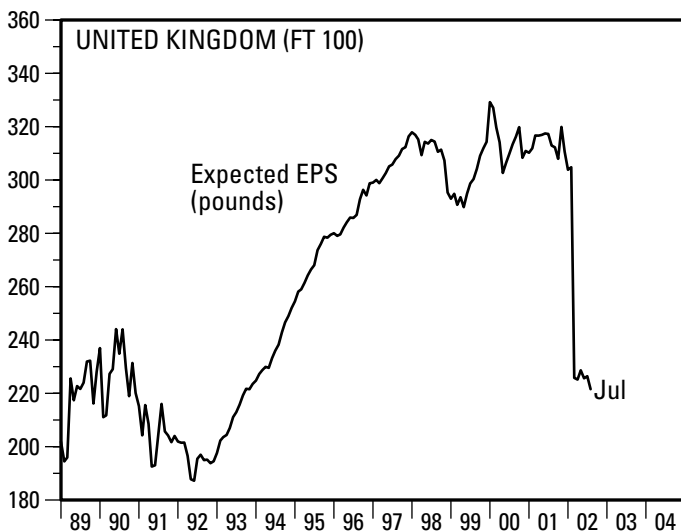
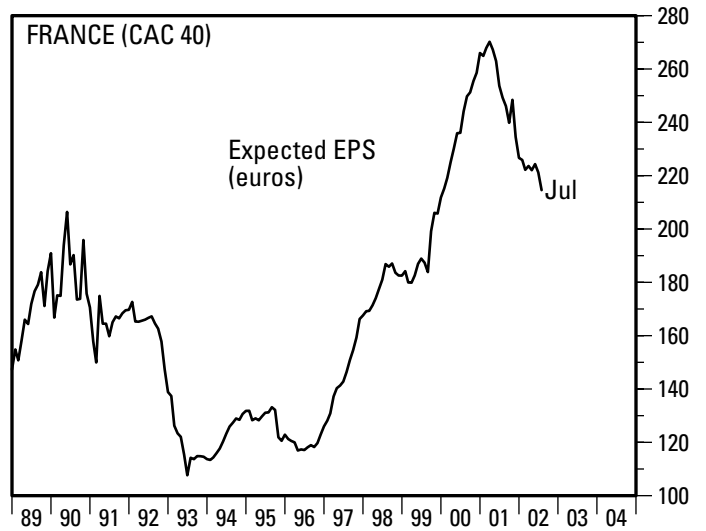
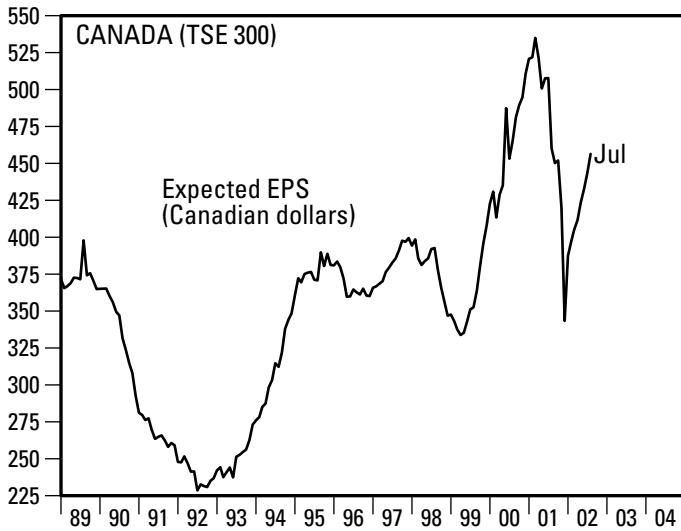
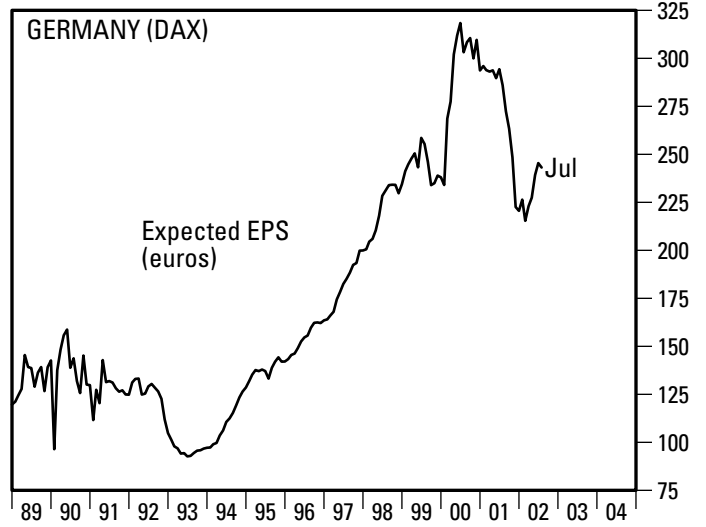
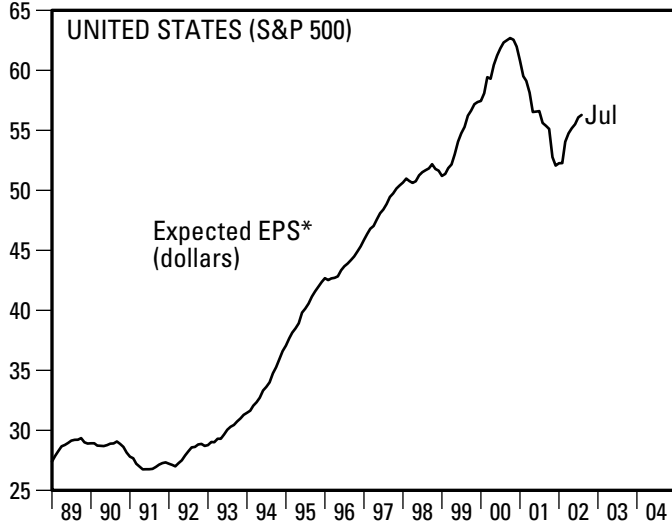


\* Monthly through 1994, weekly thereafter.

Source: Board of Governors of the Federal Reserve System and Moody's Investor Service.

# - Global: Expected Earnings\* -

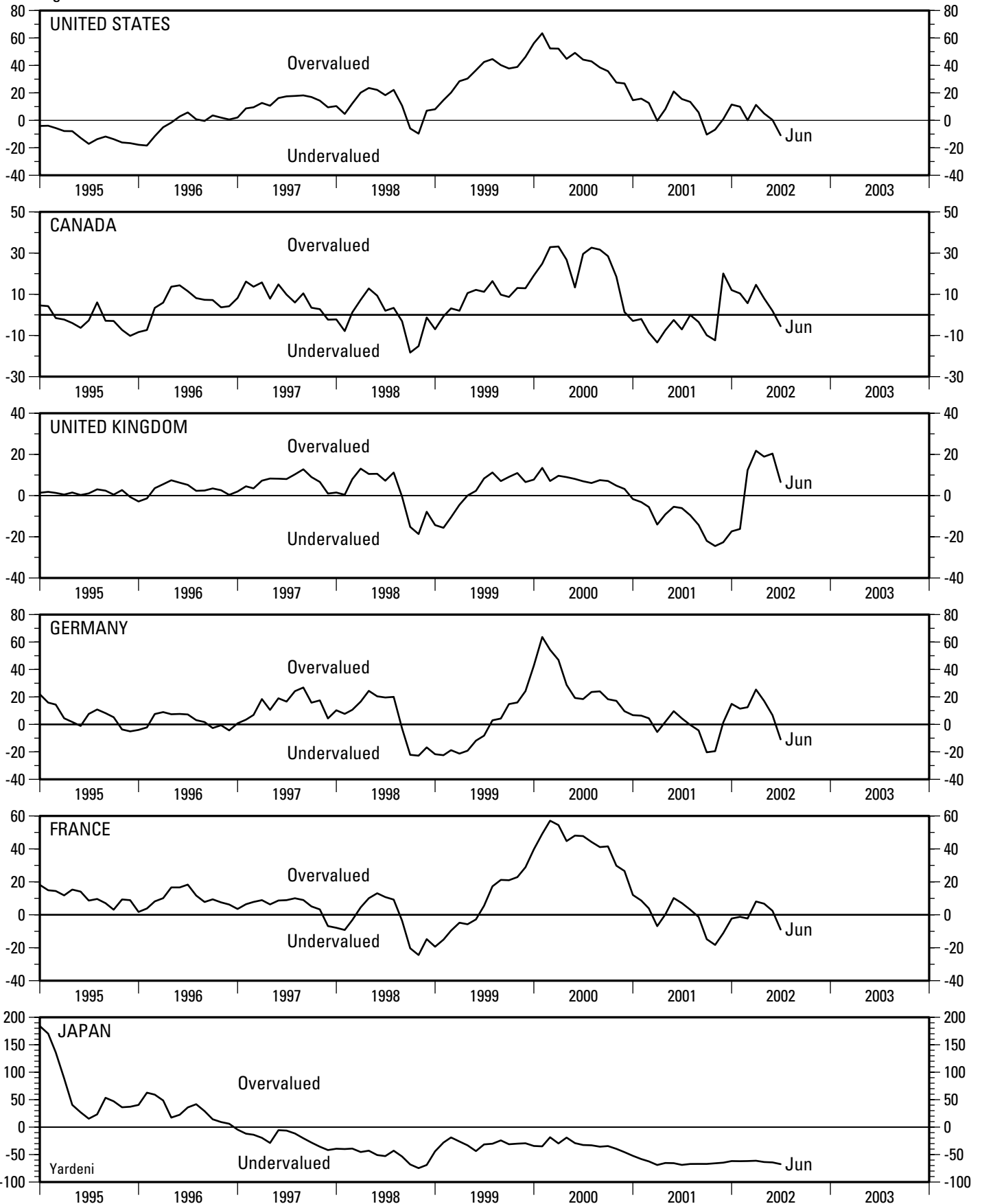
Figure 18.



\* 12-month forward consensus expected operating earnings per share. Source: Thomson Financial.

# - Global: Stock Valuation -

Figure 19.

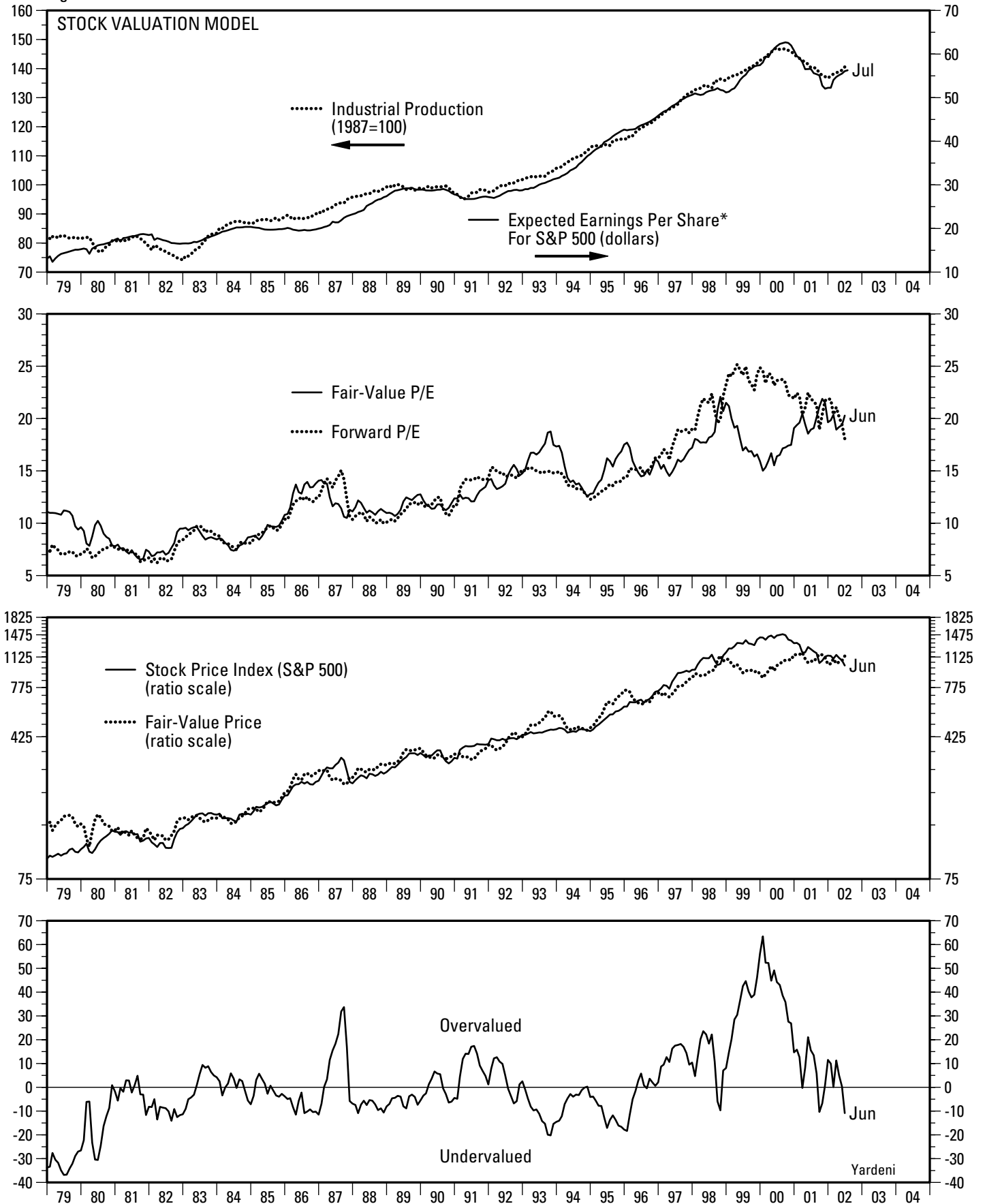


Source: Thomson Financial.



# - Global: United States (S&P 500) -

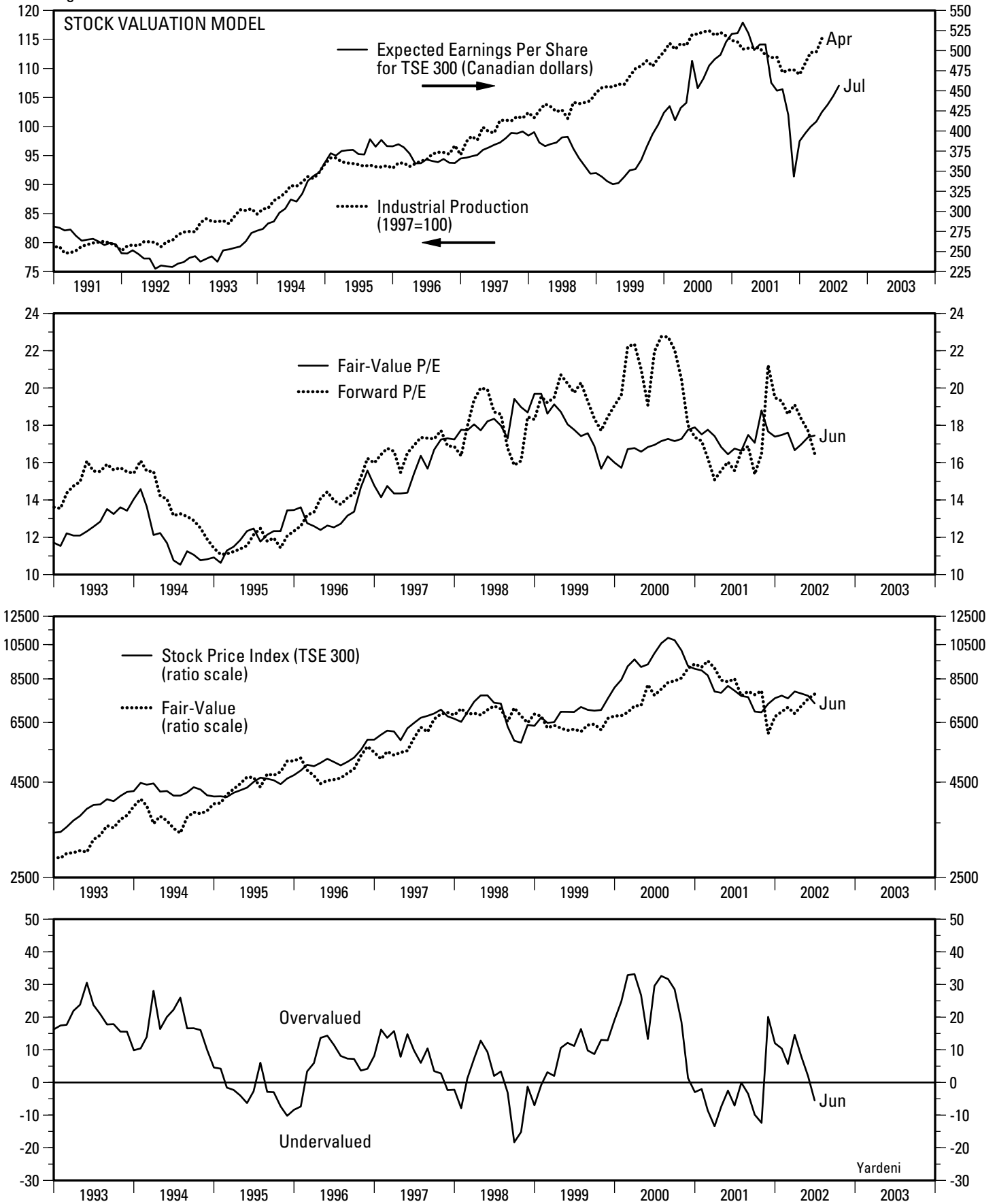
Figure 20.



Source: Thomson Financial.

# - Global: Canada (TSE 300) -

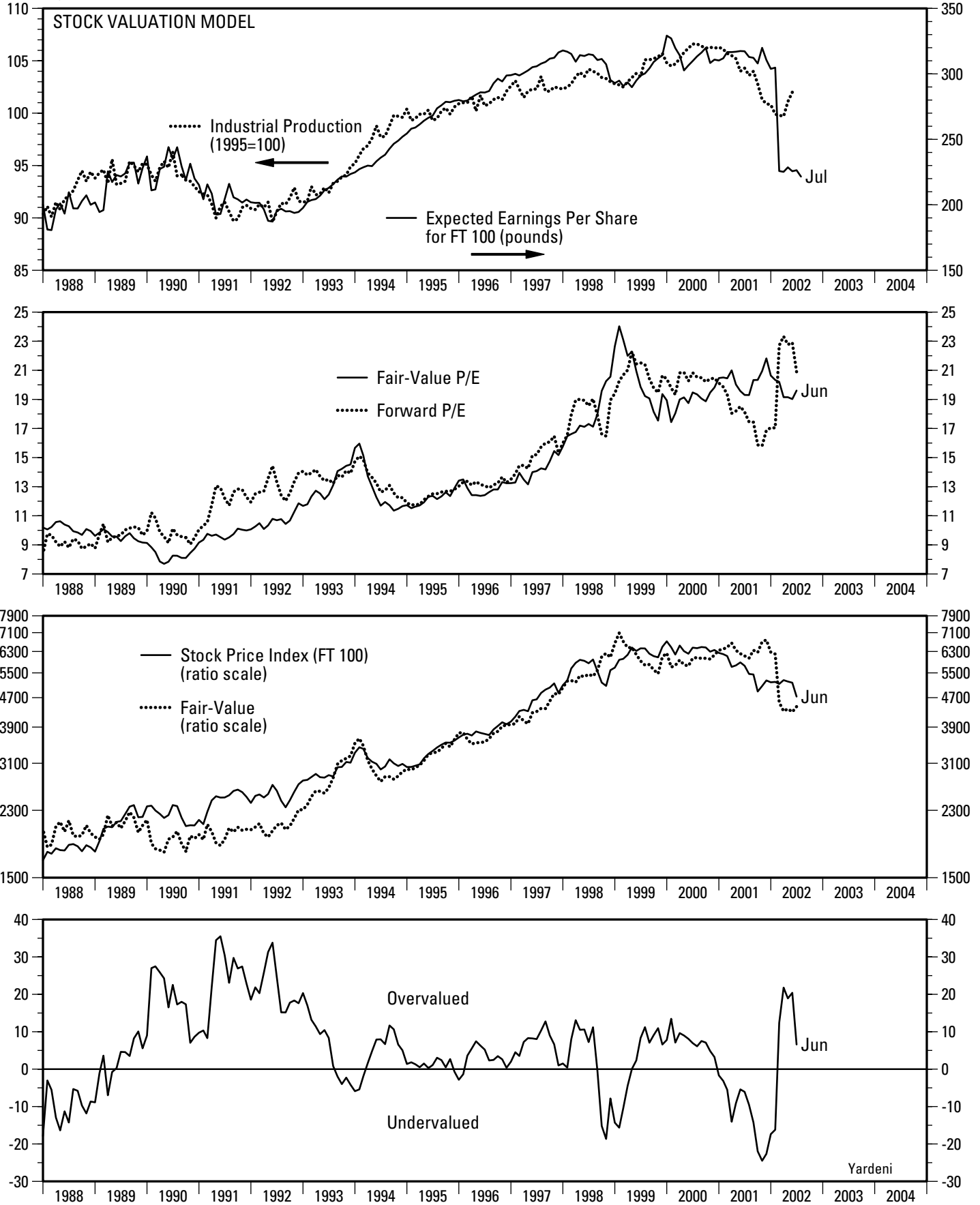
Figure 21.



\* Source: Thomson Financial.

# - Global: United Kingdom (FT 100) -

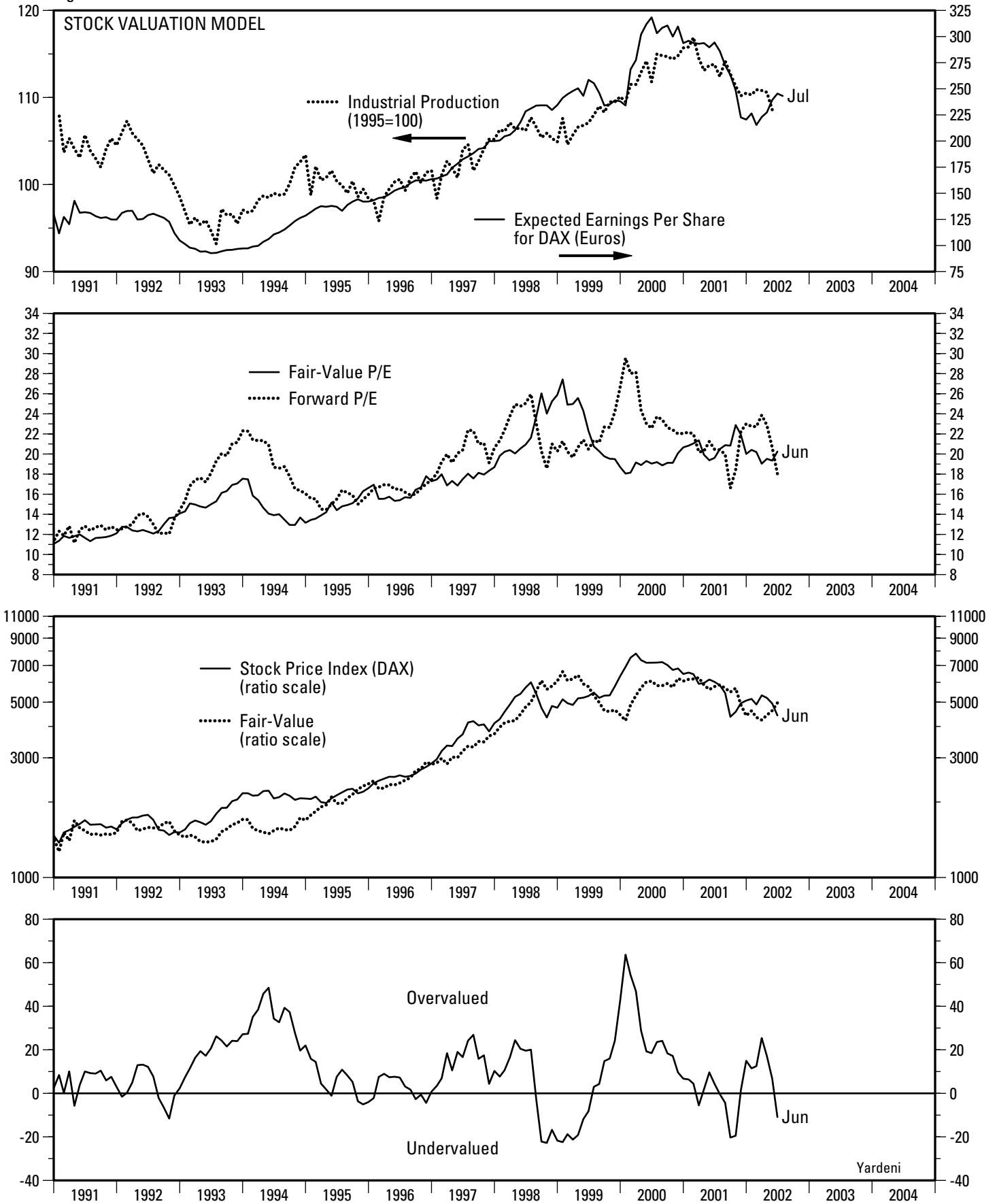
Figure 22.



Source: Thomson Financial.

# - Global: Germany (DAX) -

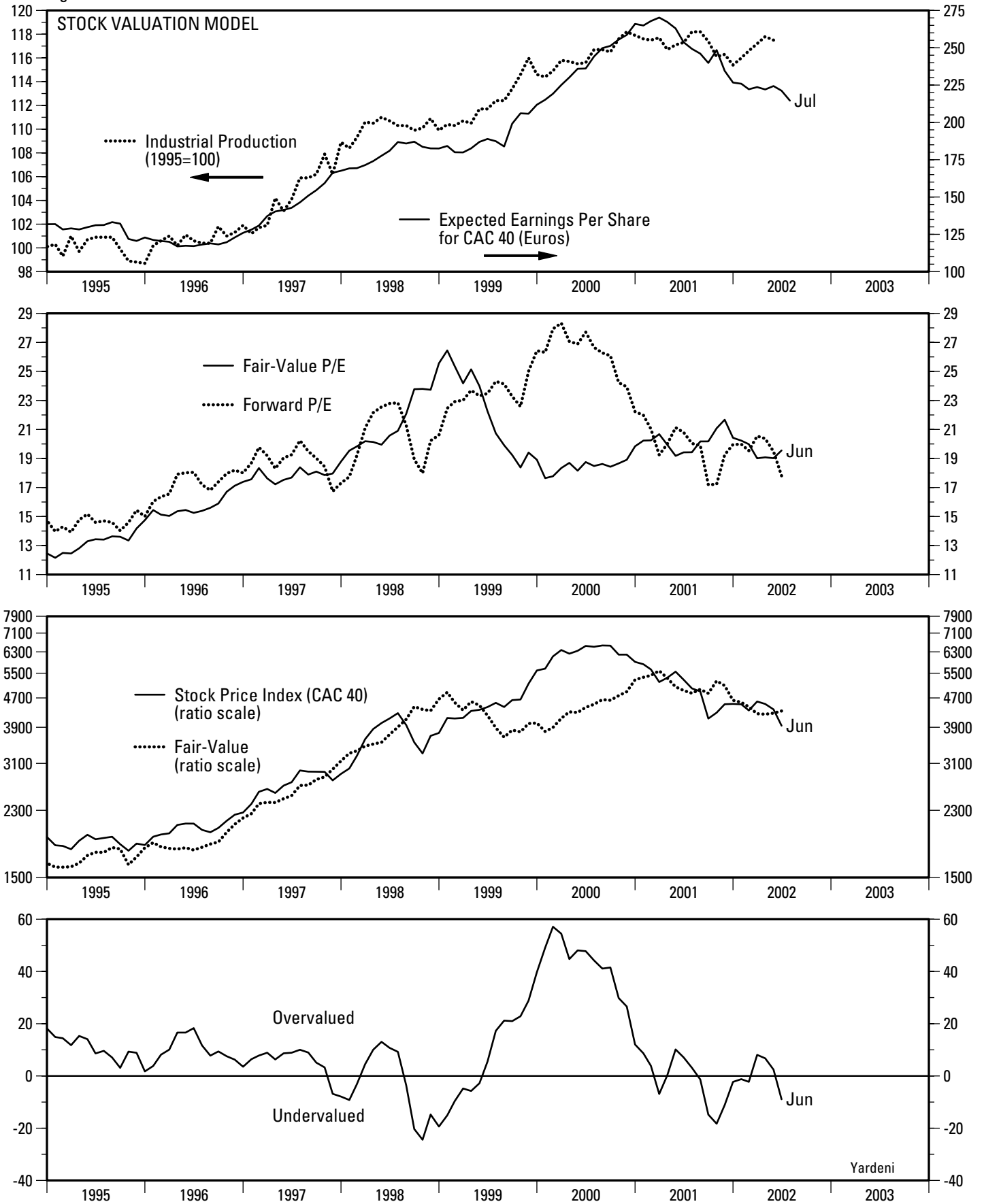
Figure 23.



Source: Thomson Financial.

# - Global: France (CAC 40) -

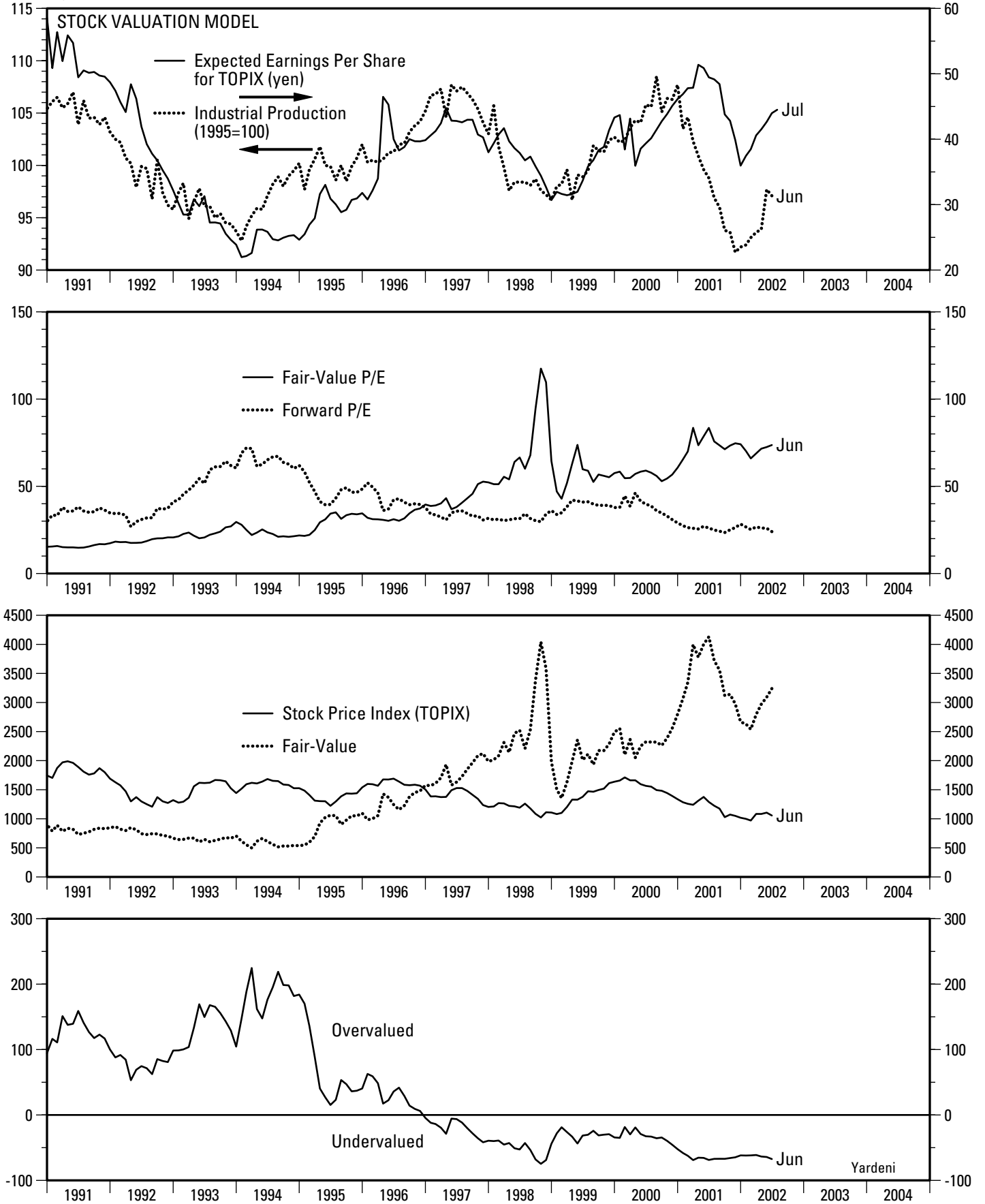
Figure 24.



Source: Thomson Financial.

# - Global: Japan (TOPIX) -

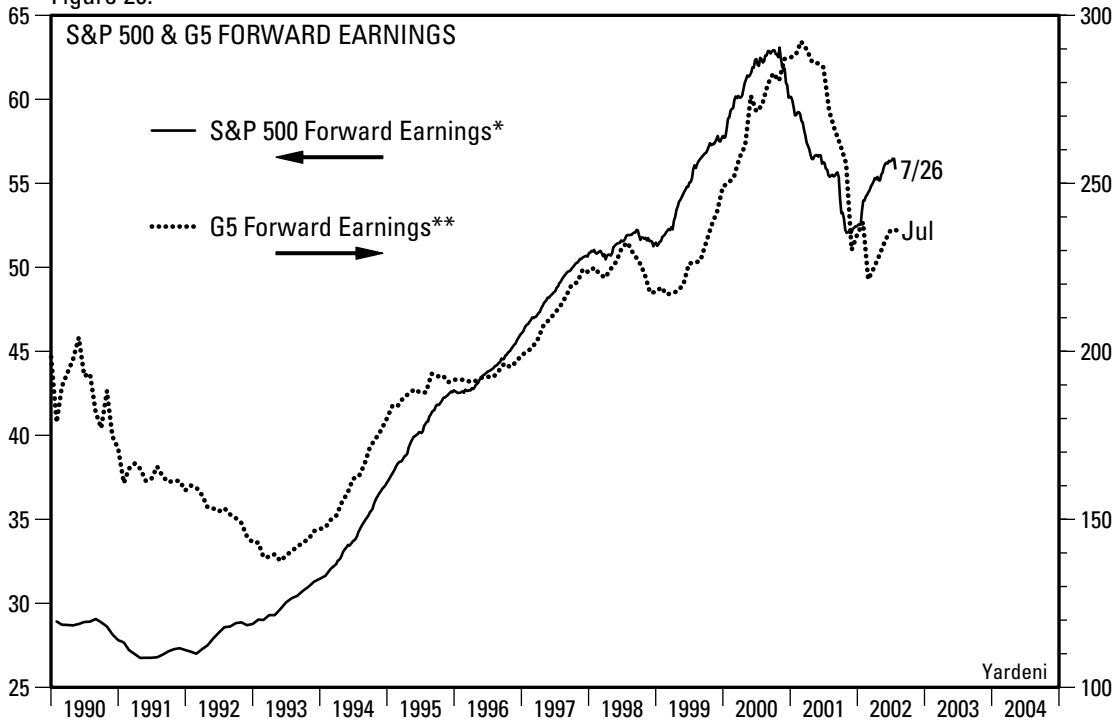
Figure 25.



Source: Thomson Financial.

# - Earnings: US vs G5 -

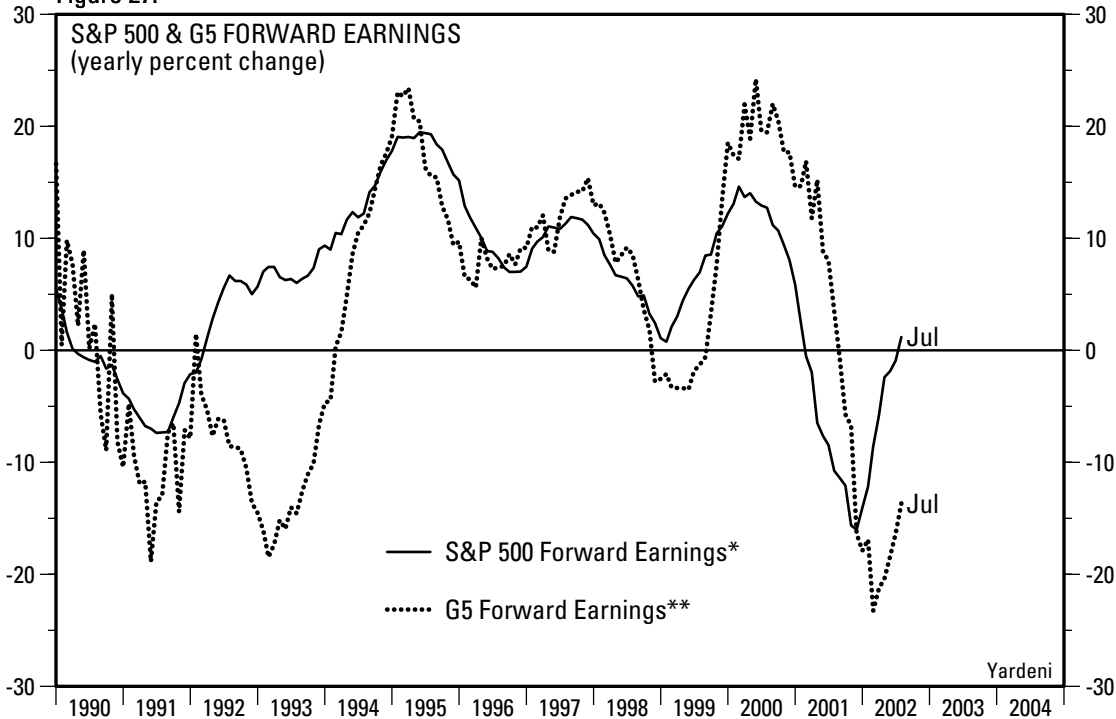
Figure 26.



\* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly after.  
 \*\* Unweighted average of the 12-month forward consensus expected operating earnings per share for Canada, France, Germany, Japan and United Kingdom. Source: Thomson Financial.

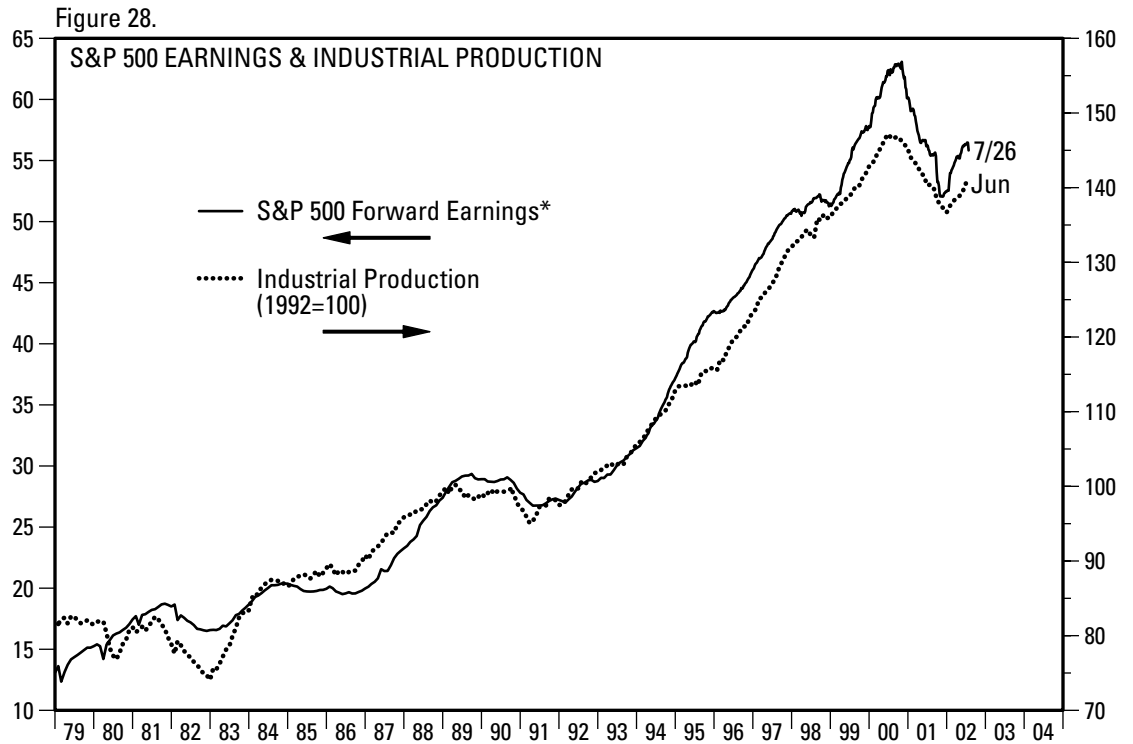
Close correlation between US and G5 profits cycle.

Figure 27.



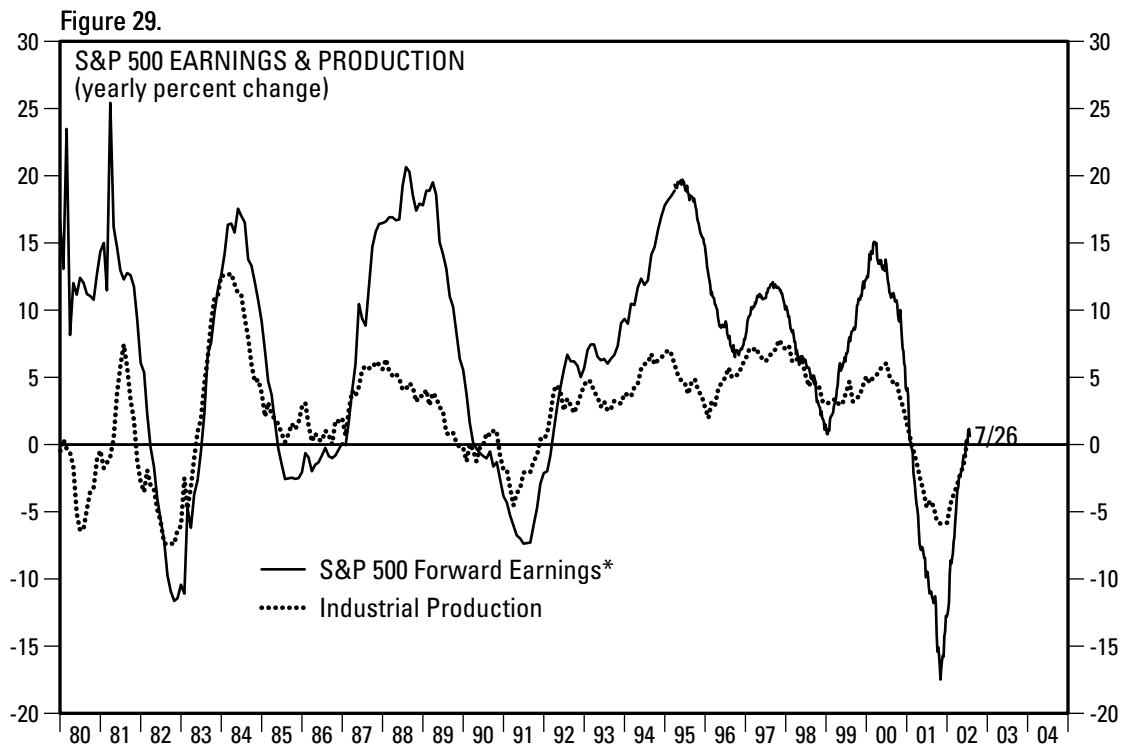
\* 12-month forward consensus expected operating earnings per share. Source: Thomson Financial.  
 \*\* Unweighted average of the 12-month forward consensus expected operating earnings per share for Canada, France, Germany, Japan and United Kingdom. Source: Thomson Financial.

# - Earnings & Output: US -



Strong correlation between US industrial production and S&P 500 forward earnings.

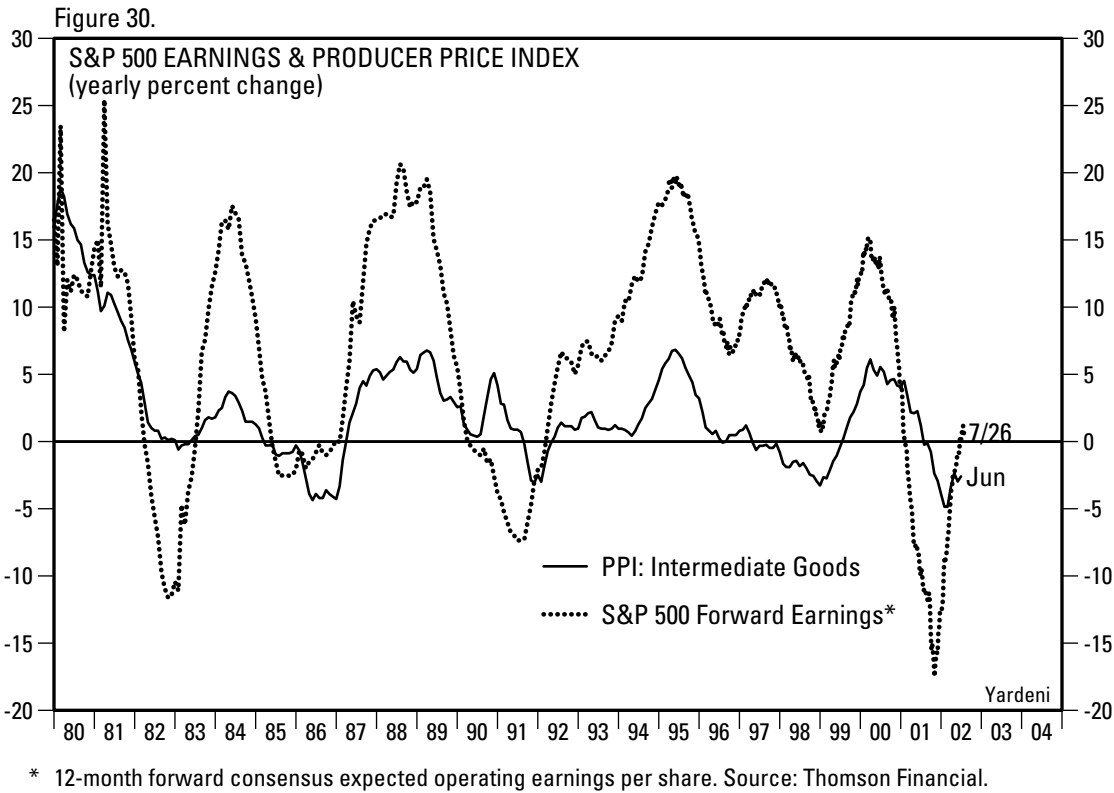
\* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly after  
Source: Thomson Financial.



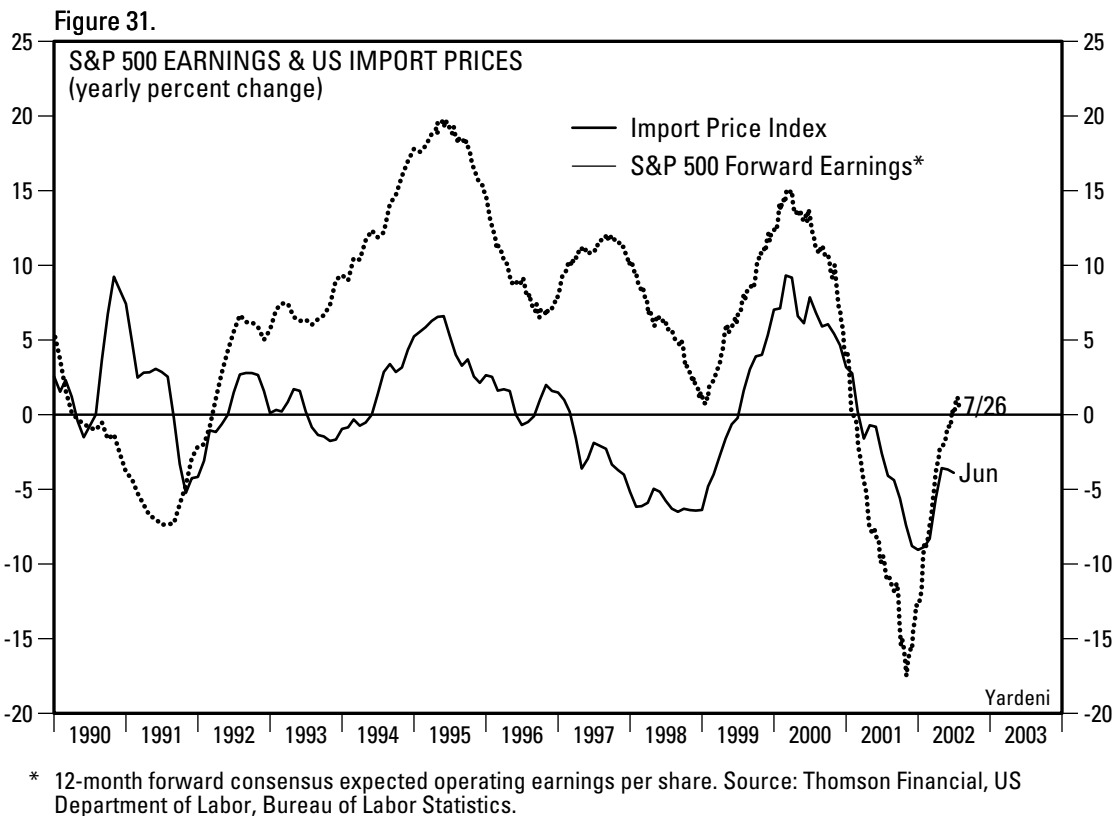
\* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly after  
Source: Thomson Financial.



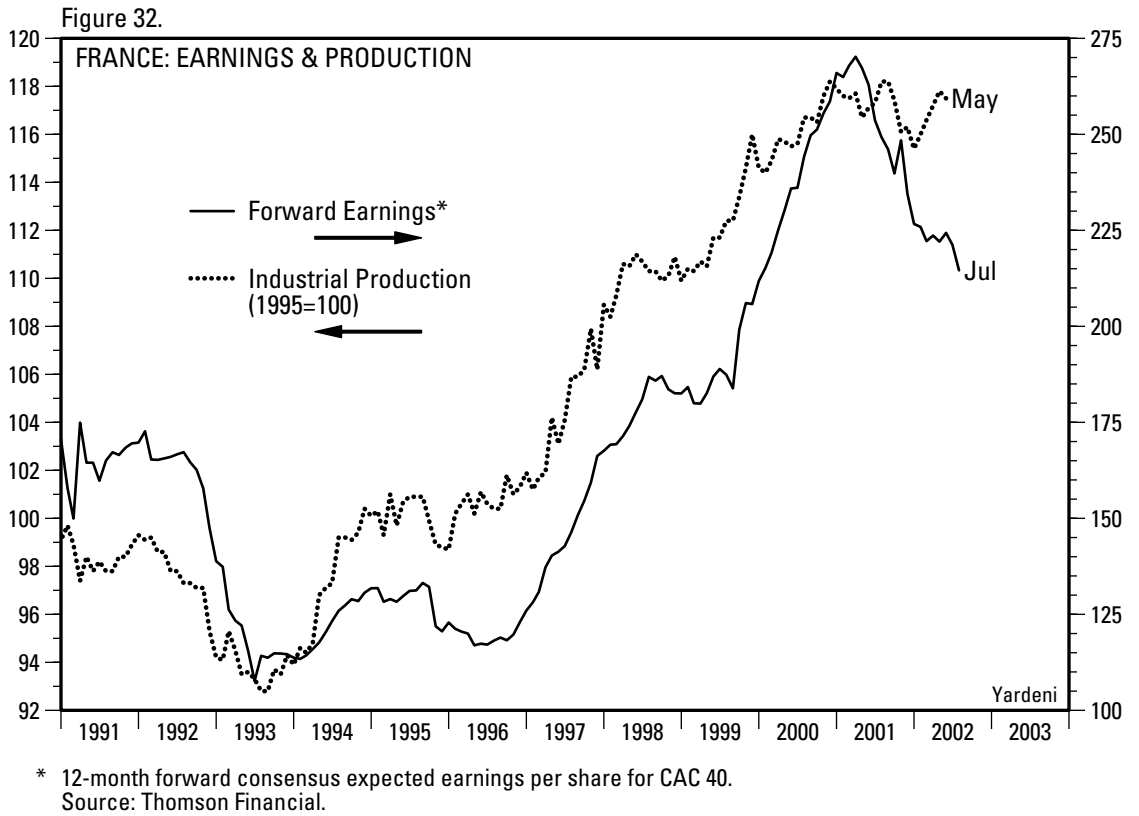
# - Earnings & Prices: US -



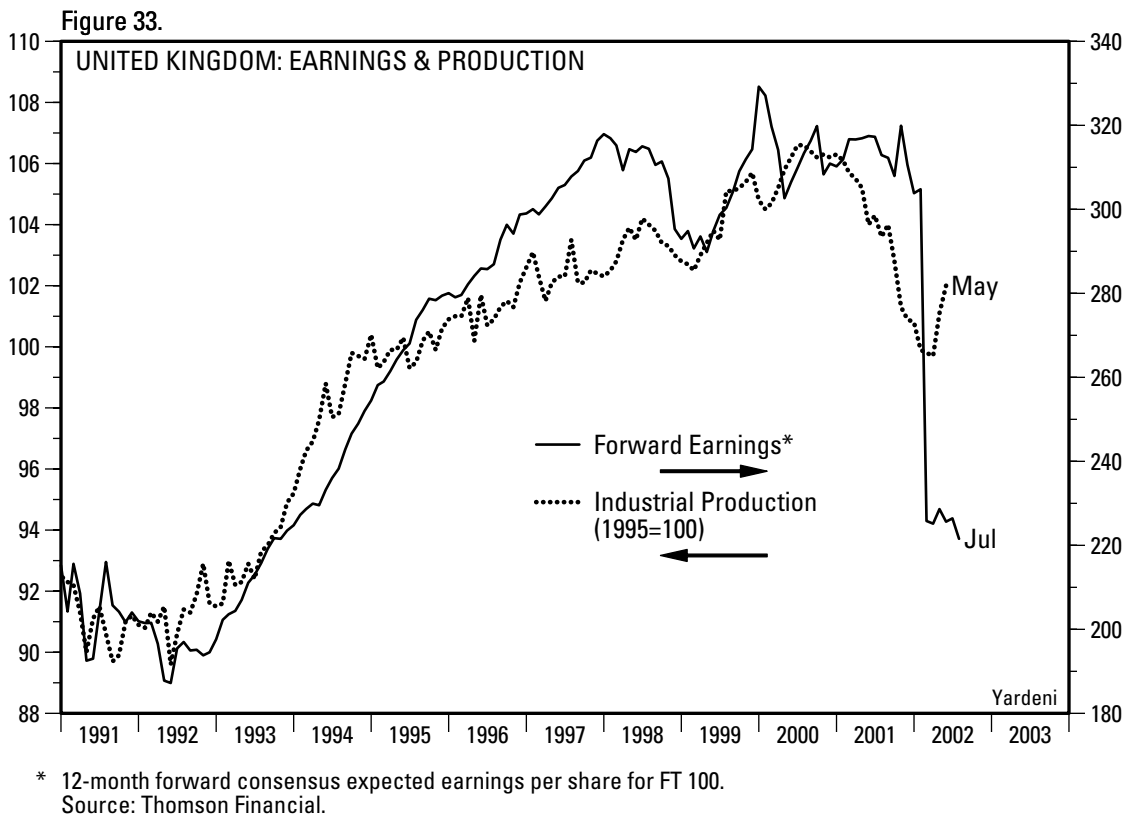
Profits cycle is highly correlated with pricing cycles especially with the intermediate goods PPI and import prices.



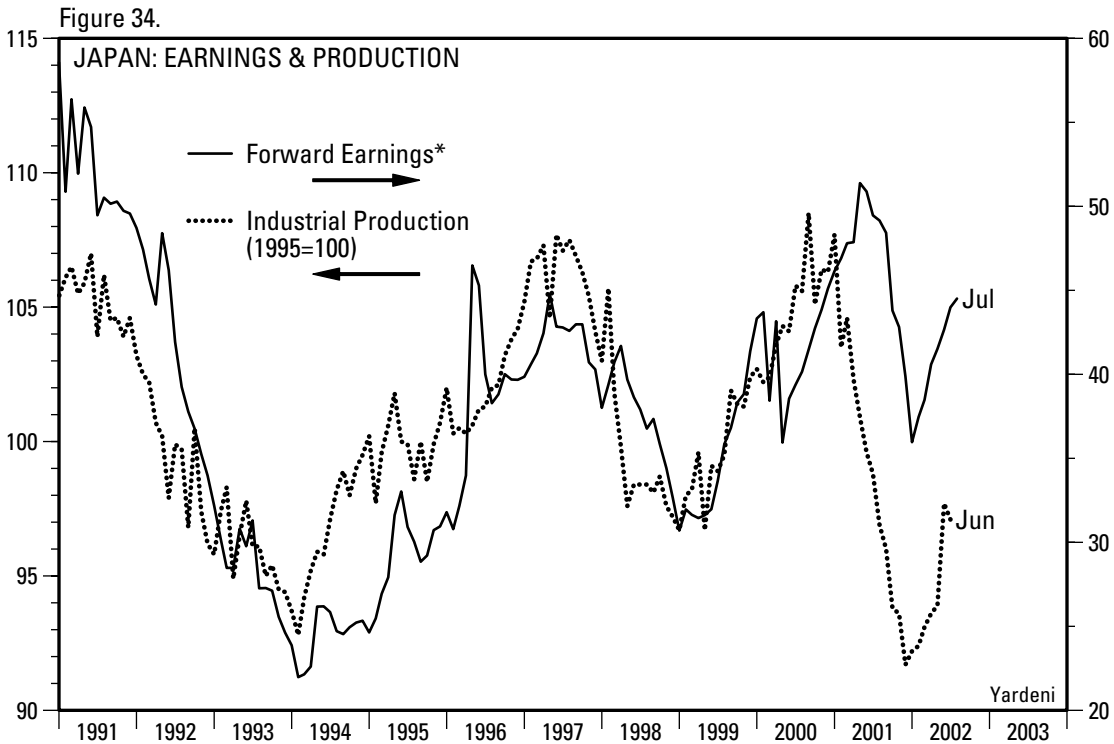
# - Earnings & Output: Europe -



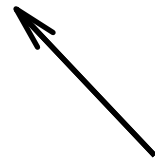
Industrial production is key variable driving profits in France and UK.



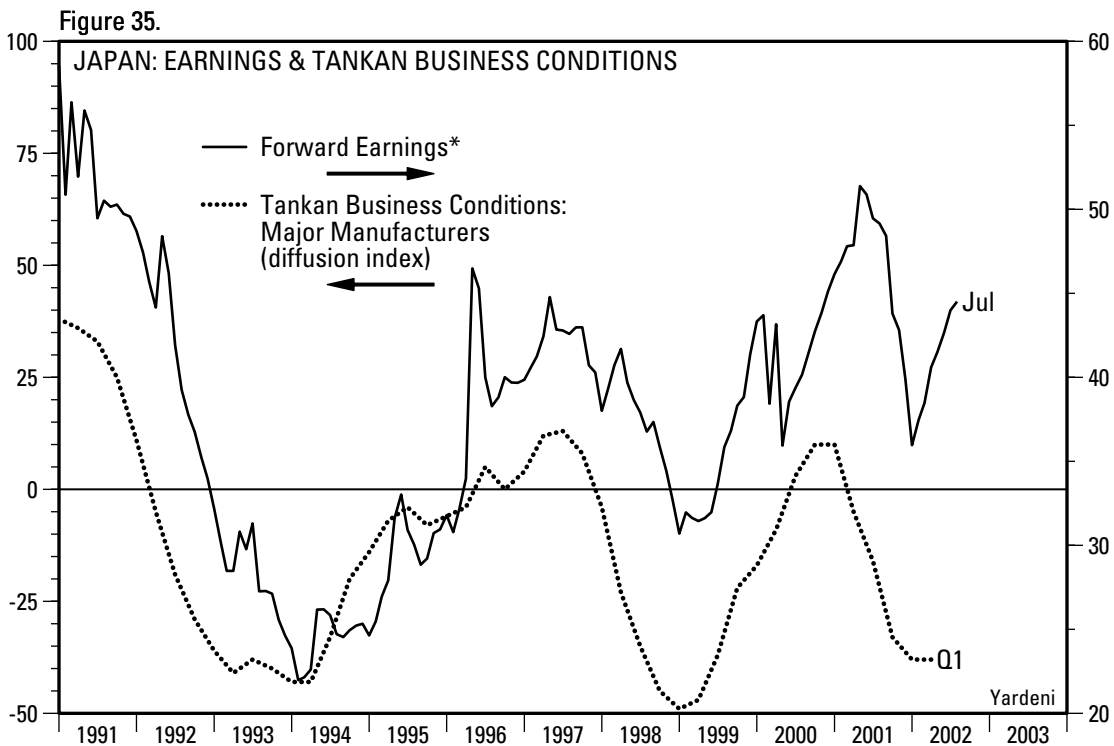
# - Earnings & Output: Japan -



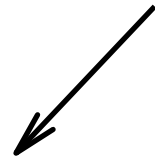
\* 12-month forward consensus expected operating earnings per share for TOPIX.  
 Source: Thomson Financial.



Japan's profits cycle driven by manufacturing.



\* 12-month forward consensus expected earnings per share for TOPIX.  
 Source: Thomson Financial.



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When we assign a Buy rating, we mean that we believe that a stock of average or below average risk offers the potential for total return of 15% or more over the next 12 to 18 months. For higher risk stocks, we may require a higher potential return to assign a Buy rating. When we reiterate a Buy rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

When we assign a Sell rating, we mean that we believe that a stock of average or above average risk has the potential to decline 15% or more over the next 12 to 18 months. For lower risk stocks, a lower potential decline may be sufficient to warrant a Sell rating. When we reiterate a Sell rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

A Hold rating signifies our belief that a stock does not present sufficient upside or downside potential to warrant a Buy or Sell rating, either because we view the stock as fairly valued or because we believe that there is too much uncertainty with regard to key variables for us to rate the stock a Buy or Sell.

#### Rating distribution

07/15/02

	Firm	IBG Clients	
<b>Buy</b>	40.00%	4.00%	50.00%
<b>Hold</b>	56.00%	5.00%	50.00%
<b>Sell</b>	3.00%	1.00%	0.00%

Excludes Closed End Funds

Any OTC-traded securities or non-U.S. companies mentioned in this report may not be cleared for sale in all states.

02-XXXX

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