Misplaced confidence - We all suffer from it

The Dunning-Kruger effect is caused when confidence is so highly prized that one would rather pretend to be smart or skilled than risk looking inadequate and losing face. Even smart people can be affected by the Dunning-Kruger effect, as having intelligence is not the same thing as leaning and developing a specific skill.

The meteoric rise in the S&P 500 index has attracted a large and diverse following of new market participants. Total returns of 31% in 2019, 18% in 2020, and 19% year-to-date are substantial.

When stocks are appreciating violently everyone looks like an investment genius. Nothing personifies this confidence more than the popularity of meme stocks, defined as a stock that has seen an increase in trading activity not because of how well the company performs, but rather due to hype on social media.

Confidence in one's investment ability grows - no one questions their investment process when the results speak for themselves. However, it befits long-term investors to be aware of the risks. After all, a big run-up followed by a big drop on a roller coaster may be exciting but may ultimately prove painful for one's hard-earned investment capital.

Given the miraculous performance of the S&P 500 Index in recent years, it's not surprising to see the euphoria of stock bulls. By contrast, the value investor cites concerns about measures of valuation, but acknowledges that valuations don't count for much in an era of zero-percent interest rates.

Valuation Levels - Now that's interesting

Even so, one wonders where the market is going when the price-to-sales ratio for the S&P 500 index is now at more than 3.1 times, 32.3% higher than the March 2000 dot-com peak. Hypothetically, if the global pandemic never happened, would the S&P500 be 30% above its peak in February 2020? All else equal, without Covid, would U.S. ten-year treasury real yields be negative . . . . and without negative real interest rates, would the stock market trade at multiples never sustained outside of the 1990s technology bubble?

source: The Bloomberg

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A deeper understanding of the price-to-sales ratio of the S&P 500 is a useful reminder of the challenging arithmetic that passive index investors face at current market valuation extremes. Assume that over the next five years, S&P 500 revenues grow at the same 4% annual rate as in the two decades leading up to the pre-pandemic market highs. Additionally, assume that over this five-year period, the S&P 500 price-to-sales ratio drops from its current multiple of 3.1 down to the same level as the 2000 dotcom technology bubble extreme of 2.2. With the S&P 500's current dividend yield of just 1.3%, the market would generate a -1.6% annualized return over the next five years, i.e., revenue growth rate x (ending valuation / beginning valuation) ^ (1 / period) - 1 + dividend yield.

This simple scenario assumes that valuations do not break below their 2000 bubble peak, hardly a stretch of the imagination. One can easily make assumptions that are reasonable and backed by historical evidence that end with a price-to-sales ratio far lower. However, one cannot change the basic math that links valuations, fundamentals, and subsequent investment returns. Applying the same arithmetic to today's current extreme valuations, investors should reasonably expect average annual total returns of about 5.3% over the next five years - as the best-case scenario. Importantly, this scenario requires valuations to remain at record highs indefinitely.

Reality - Talk about a strange three-years

While it’s easy to relish the strong stock returns of the last few years, it is healthy to maintain some perspective. In the September 3, 2021, edition of Grant's Interest Rate Observer, analyst Trey Reik notes that "After achieving 2019 total return of 31.5% on the back of meager 5% earnings growth, the S&P 500 proceeded to alchemize its 33% earnings collapse in 2020 into additional gains of 18.4%. Now, with Q2 2021 warnings largely in the bag, S&P trailing twelve-month reported earnings ($150.20 estimate) are finally poised to exceed the low $130s level they first reached back in calendar 2018 ($132.39), a feat so far rewarded in 2021 with additional gains of 20.0% (as of 08/13)."

In other words, the market's impressive performance derives from earnings that have done absolutely nothing over the last three years, i.e., earnings have not grown, they’ve only managed to regain what they lost over the last three years.

One should instinctively sense that something is wrong with this picture but is at a loss to describe the stock market's behavior.

Your financial advisor has a menu of possible investment solutions. The solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

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Important disclosures

All data and statistics were provided by Global Financial Data (unless otherwise noted).

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