New Albany
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Market Insight: Valuation and Bubbles…

Despite weekly new highs in the US stock market and continued press coverage of 'bubble' like prices, it appears the path of least resistance is supportive of stable to rising prices thru year-end. And now economists are revealing their forecast for 2014 of +13% rise in stock prices on the back of 5% earnings growth. You might ask why should stocks rise +13% when earnings only rise 5%? This means P/E ratios will continue to expand and valuations will become even more extended. Does valuation or price of a stock really matter? Intuitively, one would say yes, however history tells a different tale.

Valuation alone does not alter the trajectory of stock prices (up or down) but it is external influences or a shock that causes abrupt changes. Looking back at stock market volatility over the last thirty-five years shows that prices of financial instruments generally exhibit inverse price elasticity. In other words, demand increases as prices rise and demand falls when prices fall. (In layman terms, this phenomenon is called the 'herd mentality'.) This positive price/demand correlation is not interrupted until an external force overwhelms the price momentum. Thus, valuation itself has little to do with the timing of a market top (or bottom), but it does tend to influence the magnitude of move.

So what are the external influences that could tip the scale? Of course there are many potential geopolitical events, but I believe it is the Federal Reserve's bond buying program (Quantitative Easing) that is the tsunami on the horizon. The good news is that this influence is <u>currently</u> strategically 'controlled'. The bad news is no one, not even the Fed, knows with any confidence, how or when this program can be altered, and if this influence will eventually lose its positive effect on stock prices.

It is against this backdrop that the current investing environment is quite challenging. It is tempting to go 'all in', with 100% exposure to stocks and 'ride the wave', so to speak, but just be sure to get out at the top - before everyone else! This strategy is both foolish and dangerous and is the reason why so many investors have postponed their retirement date.

Wealth is hard to create, but can very quickly be wiped out and is why each portfolio has defined risk limits, is well diversified, and actively managed. The current investment strategy is positioned so that portfolios can benefit from further stock price gains, but not be overly exposed. At the same time, if prices stagnate or decline, the portfolios are buffered with income producing assets. Balance and prudence is the sure way to grow AND preserve wealth.

As always, please contact me with any questions or concerns.

May your Thanksgiving be a joy-filled celebration with family and friends!

Barbara

Barbara HS Huff

CEO & President
New Albany Investment Management
614-216-6139 ~ www.newalbanyinvestment.com