MOISAND | FITZGERALD | TAMAYO

Financial Planning and Wealth Management

BEAUTY IS IN THE EYE OF THE BEHOLDER

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Buy low, sell high. This simple concept is far from easy because it is often difficult to assess whether or not a potential investment is being offered at a low value or high value. Just ask Rupert Murdoch.

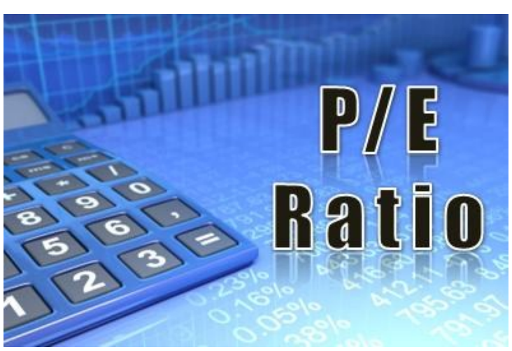
In 2005, his conglomerate News Corp. bought arguably the hottest social media company among young internet users, My Space, for $580 million. Shortly after the purchase, My Space signed a $900 million, three year deal with another internet giant, Google. This got Murdoch, a 20th century media mogul, a wave of publicity as he was lauded for adapting to the rapid change of the digital age and hailed as a 21st century mogul of new media. Advertising revenue at My Space quickly jumped from $1 million to $50 million per month.

Yet only six years later, according to the *Financial Times*, what had been the top company in social media lost over $500 million in its fiscal year and Murdoch sold it for $35 million, a mere 6% of its purchase price. What had seemed a great value became a bust and a massive loss.

Diversification can keep one from getting wiped out by such poor value assessments about a single stock, but gauging whether the market is under or overvalued is almost an obsession with some of the financial press. There are many measures of valuation in the marketplace which compare the current price to some other data point.

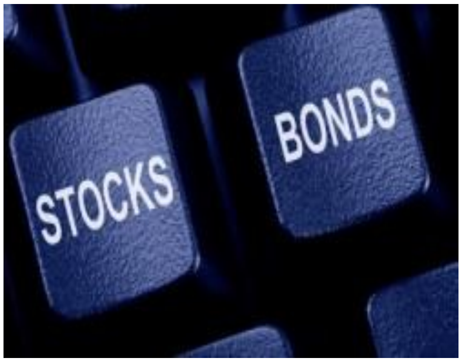
The most common valuation method used for stocks is the price earnings multiple or "P/E ratio". This ratio is calculated and compared to P/E ratios during other time periods or the P/E ratios for other groups of securities. When the P/E ratio is relatively low, people will say that stocks are undervalued and conversely when P/E ratios are high, many will say that stocks are overvalued. If only it were that simple.

First, not all P/E ratios are the same. Obviously, the current price is the same for all forms of P/E ratios. It is the earnings or "E" in the ratio that is problematic. Some P/E ratios quoted will be the price to estimated future earnings. The subjectivity involved with making these estimates is clear. Other P/E ratios compare the price to the prior 12 months earnings. In recent years, more attention has been paid to cyclically adjusted price earnings ratios, or CAPE ratios, which is the current price relative to an average of the earnings over the last 5 or 10 years. This helps smooth the impact of the sometimes volatile changes in the earnings of companies.



For instance, it is quite common for even well-established companies to have periods where profits are low or nonexistent. Such times produce high P/E ratios because the E or earnings are low. Yet these lean times are often followed by prosperous periods for the same companies. Not only will these different methodologies produce different numbers for the P/E ratio, they can be interpreted in vastly different ways.

A recent example of this was highlighted in a presentation by noted economist and professor Jeremy Siegel at a conference in Orlando put on by TD Ameritrade and



attended by several of the Moisand Fitzgerald Tamayo team. Siegel believes that current prices represent a market that is 20% undervalued if high inflation does not strike. If the current low inflation environment persists, he believes the market could rise 50%.

Siegel contrasted this with the assertion of his friend, Dr. Robert Shiller, who believes the market is 30% overvalued. Shiller is the primary advocate of CAPE ratios. The result is we have two well-regarded experts looking at the exact same price level for the market yet coming to radically different conclusions about the market's prospects.

This isn't particularly surprising to us as most of the time markets are not clearly undervalued or clearly overvalued and differing opinions abound. Other valuation methods, such as price-to-book and so-called "fundamental" measures like price-to-sales or price-to-revenue, typically produce similar discord among prognosticators. At all times, as we are fond of pointing out, you can't be a buyer unless you find a seller and you can't be a seller unless you find a buyer. Difference of opinion is normal and this is a significant reason why trying to time markets is folly. What about the times when markets are "clearly" over or undervalued?

Even points of valuation extremes are not particularly useful as timing mechanisms. When markets are cheap they can stay cheap a long time or continue to get even cheaper. Likewise when markets are expensive, they can continue to rise substantially or stay expensive for a long time. By most measures, stocks had become expensive on a historical basis in early 1996. If one took that as a sell signal, they would have missed out on the four most profitable consecutive years in the history of the US markets.

Since the crisis of 2008, many people have pointed to the historically high prices of US government securities and recommended abandoning these holdings. In fact, Bill Gross, arguably the most famous bond fund manager in the world, sold out of treasuries entirely last year for fear of rising interest rates. Rates did not rise and Gross' funds dramatically lagged, damaging his reputation as a savvy exploiter of interest-rate changes.

Rather than taking an all or nothing position as a speculator might do, we believe a better way to handle the mixed messages valuation measures can send is to reject behaving like a speculator and embrace acting as a true investor. When stock or bond markets are up, they often demonstrate high valuations. We will not abandon broadly diversified holdings but we will consider reducing exposure to these more expensive segments of the market. Currently, we are lightening up on most US government bonds. In essence, we are taking some profits after we have been rewarded for taking on the risk.

When stock or bond markets fall, they often demonstrate low valuations. In these cases, we do not sell everything else in order to load up on what appears to be cheap asset classes but we will consider increasing our exposure to these more attractively valued segments of the market. In essence, we are committing some additional capital after the risks have shown their ugliness and before the next rise in prices.

Valuation can be important over the long term but relying on any valuation measure as a short term timing mechanism is unreliable. By investing, not speculating, we essentially eliminate unnecessary risks while increasing our clients' chances of long term profitability and success.

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