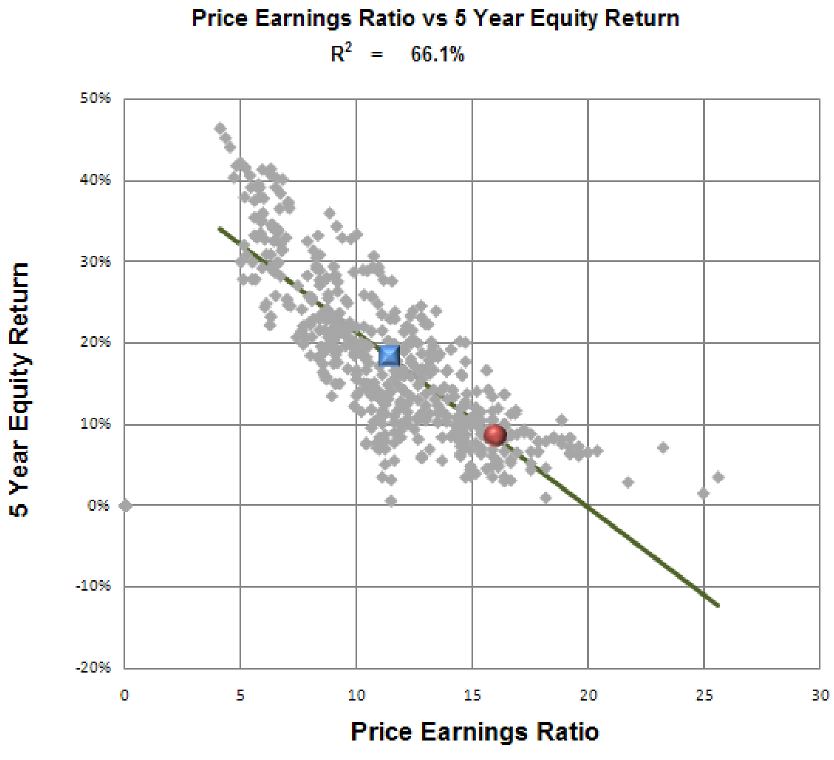
THE MARKET IS EXPENSIVE - WHAT NOW?

MIRACLE WATERS: By any reasonable measure, the stock market is starting to become expensive and we may be getting into dangerous territory for new investors. This poses some issues for someone with new cash to invest in the JSE – what should you do with your money now?

HOW TO TELL WHEN THE MARKET IS OVERPRICED

The clearest measure of the market's value is the PE ratio. If the overall stock market is on a high PE, you need to be wary about making new equity investments. A PE ratio sounds complicated but it is actually quite easy to understand and is best explained by looking at an individual company. You start by dividing the company's current price per share by the profit (after tax) per share. If a company is trading at R10 and earns R2 per share in profit, the PE is 5. This means that you will need five years of current profits to pay for the current price of the share. The PE for the whole market would be the total market capitalization of the JSE (Price) divided by the total profit earned by the companies (Earnings) on the JSE.



Source: Nedgroup Investments

The graph above was compiled by the rocket scientists at Nedgroup Investments and is really instructive. It shows what happened in every subsequent five year period on the JSE from the time the market reached a particular PE as indicated by the grey dots. As an example, when the market was at a PE of 25 (bottom right) the subsequent return was 1% per year for the next five years. The lowest PE was 4 and the highest was 26. The current PE of the market is shown by the red dot while the long term average PE is indicated by the blue square. We can expect the returns of the market to be approximately

19% per year for the 5 years after it has reached a PE of 11. At the current PE of 17 (red dot), we can expect approximately 9% per year for the next 5 years – this is a very poor return from shares. In summary, the market is expensive now but it can become more expensive. PE's of 17 – 20 are not unusual however the odds are increasingly against good returns over the next five years.

This is a graph showing historical market returns, which means it is a good indicator of possible future outcomes but it is certainly not a predicting tool. I tend to use this graph to give me a broader picture of the market and where it could go in future but I certainly don't rely on it to make money decisions.

WHAT SHOULD YOU DO WITH NEW MONEY

There are three scenarios that could play out from here: the market runs further, the market drops or the market becomes cheaper without dropping. The last scenario is the best outcome but least likely. In order for this to happen, the market needs to remain at current price levels but the companies need to generate increased profits from these levels. Considering how our economy is doing (okay but not great) it is unlikely that we are going to see fantastic profit growth in the next few years.

As Anil Jugmohan from Nedgroup Investments says, "The current PE of the market is pretty high at 17.01 and it's looking quite expensive. But as you know, there's very little stopping an expensive market from still going up – all you need is the high earnings expectations to come through (despite how unlikely it might seem) – and then you're stuck in the cycle of trying to predict whether earnings are going up or down."

Given his views, you could be tempted to keep your money in cash and wait for the next drop. For me, the loss of potential dividends (which should be re-invested) makes it a non-starter to keep 100% of my money in cash. This means you have two options from here – invest all your money now or phase in your money over time. My preferred option is to phase money into the market over the next 12 months. History has shown that this is not always the best route, you would normally get better returns by remaining fully invested even with a big drop. Unfortunately it is very difficult to watch your money fall in value during a market crash, most investors tend to panic and sell out in order to cut their losses. This is the worst case scenario because you have guaranteed that you cannot participate in the next recovery.

If you decide to take the plunge now, I would suggest that you select your equity investments very carefully. Try to choose companies that have not recovered along with the market i.e. those that are still undervalued. These include companies that are listed overseas or those that earn most of their revenue in hard currency. Alternatively, you can invest in an index ETF provided you are comfortable to ride out the market drops when they come. Perhaps the best value on our market are the foreign ETF's listed on the JSE, these include the DBX World & DBX USA investments.

WHAT IF YOU ARE ALREADY INVESTED?

If you are already in the market, you should be prepared to ride out market movements. This is especially true if you are in ETF's which are not as volatile as individual shares. Once you have already invested in the market, you must take the rough with the smooth – over long periods of time, shares have always beaten cash.