Market Update

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PA. Guaranteed Savings Plan—A Click of Your Mouse Can Yield Higher Account Balances.

Starting points matter and are critical in estimating forward investment returns. Below we discuss valuation levels and forward looking return expectations based on P/E ratios at various points in history. But first, we thought we would share some very interesting information on Pennsylvania's 529 Guaranteed Savings Plan (GSP) , where savers get to look in the rear view mirror and have their cake and eat it too.

The Pennsylvania Guaranteed Savings Plan(GSP) is a 529 college savings plan that ties the growth of your investment to tuition increases at one of Pennsylvania's State System Of Higher Education Schools, Community Colleges, and State-Related Universities. Your funds are placed in a State run investment account, and regardless of how those investments perform, your 529 savings plan account growth is tied to the tuition increase rate of the selected institution from one of the above mentioned categories. With equity markets at fair to rich valuations signaling lower expected returns, the option to index your return to tuition increases is fairly attractive—somewhat like a defined benefit pension plan where the company, in this case the State, assumes all of the investment risk. However, participants in this plan need take a closer look, as many savers are likely not aware of the ability to make a change in their choice of institution, which can result in an immediate and significant increase in account balances.

For example, over a period of about 15 years, our client accumulated an account balance of $60,800 in the GSP based on the growth rate of tuition at Penn State University-our client's choice for the tuition rate indexing. Ready to begin writing tuition checks out of the account, but curious to see what would happen by applying another qualified institution's tuition growth rate to his funds, with the click of his mouse our client's account balance increased from $61,800 to $91,000! By selecting a school with a higher historical tuition inflation rate, GSP participants can increase their account balances by a significant amount. Hard to believe, but yes it is true and available. It is tuition payment time, and we would recommend that anyone saving with the GSP take a closer look at the various indexing options and make changes accordingly. We can help with any question you might have.

Rational Exuberance, August Angst and Starting Points

Now on to the markets, where we unfortunately do not have the luxury of looking back and picking the best performing asset class. As we discussed in recent letters, the markets have been overly calm and complacent, with the VIX volatility index holding at all-time lows. We overlay that observation with our belief that investors still remain worried and have not entered the euphoric stage that precedes most bear markets. U.S. stocks continue to benefit from strong earnings, with S&P 500 earnings advancing by 9.1% in the second quarter. Analysts are now projecting earnings growth of 5.6% and 11.4% for the third and fourth quarter respectively. On top of that, a record number of companies in the index are actually beating sales estimates as well, with 70% of companies beating revenue estimates in the second quarter. The fundamental underpinnings of the market—strong earnings and low inflation—remain in place.

It appears that the market has already assimilated much of the earnings forecast into today's market prices, leaving us with that higher "starting point". Note the chart below, where we show the beginning price to earnings ratio (P/E) for various starting points beginning with 1929 and breaking out into ten year periods. The P/E shown here is based on trailing earnings. As you can see, if you invested a dollar at the beginning of any period with a higher P/E, the subsequent 10 year returns were significantly lower than if you had started in the year with the lower P/E. Simple and intuitive, yet we still see many planners and investors estimating double digit returns from these higher starting points.

	Starting P/E	Subsequent Ten Year Avg. Annual Return
1/1/2007	17.36	6.90%
1/1/1997	19.53	8.40%
1/1/1989	11.82	19.20%
1/1/1979	7.88	15.30%
1/1/1969	17.65	3.20%
1/1/1959	18.79	10.00%
1/1/1949	6.62	20.10%
1/1/1939	18.94	7.30%
1/1/1929	17.76	-0.90%

Source: P/E data supplied by Dimensional Fund Advisors LP

The current P/E for the S&P 500 Index based on trailing earnings is 24.7. To put this in perspective, since 1990 there have been seven years where P/E levels have equaled or exceeded 24.7. Of note is that between 1929 and 1990, there was not one year where the trailing P/E ratio was above 20. Context is important, and post 1990 the markets experienced rapidly falling inflation and interest rates—both yeast to the mix of a steady expansion in price to earnings ratios.

This new plateau appears to capture much of any continued rosy outlook for earnings, interest rates, and perhaps a fair chance of corporate tax reform. That investors remain anxious is a good thing, reinforcing a wall of worry that holds us back from crossing over into the euphoric stage. Aging bull markets are sometimes likened to the game of musical chairs, where the players might want to dance closer to a chair as the party ends. Yet we do not believe we are at the end of the economic cycle. Global growth continues to expand and there remain other markets and other indices outside of the S&P 500 Index with lower starting points for investors. On a forward looking basis the S&P 500 Index is trading at about 17X future earnings, reflecting fairly strong earnings growth, low inflation, and low interest rates.

Geopolitics and a possible overshoot by the Federal Reserve appear to be the main threat to global markets and the lull in volatility. An aggressive response by North Korea to sanctions could threaten global growth and cause a correction in the markets. Likewise, a Federal Reserve bent on raising rates in the face of low inflation and weak wage growth could trigger a market response and overdue correction.

We prefer to remain patient and follow a value approach to our portfolios. With S&P 500 Index returns being driven by a few large cap tech companies, there remain a number of stocks that have not participated in this run-up and are trading at attractive valuations. While it may not yet be time for investors to dance closer to their chairs, we do believe it important to maintain discipline in rebalancing portfolios and reallocating funds to asset classes with better valuation characteristics.

As always, we are available to meet and review your investment and life plans. Please feel free to call us to set up an appointment.

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