



LOUIS RUKEYSER'S MUTUAL FUNDS

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Markets Look Absolutely Expensive? Think Relatively

By Phil DeMuth

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Today's markets remind me of many politicians: bloated and overvalued. Whether we turn to stocks, bonds, real estate or commodities, valuations are inflated compared to long-term historical averages. What is an investor to do when everything is expensive, and therefore likely to offer subpar returns going forward?

That is the \$64 question at the start of 2005. Even cash is a guaranteed losing investment after taxes and inflation. There's no Free Parking anywhere, and yet we have to put our money somewhere.

In *Yes, You Can Time the Market*, Ben Stein and I argued that it was vital to value the market before plunging in with your hard-earned dollars. The theory we attempted to debunk was simple: the stock market went up 10.6% a year over the long run, so it really didn't matter when you bought. If true, the whole concept of "price" would

have no meaning when it came to the stock market. Ben and I thought this was impossible. How could price be crucially relevant in every other marketplace in the world, but somehow be irrelevant as far as the highly efficient stock market was concerned?

Well, we went through a century of data and discovered that price was extremely relevant to the S&P 500: people who bought when the market was low did vastly better than those who bought when it was expensive. It didn't make any difference for short-swing trading, but it sure did for long-term investors. While we looked at a number of different measures, including dividend yields, price/earnings ratios, the so-called Fed Model (earnings versus bond yields), it turned out that the humble price of the market, even taken all by itself, proved to have considerable predictive validity.

Yes, You Can Time the Market was a book about the S&P 500, but its implications can be extended to all asset classes. Price always matters.

When it comes to stocks, the lower the price, the higher the expected return. It's that simple. But just because it's that simple doesn't mean it's that easy. Jack Nicholas' golf swing is simple, too—but just try to do it yourself.

How can we apply this insight? Just because diversification is the investor's best

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friend, it does not follow that we should divide our assets exactly evenly among various types of investments. In situations like today, when all major markets are overvalued, the sensible thing to do is pit one market against the others, or one part of the market against another. We can do this by comparing relative valuations, and buying more of what's cheap and less of what's expensive. Asset allocation in the present becomes market timing in practice. Even if everything is overvalued, some market segments are more overvalued than others.

Take the U.S. stock market as a whole, but dissected into four parts. This is captured beautifully by four indexes constructed by the Frank Russell Company: the Russell 1000 Growth Index of the largest 1000 growth stocks; the Russell 1000 Value Index, which does the same for value stocks; the Russell 2000 Growth Index, which captures the returns of small-capitalization growth stocks; and finally, the Russell 2000 Value Index, which tracks small-cap value stocks. Put them all together, and you have the Russell 3000: virtually the entire U.S. stock market.

Under ordinary circumstances (which is to say, never), a diversified investor might spread his bets equally across the four corners of the U.S. stock market, as shown in "Equal Distribution."

This way, he's got the bases covered. But now, let's apply the lessons of *Yes, You Can Time the Market*. We

EQUAL DISTRIBUTION

Equal-Weighted US Market

	Value	Growth
Large	25%	25%
Small	25%	25%

know that small-cap stocks and value stocks have been on a tear lately. Their prices are way up. Meanwhile, the large-cap growth stocks of the S&P 500 were pummeled when the Internet/telecom bubble burst, and many haven't really recovered.

If we compare where each of the four Russell indexes is today with what has been its average level since 1995, we discover that three of the four are selling for more than usual. "Higher Levels," shows by how much (as of 12/31/04):

HIGHER LEVELS

Market Over/Under the Average

	Value	Growth
Large	34%	-1%
Small	74%	19%

Small-cap value stocks are priced 74% above where they have been, on average, since 1995. (In other words, the level of the Russell 2000 Value Index is 74% above its average level since 1995.) But large-cap growth stocks (such as those in the S&P 500) are actually priced 1% less than their average price since 1995. If the way to make money in the markets is to buy what's cheapest, maybe the smart course is to look at large-cap growth stocks right now. If you are an individual stockpicker, this is the pool where I would saw a hole in the ice

and drop a line. "Big Growers," below, shows the Russell 1000 Growth Index's top 10 holdings—you may have heard of some of them. If you don't care for these, there are 990 others vying for your attention.

BIG GROWERS

Russell 1000 Growth Top 10 Holdings

Pfizer	Cisco Systems
Microsoft	Procter & Gamble
Johnson & Johnson	Intl Business Machines
Intel	Dell
WalMart Stores	American Int'l Group

If, like me, you prefer buying whole indexes, I would allocate my holdings as shown in "Index ETFs," below. Fortunately, iShares has an exchange-traded fund that tracks each of these quadrants. Each ETF's ticker symbol is shown in the relevant quadrant in the table.

INDEX ETFs

Valuation-Weighted US Market

	Value	Growth
iShare	IWD	IWF
Large	24%	37%
iShare	IWN	IWO
Small	9%	30%

By allocating your dollars according to these percentages, you distribute them inversely to the degree of over- or under-valuation of each segment. Even if the market gets clobbered this year (and don't say it couldn't happen), you will still be better off buying more of what's cheaper than too much of what's overpriced. If you can't buy low, then at least buy as low as possible. ▲

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