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Investment Matters

For the quarter ended June 30, 2016

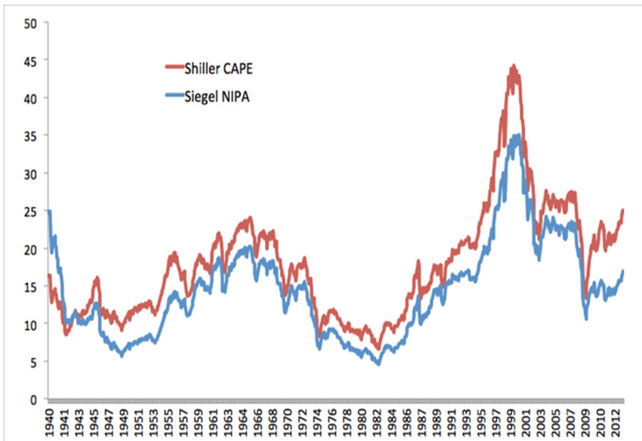
Valuation: Schiller or Siegel?

Like most brilliant ideas, Robert Schiller's proposal to value the stock market based on the past 10 years of inflation adjusted earnings, rather than just the most recent year, has probably inspired quite a few, "why didn't I think of that" comments. In 2013 Schiller would share the Nobel Prize for his work which included his new valuation model. The model quickly gained broad financial industry acceptance and is used today by most large advisory firms.

In 2000, Schiller, an economics professor at Yale published the book, "Irrational Exuberance", in which he used his new valuation method to argue that stock prices were dangerously high. His timing could hardly have been better. Over the next two years the price of the S&P 500 Index went down nearly 50%. His fame was secured.

More recently, Dr. Schiller has again argued that the stock market is overvalued. This time he has encountered some serious opposition in the form of Dr. Jeremy Siegel, a Finance professor at the University of Pennsylvania. Dr. Siegel argues that stocks are not seriously overvalued, but are priced much closer to long term historical averages.

Professor Siegel notes that, over time, the definition of earnings used in the Schiller calculations has not been consistent. Changes in accounting practices since 1990 have depressed current earnings during economic downturns to a much greater degree than earlier times. Because the Schiller calculation uses publically reported earnings over the past 10 years, a time which includes substantial losses reported during the Great Recession, it makes stocks appear to be overvalued today when compared with historical standards.



VALUATION BASED ON REPORTED PROFITS (SCHILLER—RED LINE) IS MUCH HIGHER THAN VALUATION BASED ON PROFITS REPORTED TO THE IRS (SIEGEL—BLUE LINE)

Fortunately, there is another source of earnings numbers which rely on a consistent accounting formula. These numbers are the profit figures which each company reports to the IRS. Businesses have every incentive to report these figures accurately: if they under-report earnings they may be charged with tax evasion; if they exaggerate their profits, the result will be an inflated tax bill.

Using Schillers valuation model, but substituting earnings reported to the IRS, Siegel has re-calculated the valuation history of the S&P 500 Index. While Schiller's calculations showed that the S&P 500 was 40% above the historical average, Siegel's new calculation showed that the market was only 19% above average. This is important to watch but considerably less alarming than the Schiller conclusion.

For a complementary review of your investment portfolio please call our office at (716) 633-6555 to schedule an appointment at your convenience

Consumer or Producer

Are you a consumer or a producer? Of course 100% of us are consumers and all of us who have jobs are producers. As a consumer we have a clear economic interest in paying lower prices. If prices are lower, we will receive more value for our money. But as a producer we each have an interest in receiving a high prices for the goods or services which we produce. This paradox: that we prefer a high price for our production and a low price for the production of others is at the heart of many economic debates.

As a consumer we receive unquestionable benefits from seeking the best quality goods at the lowest prices. All of us value our freedom to buy from whomever we choose, usually the provider which offers us the best value for our money.

As a producer, it is clearly in our best interests to receive the highest price for our labor. One way to do this is compete more effectively in offering the best value to all consumers. This is difficult at best and may be impossible due to circumstances entirely beyond our control such as high labor costs or high prices of raw materials. So, another option is to lobby for new laws which restrict the ability of our competitors to effectively compete against us.

These protective laws take many forms. All involve political means to restrict the freedom of willing buyers and sellers. Tariffs which directly add to the free market price of foreign goods are the most obvious example. Other laws which

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impose unnecessary costs on non-favored producers are less obvious but more common. Protectionism even includes policies which depress the relative value of our currency in an attempt to make our goods appear cheap to foreign buyers.

But when you benefit from restricting your competitors, thus allowing you to charge higher prices, all of your customers suffer. They receive less value for their money spent on your production. They also have a little less money to spend on the production of everyone else. Other producers sell less of what they make because you are charging more than a free market price.

Every effort to control, reduce or restrict the freedom of consumers to buy the best value available in the worldwide market not only hurts consumers but also hurts all other producers. In a broad sense economic freedom always produces the greatest prosperity for the greatest number of people. While trade and competitive restrictions may benefit the few special interests who can manipulate the levers of political power, it makes no economic sense for society

Not Widely Known

In 1990 there were 456,000 newspaper jobs in the U.S. Today there are 184,000, a decline of 60% in just 26 years.

The Federal Reserve was founded in 1913. A quick glance at a chart of long term government bond interest rates since 1790 shows that rates were much more volatile after 1913 than when there was no central bank in the U.S.

In 1967 only 8.1% of U.S. households had annual incomes in excess of what would be $100,000 in today's dollars. In 2014, 24.7% of all U.S. households exceeded that level.

Half of all U.S. natural gas comes from wells which use fracking technology. By 2040 fracking is expected to produce 70% of our natural gas.

ATM machines appear to threaten the jobs of bank tellers but since 2000 teller jobs have been growing faster than the labor force as a whole. The paradox is explained by the fact that ATM machines reduced overall costs which allowed banks to create more but smaller branch offices to better reach their customers.

The Congressional Budget Office reports that since 1979, adjusted for inflation, taxes and government welfare type payments, the incomes of the middle 60% of U.S. wage earners has risen 41%.

A recent survey of 700 wealthy individuals by U.S. Trust revealed that only 10% inherited their money. The rest used the time-honored methods of work, save and invest.

In the 20 years from 1996 until 2015 the stock market returned about 8.2% per year. Despite this, the average return of actual investors in equity mutual funds during this period was only 4.7%. The difference is largely explained by poor buy and sell decisions. Over 20 years investors who attempted to time the market received about half of the available total return.

The five cars sold in the U.S. with the most American made parts are all Toyotas or Hondas.

While it's true that the U.S. has a trade deficit for manufactured goods, it has a growing trade surplus for services. From 2003 until this year the trade surplus for services rose from $60 billion to $260 billion.

Since 1978, the price of educational books has risen nearly four times as fast as the Consumer Price Index.

Typically, ridesharing services Uber and Lyft are 36% to 48% cheaper to use than taxis. They are even taking market share from the car rental companies.

The percentage of 18-34 year old men living with their parents has risen to 32.1%, more than the percentage married to or living with a woman (31.6%).

According to the Federal Reserve, the total net worth of all U.S. households reached $88.1 trillion in the first quarter of 2016. This is 10.8% above the pre-recession peak of $79.5 trillion in 2007.

The number of U.S breweries recently reached 4,600. About two new breweries are opened every day.

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The Bottom Line: 6/30/2016

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	2099	4.0%
Small company stocks *(S&P Small Cap Index)*	694	-2.5%
Short term interest rates *(3 Month T-Bill Yield)*	0.3%	From 0.1%
Long term interest rates *(10 Year T-Bond Yield)*	1.5%	From 2.4%
Inflation *(Consumer Price Index)*	239.9	1.1%
Energy *(West Texas Intermediate Crude Oil)*	$49.54/bbl.	-16.2%
The economy *(Inflation adjusted GDP)*	$18.4 trillion	1.7%

QUOTABLE

"What protectionism teaches us, is to do to ourselves in time of peace what our enemies seek to do to us in time of war."

Henry George, Economist

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