On The Mark

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You, Sir, Are No Warren Buffett… But That's OK

Key Takeaways

- Berkshire Hathaway, the company famously led by Warren Buffett, made headlines for raising its **cash levels to all-time highs**.
- This prompted some investors to **wonder if markets are over-valued**. Stock market valuations are only one factor in evaluating future performance.
- **Timing markets is very difficult**. We suggest investors maintain a stock market allocation consistent with their strategic asset allocations.

Price Versus Value

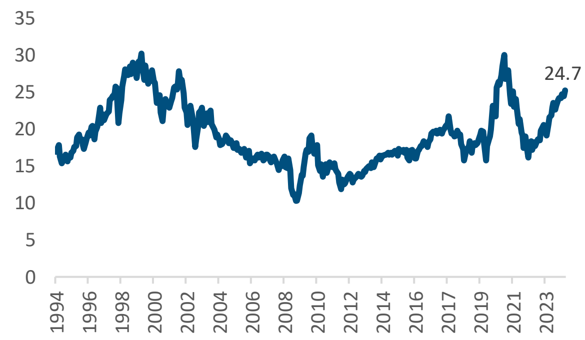
Berkshire Hathaway, the company famously managed by Warren Buffett, made headlines in November for raising its cash levels to all-time highs. This has prompted investors to wonder if the stock market is overvalued.

One common way to assess the valuation of a stock is to measure a company's stock price relative to its earnings over a given period of time. This measure, in which you divide a company's stock price by its earnings, is referred to as a company's price-to-earnings ratio or P/E ratio.

If a company (or the market) has a P/E ratio that is high relative to its history or other companies, you could think of it as being "expensive" or "over-valued," Conversely, if its P/E ratio is lower, you could think of it as "cheap" or "under-valued."

On that basis, the S&P 500 is quite expensive relative to its history. Its current P/E ratio of 24.7 ranks in the top quartile (top 25%) of the index's history over the last 30 years.

Price-to-Earnings Ratio of the S&P 500



One of Many Considerations

There is some evidence to suggest that stock market valuation is related to future stock market performance. Importantly, valuation is only modestly related to future performance and only over very long time horizons.

For example, if you look at periods when the stock market is relatively cheap (low P/E ratios) and compare them to periods when it is relatively expensive (high P/E ratios), you will find some surprising results.

Market Valuations and Market Returns

Market Valuation	Percent of Time Positive[1]	Average Return
Under-Valued[2]	71%	9%
Fairly-Valued[3]	83%	14%
Over-Valued[4]	71%	9%

In periods when the stock market is "under-valued"[2], the market is positive about 71% of the time, with an average one-year return of 9%. In periods when the stock market is "over-valued"[4], the market is also positive about 71% of the time, also with an average return of 9%.

This is because valuation is only one of many factors that drive the direction of the stock market. In our view, the direction of company earnings and the direction of interest rates are more important drivers of short- to intermediate- term stock market performance.

In the 16 calendar years (since 1955) when the S&P 500 experienced a negative return, 15 of those years occurred when either company earnings declined or the Fed raised interest rates.

Consistent with today's strong economy, we expect company earnings to increase next year (the analyst consensus estimate for 2025 earnings growth is +13%). Additionally, we expect the Fed to continue its rate-cutting cycle into next year, albeit at a slower pace than this year (the consensus estimates a 1% lower Fed Funds Rate in 2025).

What Investors Should Do

Timing the market is very difficult. The future is hard to predict, and concepts like value, which make sense in other parts of our lives, do not always translate to successful investing. The good news is that you don't need to be Warren Buffett to generate wealth. Staying disciplined in a long-term investment plan is the best path to successful wealth creation.

[1] Percent of calendar-year returns for the S&P 500 which are positive since 1955.
[2] Periods when the S&P 500 has a P/E ratio in the lowest quartile of its history.
[3] Periods when the S&P 500 has a P/E ratio in the second and third quartiles of its history.
[4] Periods when the S&P 500 has a P/E ratio in the highest quartile of its history.

AssetMark, Inc.

1655 Grant Street
10th Floor
Concord, CA 94520-2445
800-664-5345

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