NEW MINERVA REPORT

# Valuation Metrics

\We believe that we are standing on the cusp of a new investment era. In a few years' time, many will look back at the last couple of years and ask themselves, why they had not spotted what was happening. Looking back through history, you will notice that there are investment eras. There are often shorter term cycles that deflect investors' vision, and which can make investors believe that everything has changed. The new era will not be so good for investors. We have already seen markets fall on this cusp. From the highs at the end of 1999, most major markets have dropped by over 20%, which to many is enough to be called a bear market.

The problem that the markets have is that their accepted "norm", has become just the history of the last 20 years. There are some of us who can remember before that time. It is widely accepted by long term cyclical analysts, that the summer of 1982 represented the beginning of the bull market. Whilst we have obviously had set backs over that period, not least the crash of 1987, the markets have gone ever upwards. The FTSE didn't exist at the beginning of that period, but the FT30 Share Index was at 550 then, and hit a high of 4198.4 on 19th July 1999. It currently stands at 3000.

What has occurred in the past 20 odd years is that markets have slowly, but surely, adjusted to a non-inflationary era. The 1970s saw a level of inflation unprecedented in the UK economy. When there is high inflation, investors are not willing to pay so much for the earnings of companies, because these are of poor quality, as they are being eroded by inflation. As inflation falls, then investors are willing to pay more for those earnings as the quality gets better. This is bourne out by the value measure used by investors, the price earnings ratio. This is the ratio between the earnings per share, and the share price. The higher the ratio, the higher the price is relative to the earnings. In 1974 the p/e ratio fell to a low of 4.13. In 1999 the p/e ratio reached 25.41. The p/e ratio currently stands at 19.3. Now a lot of commentators, and younger investment managers, are saying that with p/es under 20, the market is cheap. But they are ignoring history, and they are expecting companies to continue to grow their profits at a healthy rate. Over the next decade, we expect p/es to revert back to their more traditional median of 15. Whilst this implies a correction in the market of another 22%, we expect it to take a lot longer to revert to this norm, and it will be helped by the earnings growth over that period.

Another measure of value, the yield, has also moved to an extreme. Until five years ago, there was a simple rule of thumb, that if the equity market yielded less than 3.5% at the turn of the year, the market would fall in the following year. The current yield on the FT30 share index is 3%. It stands to reason that if markets go sideways, investors will want some reward for holding shares. Investors will require Income.

### Rule Of Twenty

There are a couple of points to bring over from page one. Firstly, before the upsurge in p/es at the end of the 1990s, there was an old rule for working out where a p/e should be. This was the Rule of Twenty. The p/e, plus the rate of inflation, should equal twenty. The current inflation rate in the UK is 2.1, which implies a p/e of 17.9.This suggests the market must fall by just over 7% to get back to the old rule.

Secondly, putting yield into an historical perspective: in the last century, only the last decade had an average yield of less than 3.5%. This was caused by the last four years in the decade, when the yield was sub 3.2%.All other decades had an average yield in excess of 4%. If markets chose to correct this overnight, that would signify a drop in share prices of 25%. So, whatever you do, do not believe that this market is cheap. It is not! Unless something goes substantially wrong, this will correct itself over a number of years.



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