

Office for Financial Success – Financial Tip of the Week
A service of the Personal Financial Planning Department
College of Human Environmental Sciences
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Curbing our enthusiasm

I recently read an article by Jason Zweig, in the *Wall Street Journal's* weekend edition. It is my hope that the following is a meaningful echo of his work.

As of last weekend, the Dow Jones Industrial Average had increased 46% since its low point in March. This is the seventh largest and fastest rebound in the history of the Dow. Certainly, this is cause for ebullient optimism and ceremonial toasts. And, yes, it has been quite a ride. On the flip side, remind yourself that three of the past five days have seen the DJIA close below where it opened each day, shedding 3% of its value during that time. Moreover, the DJIA has to increase another 43%, from Wednesday's close, to be at the same level it was twenty months ago, at the end of 2007. Risk – you have to learn to love it.

The price-earnings ratio is a very common measure of the value of the stock market. It, simply, indicates how much an investor has to pay (the “price”) per dollar of a firm's earnings. If you think of buying stocks like you do buying socks, I will bet that you'd rather pay less per pair of socks than more. The same is true for stocks; you'd rather pay less per dollar of firm earnings than more. Currently, the average price-earnings ratio of the Dow is over 18. In March, however, it stood at under 12 (hence, a better value), while the long-term average is slightly more than 16. So, are stocks currently overpriced?

Well, I'll retreat into the answer of an economist, “That depends”. It depends on the future earnings of firms. For example, given the current price-earnings ratio of 18, if the earnings of all the firms in the Dow were to double by this time next year (not likely) and the price of stocks remained the same (I guarantee that this will not happen if earnings double), today's price-earnings ratio would fall from 18 to 9. If, however, stocks did increase in price and they settled at the long-run average price-earnings ratio of 16, their price would have to increase, on average, by 77% from current levels. On the other hand, if earnings stay constant and the price-earnings ratio reverts to its long-term average, stock prices will have to fall by 11%. Of course, if earnings decline, stock prices will fall by more and, perhaps, much more as investor pessimism takes another turn at the helm of the world's financial markets. Clearly, it depends on what the future holds and, the last time I checked, tea leaves make a better drink than they make a forecasting tool. (The same holds true for most analysts, assuming they can make a good drink.)

Consider the success of Warren Buffett, protégé of Benjamin Graham, author of *The Intelligent Investor*. Mr. Graham taught Mr. Buffett (and us) that investors should expect change, in both directions, in the value of their portfolio and to not be overly concerned with movements in either direction. That is, investors need to remain calm at the helm of their portfolio – just like when they are at the helm of a ship. When the seas are calm and the wind is behind us, the exhilaration feels like nothing can stop us. Our greed drives us to race ahead of all others – right into the squall. Similarly, when the seas become choppy and we find ourselves in a gale, we seek immediate shelter – often running aground as our rudder strikes an unknown shoal. So, what is the answer?

The answer is simple and the answer is discipline. One of the best ways to remain disciplined is through dollar-cost averaging – the act of investing a fixed dollar amount each week, month, or year into a low-cost, diversified portfolio. This allows you to buy more when prices are low (on sale) and less when prices are high (overpriced). When coupled with periodically rebalancing across market sectors, allowing you to sell a sector when prices are high and buy when prices are low, you won't get rich quick, but you will achieve financial success.

Postscript: Many of you sent me a reply email last week to express condolences on the death of my father. Your expressions were beautiful and it deeply touched me to have others, some of whom are absolute strangers, communicate their sympathy. Thank you! - Rob

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