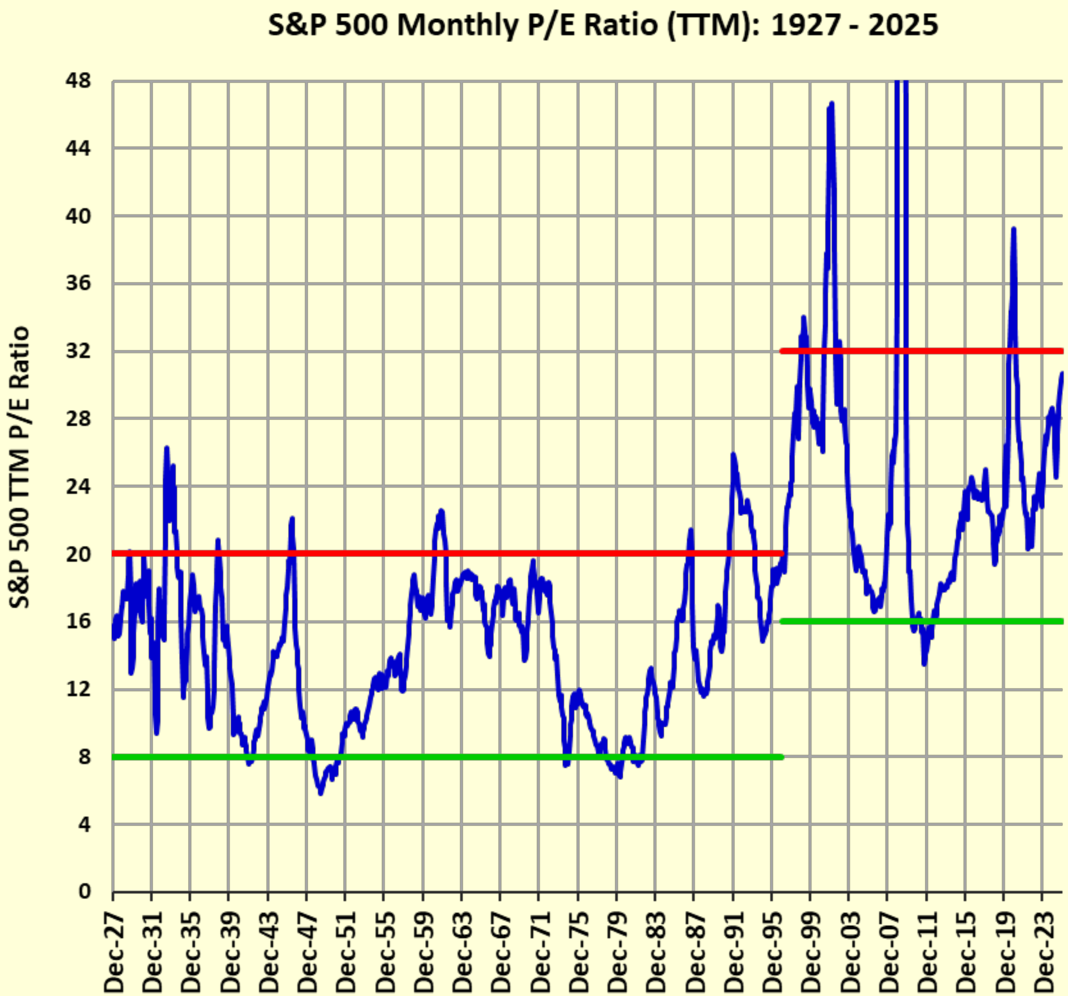
MARKET MICROSCOPE – The Two Eras Of Stock Market Valuation: Before & After The Tech Bubble



For 70 years, the S&P 500's P/E ratio generally stayed in a range of 8X to 20X. However, since the rise of the Tech Bubble in 1997, the index's P/E multiple has rarely fallen below 16X and often has traded well above 20X.

While we cannot definitively state why the market today routinely trades at a higher multiple than in the past, we can identify several likely contributing factors:

- The rise of the Internet brought with it many new Technology companies that had higher growth rates and in turn commanded higher earnings multiples.
- The S&P 500 has become increasingly concentrated in the Tech & Communications sectors – those two sectors combined now represent 45% of the total index, which exceeds even the Tech Bubble peak (40.5%).
- The weight of the top 10 stocks in the S&P 500 has risen to 40% today, so a smaller number of very large, higher-growth stocks can skew the total index's P/E ratio upward.
- Interest rates have been low for much of the past 30 years, and money market funds offered little or no return for long periods of time. This may have prodded investors to keep piling assets into the stock market as seemingly the only viable option to earn a return on investment.
- A form of cognitive bias known as "anchoring" - research has shown that humans tend to overemphasize (become "anchored" to) the first piece of information they receive, even when they have no logical reason to do so. Many of today's investors have spent their entire careers in the "Internet Era." This may have "shifted the goalposts" of what is mentally considered to be an "acceptable" valuation multiple.
- The 1990s saw 401k plans take over as the predominant retirement savings vehicle for most people. Millions of people automatically depositing a portion of each paycheck directly into stock mutual funds creates a constant source of demand for equities that did not exist in the past.

Monthly S&P 500 Valuation Source: www.multpl.com