The CJ Investment Newsletter

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The Relevance of the P/E Ratio

Purpose

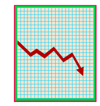
The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

The CJ Growth Strategy (back page) has been an ongoing aggressive growth model portfolio since 1/98. Its results continue to be tracked herein.

Quick Look

Market	**Next Expected Move**
	

- From the Wall Street Journal – P/E ratios are less relevant now? Really? Unbelievable.
- Gold – higher prices recently make me wonder about getting in. Current thoughts.

What Say, *WSJ*?

In the 8/30/2010 *Wall Street Journal*, page C1, the "lead" article, "The Decline of the P/E Ratio" by Ben Levisohn discusses the decline of the P/E ratio – "…in Size and in Relevance." In the first part of the article, he relays, quoting some noted experts, that market uncertainty tends to depress P/E. Later in the article, he puts forward a case that the P/E ratio is becoming "less important" to traders and other market players.

Let's discuss P/E. P/E is the Price/Earnings ratio – the price of the stock divided by annual earnings expressed as a factor. It is considered a "fundamental" analysis measure, meaning a measure of relative value over time and/or compared to other securities. Often, this factor is compared to the company's growth rate, expressed in %. "Parity" (at least in the late 1990's) would be when the P/E ratio and the % growth

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rate were equal. For example, a security with a 20 P/E and a 20% growth rate would be considered in parity, or "fairly valued." The same security with a 25 P/E would be "overvalued." Not surprisingly, such terms as "fairly," "over" and "under" valued are more subjective than most "experts" would like you to believe. "Fairly valued" changes with the times somewhat, as well as with each security and analyst.

Levisohn, the author, goes off the rails when he writes, "Not only is the P/E ratio dropping, it also is in danger of losing some of its prominence as a market gauge." He goes on to write, "…P/E ratios often shrink in size and significance during periods of uncertainty as investors focus on broader economic themes."

What? It's bad enough this man has obviously never read (and/or understood) some of the great works of market theory and analysis, but for the *WSJ* to publish this article? Charles Dow and William Peter Hamilton must be turning over in their graves.

Charles Dow was an original founder and publisher of the *Wall Street Journal*. He created the Dow Jones Industrial Average, the Dow Jones Railroad Average (now the Dow Jones Transport Average) and founded Dow Theory. Dow Theory uses the movements of both the Industrials and the Rails (Transports) to track the activity of bull and bear markets, with a particular eye on when the markets would change from one type to another.

My quick look through Hamilton's The Stock Market Barometer and Robert Rhea's The Dow Theory did not produce a reference to the P/E ratio. Still, both were written before the Securities Act of 1933 and the Securities Exchange Act of 1934. Perhaps information before those two acts was so unreliable that if the P/E ratio existed, it was used only sparingly.

However, I've read Richard Russell for years. He clearly relates the P/E ratio and dividend yields to major turning points in the markets, and it sure seems to me that he attributes that idea to Charles Dow himself, as Dow incorporated the concept of value into the cyclic nature of his theory. Russell is likely the greatest Dow Theorist of all time, although you'd never get him to say so. According to Russell, one of the major signs that a bear market could be ending is when the P/E on the DJI is below 10 and the dividend yield on the DJI is above 6%.

The historical average DJI P/E is about 15. Most market students will tell you that when the P/E on the DJI or any broad index approaches 23, the return on those investments for the next 10 years is historically poor – and sometimes negative.

John Mauldin, himself a brilliant market analyst and a man capable of reading, understanding, retaining and applying more information than anyone I ever remember reading is much more direct about the importance of the P/E. From Mauldin's Bull's Eye Investing, 2004, John Wiley & Sons, "I suggest that we view a secular bear market a little differently, as the period in which the price-earnings (P/E) ratio goes from very high to quite low. It is in these periods of low valuation that we can once again begin to confidently put our money back into stocks, as the rubber band is getting ready to snap back." (p.4)

Getting to the crux of the matter, Mauldin later writes on p.63: "*In all cases, throughout the years, the level of returns correlates very highly to the trend in the market's P/E ratio…*Higher returns are associated with periods during which the P/E ratio increased and lower or negative returns resulted from periods during which the P/E ratio declined. (His italics)

"This may be the single most important investment insight you will get from this book."

Cutting to the chase, the evidence is pretty convincing that bull and bear markets are both *defined*, for all intents and purposes, by the expansion or contraction of the P/E ratio, respectively.

I think Levisohn misses the forest for the trees. He writes as if the P/E ratio just *happens* to be low in down markets like the one we're in now. No. Many believe bull markets are *defined* by the willingness of investors to pay more for earnings than in previous days, weeks, months – the *expansion* of the P/E ratio. Conversely, many believe bear markets are defined by the *contraction* of the P/E ratio. It seems it has much less to do with the movement in earnings than in the investors' willingness to pay for them.

Levisohn also discusses market traders in attempting to make his case for the declining relevance of the P/E ratio: "But thanks to the recent shift toward rapid-fire stock trading, the P/E ratio may be losing its relevance." Really? Short-term traders have *never* (or certainly only rarely) used the P/E ratio, which is a longer-term indicator of relative valuation. The time frames are not really compatible. "Traders" are interested in *short*-term trends and market moves. P/E ratios don't address that. So, while his statement

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: **BEAR**
Appropriate Current Allocation: **DEFENSIVE**

Asset Class	**Conservative**	**Aggressive**
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. I expect such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains if the dollar declines against foreign currencies due to Fed monetary policies.

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that traders rarely use the P/E ratio is true, it's *always* been true. Therefore, his statement is not only wrong; it's meaningless. "Recent shift?" Really? Gawd.

I'm ashamed of you, *WSJ*. How could you publish something like this? Sounds like a reporter with limited financial background writing about things he doesn't understand.

Gold

The recent moves in gold need to be addressed, especially for my client readers. The recent upward move in gold the metal since the 7/27/2010 closing low of $1160/oz is troubling, especially since I thought the decline from 1260.60 on 6/18/2010 would continue. A review of the fundamental environment and the technical charts is in order whenever the actual price moves don't bear out as expected – or any time a logical outcome doesn't happen.

Two fundamentals generally propel gold (representing all precious metals here) to higher prices:

- Inflation
- A crisis of confidence in a fiat currency.

Neither of these should propel gold to higher prices now because:

- The money multipliers and money velocity are quite low due to the current recession.
- Any currency crises in the US$ has been aborted by the unwillingness of people/citizens to borrow and expand the higher-level money supplies.
- I believe the current government doesn't have the patience or understanding to do what it takes to end this recession quickly.

Therefore, no inflation or monetary crisis. The US$, the Fed and the government have been saved by the people. Ironic. If you'd like further explanation, please call me.

This is consistent with the Austrian theory that, in a recession all things become cheaper except cash (currency). Therefore, there is no fundamental force that should drive gold higher, unless I'm missing something important.

From a technical point of view, my indicators agree, suggesting that gold is in a catch-22 situation:

- Should it reach a new high quickly, would create a 3rd bearish divergence with its underlying MACD (of my own time-sequenced length). I don't think I've ever seen three consecutive bearish divergences before. My fear is that gold's price would subsequently drop like a stone.
- Should gold not reach a new high, it would create a huge head-and-shoulders top formation, leading me to believe it would continue to drop to a new, much lower (than the 7/27 $1160) low. If it does, there is no support until $1050.

I'm reminded of the bumblebee in this situation. Engineers analyzed the power of the bumblebee's stroke, the lift of its wings, its weight and a host of other things I don't understand and concluded that the bumblebee couldn't fly. Of course, the bumblebee had not read their results and continued to fly anyway.

Still, my beliefs have helped us outperform the indices on page 4 for 9+ years. I won't desert them without sufficient evidence. The preponderance of evidence in which I believe says that I need to trust what I think is true, be patient and stay out of gold and gold equities for the time being. I anticipate that gold will decline and we can "catch" the long-term gold bull market later at a cheaper price.